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For any information on any of the subjects covered by this letter, do not hesitate to contact us:

Gilles Kolifrath, Partner
T: +33 (0)1 44 09 46 44, M: +33 (0)6 75 18 84 12
E: gkolifrath@kramerlevin.com
Kramer Levin – 47 avenue Hoche, 75008 Paris
www.kramerlevin.com

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Capital markets

Negative interest and CSA

The thorny problem of the application of negative interest has just been brought to the fore again by a decision of the English High Court of July 25, 2018 in a case between the Netherlands and Deutsche Bank on the application of negative interest in an ISDA Credit Support Annex (CSA).

The problem of the applicability of negative interest has been widely debated in Europe since its existence in the Euro zone. In particular, it was partially taken into account by the ISDA 2014 negative interest protocol. However, the protocol does not cover all types of CSA and only a limited number of counterparties (having adhered to it).

In its highly motivated decision, which sets out the key mechanisms for the interpretation of English contract law application to the ISDA Master Agreement and its appendices, the English High Court specified the scope of application of negative interest within the framework of a CSA contract not subject to the negative interest protocol: there is no obligation to pay negative interest in view of the CSA contract which had been submitted to it. The reasons are as follows:

The High Court considered whether the constituent was obliged, in the absence of express provisions and stipulations to that effect, to pay interest for the beneficiary of the guarantee (in cash) in cases where the rate stipulated in the CSA was negative. The High Court, for the reasons outlined below, concluded that the constituent was not subject to such an obligation.

In this case, Deutsche Bank and the Netherlands had concluded a CSA requiring Deutsche Bank to provide cash as collateral in the Netherlands to hedge risk exposure on certain derivatives (classic case). The contractual interest rate stipulated in the CSA was then negative, but the negative interest protocol (generally in effect for most transactions post-2014) was not applicable because the CSA had been concluded previously and the parties did not want to submit, after the signing of the CSA protocol, to its stipulations.

In its application, the Netherlands argued:

- first, that accrued but unpaid interest (including negative interest) should be included in the calculation of the Credit Support Balance (and consequently in the Return Amount and Delivery Amount); and

- secondly, that the purpose of the CSA was to protect them from Deutsche Bank's default and that negative interest was intended to apply to allow an "equivalent" commercial treatment. In support of this, the Netherlands also relied on ISDA's 2013 Best Practice Guideline on the use of the CSA (which [also] contains a principle that the parties should consult each other and decide how to deal with negative interest rates).

In contrast, Deutsche Bank argued that:

- the reference to negative interest should be express; and
- The ISDA CSA User's Guide, in paragraph 5 (c) of the CSA provides that the Assignee must pay interest on any cash collateral at the agreed rate (which may be nil).

The High Court retained the following arguments:

- referring to the Firth Rixson case law regarding the interpretation of the ISDA Master Agreement, it stated that the interpretation of CSAs must follow the usual contractual principles of: studying the impacts on the commercial relationship by meeting the objectives of clarity, certainty and predictability;
- the Netherlands had not demonstrated that there was an obligation of Deutsche Bank to pay the negative interest - the use of paragraph 5 (c) (ii) provided only (unless otherwise specified) for the transfer of interest by the beneficiary to the constituent; however, it did not require the constituent to pay interest to the beneficiary (and therefore the concept of negative interest could not be deduced from it);
- concerning the argument of the Netherlands, which included the calculation of negative interest in the Credit Support Balance, this reasoning resulted in a distinction of regime between positive interest (included in the direct payment) and negative interest (included in the Return and/or Delivery Amount by the mechanism of the Credit Support Balance). Deprived of any real economic foundation, this argument could not succeed; and finally
- for the equivalence of commercial terms argument, the High Court noted that the plaintiff would not necessarily suffer losses by holding cash in a context of negative interest rates and that it was open to the plaintiff to invest this cash in other products to derive the expected benefits.

The decision is not surprising and takes into account the uncertainties that have existed for several years already in the markets as to how negative interest should be treated in the absence of express contractual stipulations and where the ISDA protocol does not apply. The principle that follows from this decision could be applied to any form of financial contracts providing for the payment of interest. Ultimately, the decision of the London High Court was based on the clear drafting of the CSA in comparison with other types of contracts on which

several French Courts of Appeal have already ruled in favour of the application of negative interest (in loan agreements in particular) in the absence of specific contractual stipulations.

Consequently, and even if we can still question the concept of negative interest (interest representing the price of passing time), it seems to us that it is therefore necessary to analyse on a case-by-case basis the (possible!) application of negative interest clauses and to do so according to the degree of sophistication of their drafting.

Enough to unleash the passion of the most skilled writers and their readers ...

Interest rate swaps

On June 20, 2018 the commercial division of the Court of Cassation had the opportunity to rule on investment advice and to specify that although the banker is bound in his sole capacity as investment services provider by an obligation to advise, he must nevertheless, when advising a client, whether at his request or spontaneously, do so with relevance, caution and loyalty, inquiring about his knowledge, his experience in investment as well as his financial situation and objectives, to ensure that the financial instrument is suitable.

The present case concerned a client, finance lessee, who wanted to change his exposure to variable interest rates (Euribor). The bank then proposed to its client as a financial solution:

- a variable rate swap for a fixed rate; or
- a tunnel (the tunnel allowing to cap and floor the amount of interest due according to its variation).

The client, on the advice of his bank, chose the interest rate swap and waived the variable interest (upwards or downwards against a fixed rate). Following a decline in rates which the client could therefore no longer enjoy, the client sued his bank for damages, considering that it had breached its duty to advise.

The Court of Appeal acknowledged that the bank had breached its duty to inform. Following an appeal in cassation by the bank, the Court of Cassation clarified to what extent the elements in this case were likely to justify the alleged breach, i.e.:

- the bank had refrained from offering its client a cap, a usual financial instrument in this area and much less expensive for the client, in favour of a swap, which ensured a maximum remuneration for the bank;
- the cap was adapted to the client's situation, responded to his request and was in line with the forecast for declining rates which the bank was aware of since February 8, 2008;

- the bank proposed the swap for a notional amount of 1,400,000 Euros, although 250,000 Euros were to be the subject of a zero interest financing by the local authorities, meaning that the subscription of a swap was useless for this portion; and finally
- the bank offered a swap rate for a period of five years, although the financial lease provided for the possibility of transforming the variable rate into a fixed rate as of January 1, 2010, meaning that the subscription of the swap was useless for nearly two thirds of its duration.

The Court of Cassation recalled that:

"*The information provided by the investment services banker must be objective, sufficient and understandable in order to enable his client to understand the nature of the investment service and the specific type of financial instrument offered, as well as the related risks, and make an informed decision*".

This decision is in line with the strict reinforcement of investor information requirements as required by the MiFID II Directive at European level.

However, the decision was quashed on the grounds of Article 1147 of the Civil Code (on the calculation of the quantum of compensation) in its wording prior to the order of February 10, 2016. The Court of Cassation specifies, indeed, that although the damage resulting from non-compliance with the bank's obligation to inform is a loss of opportunity of a favourable rate, its quantum cannot be deduced only from the difference between the amount of the sums paid under the unfavourable instrument (swap) and the favourable instrument (the possible cap). Indeed, the Court of Cassation criticised the Court of Appeal for not having considered whether the client could have decided not to subscribe to a hedging contract or to favour another instrument than the selected cap. In doing so the Court of Appeal had not measured the injury resulting from the lost chance of avoiding the damage that had occurred but had compensated it in its entirety.

It is therefore up to the judges on the merits to quantify, at their discretion, the "opportunity", more financially the probability, of the investor's choice to estimate the quantum of the compensation. This principle is not new but it will be particularly difficult to implement in financial matters because of the complexity of the financial solutions proposed and the motivations inherent to each investor.

ISDA consultation of all market participants on alternative benchmarks for derivatives contracts

At the request of the Stability Council's *Official Sector Steering Group* since 2016, ISDA has been taking action to implement robust substitute benchmark indices for derivative contracts that refer to certain IBORs. After consultation with stakeholders, the regulators and

the *Official Sector Steering Group* decided that the substitute rates will be "RFR" (risk-free rates) for the IBORs concerned. These substitute indices will be included in the ISDA definitions for interest rate derivatives and will apply to new IBOR transactions. ISDA will also publish a protocol allowing participants to optionally include these substitute indices in existing IBOR contracts.

ISDA presents in this regard, in its consultation of July 12, 2018 addressed to all market players, possible options for adjusting the RFRs to ensure that existing derivative contracts, referring to an IBOR, continue to operate identically after an index substitution. These changes reflect the plurality of IBOR maturities - for example, one, three, six and twelve months - while the RFRs are overnight rates. IBORs also include a (banking) credit risk premium and various other factors (such as liquidity and fluctuations in supply and demand), unlike RFRs.

The consultation proposes four options to take into account the transition from a forward rate to an overnight rate:

- an overnight rate;
- an overnight rate adjusted to convexity;
- a compound interest rate with payment at the end of the period; and
- a compound interest rate with payment at the beginning of the period.

Three options are also proposed to calculate an adjustment of differences:

- a forecasting approach;
- a historical average / median approach; and
- an instantaneous approach.

In each case, the adjustment of the difference is carried out at the time of substitution of the reference index.

The consultation lasts three months. Responses to the consultation will determine the approach chosen, and ISDA will then work with an independent third-party supplier to create a system that will publicly disseminate these adjustments. ISDA will publish the final approach for review and comment prior to any changes to its standard documentation.

ESMA Consultation Paper on EMIR clearing obligations

On July 11, 2018, ESMA issued a consultation paper on EMIR clearing requirements.

This consultation paper concerns an RTS project relating to the treatment of intra-group transactions with an entity of a group of third countries.

On the date of publication of this consultation paper, there are three delegated regulations relating to the clearing obligation (two relating to interest rate derivatives and one relating to credit derivatives). These delegated regulations contain a deferred date of application of the clearing obligation for intra-group transactions that meet certain conditions, such as:

- where one of the counterparties is in a third country; and
- in the absence of the corresponding equivalence decision.

In the run-up to the deferred entry into force of the obligations for intra-group transactions and in the absence of equivalence decisions, this document proposes to extend the deferred application date to December 21, 2020 (instead of December 21, 2018).

ESMA updates EMIR validation rules

On August 9, 2018, ESMA updated its rules of validation of RTS on the declaration of Article 9 of the EMIR Regulation. The changes introduced will apply from November 5, 2018 and concern the following areas:

- time stamping;
- identification of the counterparty;
- identification of the Other Counterparty;
- identification of the underlyings; and
- means of confirmation.

ESMA statement on pension fund clearing obligations

On August 8, ESMA issued clarifications on the clearing obligation and the obligation to negotiate for pension plans. In its statement, ESMA recognises the challenges that some pension plans will face as of August 17, 2018, the expiry date of the current exemption. ESMA encourages the competent authorities not to prioritise the oversight of these entities which should be re-exempted and to apply this monitoring in a proportionate manner.

Insurance

EIOPA publishes the first series of Q&A on the Insurance Distribution Directive

On July 11, 2018, EIOPA released the first questions and answers regarding product oversight and governance requirements.

Among the 10 questions / answers, some of the topics covered include:

- the granularity of markets;
- the identification of the target market in the case where the insurance product is mandatory;
- the evidence proving that the supplier takes into account the level of information available to the consumer;
- product and governance oversight requirements for group contracts;
- the time between inspections of insurance products; and
- creating a practical exam for testing insurance products.

EIOPA will continue to publish answers to other questions. To do this, stakeholders are requested to submit them via the EIOPA tool available online on its site.

EIOPA publishes the Consultation Paper on resolution funds and national guarantee systems

On July 30, 2018, EIOPA published its discussion paper on resolution funds and national insurance guarantee systems in line with the EIOPA opinion on the harmonisation of the recovery and resolution of (re)insurers .

To date, in Europe, there are different sources of resolution funds for defaulting insurers. Indeed, the landscape of insurance guarantee schemes is also highly fragmented, with existing schemes differing significantly in terms of funding, functions, mandate and coverage.

In its discussion paper, EIOPA analysed the need for potential harmonisation of insurance guarantee schemes based on the following three options:

- maintain the current fragmented landscape with some Member States with guarantee schemes and others with no guarantee;
- set up a European network of national insurance guarantee schemes adequately funded and sufficiently harmonised (minimum level of harmonisation); or
- set up a single insurance guarantee scheme at EU level (maximum harmonisation).

On the basis of this analysis, EIOPA proposes a minimum of harmonisation for the European Union. This would benefit policyholders, the insurance market and, more broadly, financial stability in the European Union.

To this end, EIOPA invites stakeholders to provide comments on the characteristics of the guarantee schemes, including their scope, financing and coverage.

The European supervisory authorities issue additional guidance on KIID key information document for PRIIPs

On July 20, 2018, the ESAs issued new guidance on PRIIP's KIID requirements.

The guidelines are intended to promote common approaches and supervisory practices based on ongoing work on monitoring the implementation of KIIDs and supplement the documents issued last year. The new guidelines now include:

- new Q&A; and
- flow chart updates for risk and performance calculations (example: new calculation example for the category 3 PRIIP stress performance scenario).

The last document, very technical both financially and legally, on the methods of calculation of certain financial parameters, in particular for non-linear financial products (category 3) concerns risk management and compliance.

This latest information will refine the compliance and risk control procedures prior to the final implementation of PRIIPs.

Contacts

Gilles Kolifrath
Partner
gkolifrath@kramerlevin.com

François Poudelet
Counsel
fpoudelet@kramerlevin.com

Jérôme Blanchet
Lawyer
jblanchet@kramerlevin.com

Linda Sharkey
Admitted to the New York Bar
lsharkey@kramerlevin.com