RegCORE Client Alert

Financial Services: EU financial markets regulators publish their supervisory expectations in the context of the Ukraine conflict

March 2022

Financial Services

EU financial markets regulators publish their supervisory expectations in the context of the Ukraine conflict

Dr. Michael Huertas
Tel.: +49 160 973 757-60
michael.huertas
@pwc.com

Contact RegCORE Team
de_regcore@pwc.com

On 11 March 2022, the European Banking Authority published a supervisory statement reminding financial institutions that they ensure compliance with sanctions and other restrictive measures as well as to facilitate refugees' access to basing payment accounts following the activation of the EU's Temporary Protection Directive.[1]

On 14 March, the European Securities and Markets Authority (**ESMA**), working together with respective National Competent Authorities (**NCAs**), published its supervisory expectations and coordinated regulatory response to the conflict in Ukraine and the impact on EU financial markets.[2]

Both of the statements from EBA and ESMA are short and compact but they each raise issues as to what they have not covered. The other sister authority, the European Insurance and Occupational Pensions Authority (**EIOPA**) is monitoring the exposure of firms under its remit but has yet (certainly as at the time hereof) to publish any official statements.[3] The same applies to the European Central Bank (**ECB**), acting in its Banking Union capacity at the head of the Single Supervisory Mechanism (**SSM**) save that it has concluded that firms' exposures are perhaps more resilient than expected.[4] The ECB, in its monetary policy role, also continues to monitor the economic impact and adjust its toolkit as necessary.

In addition to the statements published at the EU level, many NCAs have published similar or wider-reaching statements. Consequently, supervised firms will want to ensure they are meeting all relevant supervisory expectations applicable to their operations across the EU-27.

1 EBA's publication is available here.
2 ESMA's publication is available here.
3 Although EIOPA#s Chairperson commented on the situation on 25 March 2022 in an interview available here.
4 See ECB-SSM presentation available here.

pwc

Key takeaways from the EBA and ESMA as well as ECB-SSM statements

The statements from the EU-level authorities focus on the following elements as set out below. Firms will want to act accordingly.

	Authority	Supervisory expectations	Points for firms to consider and action
1	EBA	**Robust risk controls** – Firms must ensure proper implementation of compliance with sanctions and other restrictive measures this includes firms: a. having adequate internal controls and governance including to monitor and raise awareness of fraud and financial crime typologies that aim to circumvent sanctions and other restrictive measures b. carefully considering the prudential and business impact of the short and longer risks they are exposed to in light of the conflict and/or other geopolitical developments. This includes the broader impact of economic and political sanctions, increased economic uncertainty and vulnerabilities c. reviewing the adequacy and resilience against cyber risks and appropriateness of business continuity plans	• EBA is collecting and filtering sanctions related queries and channelling them to the European Commission who will answer them[5] • EBA will closely monitor and assess the situation and inform decisions and actions needed to mitigate short- and medium-term risks affecting financial markets • The EBA does not clarify that the impacts of heightened cyber risks could not only be directed at financial services firms but on third party and real economy services providers – from telecoms to energy suppliers – upon which financial services firms and financial markets infrastructure providers rely[6]
2	EBA	**Access to Basic Payment Accounts** – NCAs must ensure that persons fleeing Ukraine as a consequence of the war should have access (provided by firms) to open and use payment accounts with basic services under the EU Payment Accounts Directive	• Both the EBA and a number of NCAs are aware that some firms are somewhat lukewarm and/or obstructive at offering basic payment accounts in the manner required by law • The EBA clarifies that financial institutions should apply a risk-based approach when providing financial products to refugees and apply standards set out inter alia in the EBA's Guidelines on Money Laundering and Terrorist Financing Risk Factors[7] and the EBA Opinion on the Customer Due Diligence on Asylum Seekers[8]
3	ESMA	**Central Counterparties (CCPs)** – ESMA is closely monitoring CCP related volatility and margin developments in energy and commodities market segments. It is also in close contact with NCAs focusing on the impact on clearing members and their clients in those markets	• Active trading counterparties will want to continue to monitor their own margin requirements and those of their counterparties and risks that may arise with exacerbated margin requirements affecting trading exposures –

5 See for example here as well as here
6 See commentary on this published (1st Quarter 2022) by Michael Huertas in the Journal of International Banking & Financial Law (Butterworths) as well as the Journal of International Banking Law & Regulation (Sweet & Maxwell).
7 Available here.
8 Available here.

			including those that are not CCP cleared
4	ESMA	**Credit Rating Agencies (CRAs)** – ESMA continues to actively engage with CRAs to ensure sufficient transparency around ratings and is monitoring the impact of sanctions on CRAs' operations in close cooperation with other regulators	• Market participants (investors inasmuch as issuers) will want to monitor risks of widespread ratings downgrades on existing issuances (notably fixed income issuances and fallen angel risks) but also adverse effects on pricing and ease of future issuances coming to market
5	ESMA	**Benchmarks** – ESMA is engaging with its supervised benchmarks administrators to verify the impact of market developments and sanctions on the provided benchmarks. It is also engaging and coordinating with NCAs regarding the impact on benchmarks provided by the administrators under NCAs' supervisory remit	• Market participants as well as end-users of (regulated) benchmarks will want to carefully consider how any suspensions, delisting or other alterations to constituent components of a benchmark may alter the benchmark, what governance and disclosure arrangements apply in such circumstances and whether any operative fallbacks are sufficiently resilient in the absence of market pricing sources or alternative proxies
6		**Investment Management** – ESMA has reinforced its coordination role by monitoring investment funds, organising frequent exchanges with NCAs to analyse market developments and supervisory risks linked to the crisis, focusing on liquidity issues and the use of liquidity management tools (**LMTs**) and monitoring issues relating to valuation of assets and potential suspension of redemptions	• Market participants (both asset managers and investors or those acting on their behalf) will want to assess the availability of when and how LMTs can be activated. The use of LMTs is not regulated in a harmonised manner by EU legislative and/or regulatory rulemaking instruments (aside from limited circumstances) and instead what is or what is not permitted is typically set out contractually and reflective of supervisory expectations set by NCAs. This specifically applies to: o Gating or other (including deferred) suspension of redemptions of funds or in specie i.e., payment in kind redemptions by investors o Use of side pockets (and synthetic side pockets) for illiquid assets and how such assets are identified, valued and treated both prior to and post any (permitted/consented) move into a side pocket o Use of swing-pricing and other anti-dilution techniques that help funds manage liquidity risk internally by passing on transaction costs to the

			shareholders associated with the redemption[9] o Managed divestments including through targeted co-investments and block sales The above will also have to consider these issues in the context of EU and non-EU domiciled funds and managers as well as the differences that exist in the regulation of funds under AIFMD and the UCITS Directives inasmuch as this also applies to the relevant assets under management, i.e., differences between say real estate funds and corporate debt funds
7	ESMA	**Secondary markets** – ESMA and NCAs are monitoring the market situation, and ESMA is assisting NCAs with the consistent implementation of sanctions by market operators including the suspension of trading in instruments by venues	• This statement by ESMA follows conceptually what has already been stated by EBA in point 1 above. The key difference is that ESMA hints at but (regrettably) fails to detail how to deal with different types of trading suspensions. Further regulatory statements may (welcomingly) follow on this area
8	ESMA	**Central Securities Depositories (CSDs)** – ESMA is monitoring, in coordination with NCAs, the impact of sanctions on CSDs' operations and assisting with their implementation in a consistent manner. It is also consolidating data on the levels of settlement fails as one of the indicators to monitor market developments	• Active market participants should consider monitoring different scenarios that could lead to exacerbated amounts of settlement fails and what this means for both that party's counterpart but also for its own obligations vis-à-vis its own counterparties
9	ESMA	**Cyber Security** – ESMA is facilitating the collection and sharing of information and experiences among NCAs regarding cyber incidents	• These points follow conceptually what EBA has already hinted at even ESMA's statements are rather high-level
10	ESMA	**Risk assessment** – ESMA continuously monitors the risks to market participants and financial stability and exchanges its risk assessment regularly with policy makers and authorities at national, EU and international level	
11	ESMA	**Sanctions Compliance** – financial market participants should ensure they comply with the relevant EU sanctions and monitor for any further restrictions. The European Commission will provide clarity and answer queries on the scope and implementation of these and ESMA is supporting the EC in collecting such queries	

[9] When used, the fund manager adjusts the net asset value upward/downward to reflect net subscriptions/redemptions. The aim of using such an approach is to afford investors better protection from costs triggered by short term investors and therefore achieve more equitable and fair treatment of all investors. Fund managers are able to maintain the expected performance of their investment strategy and improve their track record and thus indirectly sustain revenues.

12	ESMA	**Market disclosure** – issuers should disclose as soon as possible any inside information concerning the impacts of the crisis on their fundamentals, prospects, and financial situation in line with their transparency obligations under the Market Abuse Regulation, unless the conditions for a delayed disclosure are met	• Notably, market participants should consider that the crisis and the responses (globally) by respective governments may alter the nature of information that is material to an issuer's assets, operations and prospects and thus change as and when relevant disclosures are required
13	ESMA	**Financial Reporting** – issuers should provide transparency, to the extent possible on both a qualitative and quantitative basis, on the actual and foreseeable direct and indirect impacts of the crisis on their business activities, exposures to the affected markets, supply chains, financial situation and economic performance in their 2021 year-end financial report(s) if these have not yet been finalised and in the annual shareholders' meeting or otherwise in their interim financial reporting disclosures	
14	ECB - SSM	**Markets repricing** – the ECB-SSM has noted that since the escalation of the Ukraine conflicts, markets have been pricing in uncertainty of sanctions, firms' exposure and macro implications, in particular concerning firms: a. Direct exposures to Russian counterparts, including: 1. Towards sanctioned entities 2. Cross-border loans 3. Euro area-owned subsidiaries in Russia b. Direct Russian links in euro area: Russian subsidiaries c. Indirect exposures and financial markets volatility (commodities) d. Russian-sovereign default scenario e. Operational risk: notably cyberattacks, IT connections to Russia/Ukraine f. Macro impact: notably revised GDP growth and price inflation	• Market participants should consider, in addition to assessing (financial) risk exposures set out by the ECB-SSM, the operation and interoperation of contractual clauses and what this means for obligations and options for termination as well as suspension of activity (including in the event of further trading venue suspensions) or operational activity and risks that also affect the real economy
15		**Distributions and dividends – The ECB-SSM assesses banks' distributions on an individual basis and expects:** a. Distributions anchored to sound capital planning under credible baseline and severe institution-specific adverse scenarios b. Banks to define sound internal capital targets, including minimum thresholds (management buffers) above supervisory requirements and buffers, and evidence that their distribution plans remain compatible with those targets in the context of their capital planning exercise. c. Banks to refrain from expressing distribution policies in terms of absolute	• Banking Union Supervised Institutions (especially Banks) that are considering their options to pay out distributions and/or dividends to shareholders following the expiry of temporary restrictions put in place during the COVID-19 pandemic should engage in early planning and supervisory dialogue to ensure that any activity is permitted and explainable

		amounts,[10] and anyway clarify that distributions are subject to the fulfilment of strategic plans, both in terms of profit generation and capital trajectories d. Banks to liaise in supervisory dialogue before publicly announcing their distribution[11]s	

What the EBA, ESMA and ECB-SSM statements did not cover or as fully as they could

Whilst cyber risk (and to certain degree operational risk) is certainly on the agenda for EU regulators and policymakers, the statements are certainly less detailed as those issued by a number of authorities including those such as the UK's Financial Conduct Authority (**FCA**)[12]. The guidance issued by the FCA was last updated 24 March 2022 and directs firms to sector as well as "actionable guidance" provided by the National Cyber Security Centre (**NCSC**), which has published guidance tailored to (i) large firms (ii) small and medium sized firms and (iii) microbusinesses and sole traders. The NCSC also encourages firms to review its Cyber Essentials Scheme.

In contrast, the EU's equivalent to the NCSC, the European Network Information Security Agency (ENISA) has (certainly at the time of writing) been rather quiet in terms of a response on how to prepare for any additional cyber-risk threats. The ECB, acting in its financial markets infrastructure oversight capabilities has published its own principles on cyber-risk and supervisory expectations (largely adapted from international standards) but these have not been updated to accommodate the new threats, tactics and perpetrators that have or could arise in the context of more organised cyber-warfare if and when it comes to this. Various NCAs (including Germany's BaFin) have addressed these points to individual institutions, in particular in the Baltics, given that these three states share a common electricity grid with Russia, so the risk of cyber-attacks also extend to energy resilience considerations.

While regulatory policymakers' overarching tone on cyber-resilience may focus on preparation, EIOPA has also not yet published any statements on cyber-insurance – in particular since the past years have demonstrated that, unlike more traditional lines of insurance, cyber insurance can vary significantly in scope between different insurers and different policy forms.[13]

Where ESMA has also failed to focus its statements is how firms should deal with suspensions in activity. This includes trading suspensions, listing suspensions by the regulator and/or listing authority or at the company's request as well as de-listings, deletions from indices as well as large scale rating downgrades (fallen angel risks) including demergers. These considerations, notably with respect to disclosure obligations) apply to equity listings as well as to global depository receipts including even when trading of securities has been suspended.

Further considerations apply with respect to changes to boards with some directors being under pressure to resign.[14] Another issue that has not been considered is that the various international sanctions regimes may restrict the ability of shareholders subject to such sanctions from exercising their voting rights (or having votes

[10] In line with EBA Q&A 2019_4731 – Banks should not set their dividend policies in terms of absolute amounts.

[11] The ECB-SSM states that it is neutral on cash dividends vs. share buy-backs and by law, different tools are subject to different processes, these can be summarised as:
- Banks can distribute cash dividends after the supervisory dialogue. Possible formal restrictions apply if a bank breaches its maximum distributable amount trigger or where the supervisor has serious concerns about the bank's capital trajectory and its ability to meet supervisory requirements;
- Share buy-backs require an ex ante authorisation by the supervisor within three months: decision taken by the SSM Supervisory Board but can be delegated to Senior Managers below an impact of 100 basis points. Process is eased in the case of yearly renewal of authorisations in the same amounts;
- Distributions of excess capital, i.e. exceeding profits generated in any specific year, are admitted, as long as they are consistent with sound capital planning and capital targets, both in baseline and adverse scenarios. Banks should clearly distinguish in their disclosures the ordinary component of distributions from the extraordinary distribution of excess capital

[12] See details available here and here.

[13] Generally, cyber insurance may be categorised as insurance which provides cover for losses relating to damage to, or loss of information from, impairment of the service provided by IT systems and networks. Cyber insurance is either purchased as a standalone policy or as an extension to an existing policy (including business disruption insurance).

[14] See also the following statement from the European Confederation of Directors' Associations.

recognised) including at general meetings to approve transactions. This puts relevant companies and directors into a predicament as to how to ensure equitable treatment of shareholders despite the barriers restricting their shareholders rights.

Trading documentation considerations

Most trading documentation aims to preserve the ongoing performance of transactions. Epidemics, pandemics and military conflict are generally no exception to that aim, unless certain agreed exemptions, such as market disruptions, have been agreed and these apply to the circumstances existing at the time. However, a number of these clauses and thus details on when and how exposures may be terminated and/or suspended might not have been drafted with prolonged market disruption and/or closures, whether government-led or not, in mind. Nor have they (thankfully) had to give much thought to the impact of military conflict nor wide-scale power outages and the resulting impact on trading venues. Some but not all market participants have chosen to include drafting to cover wider events than what is set out in standard versions.[15]

The freedom of parties to transact on terms they agree to is an issue that allows such terms to be unique to their relationship, regardless of whether a trading relationship, whether documented or undocumented is based upon “market standard” practice and/or terms that exist in master agreement documentation suites, in particular those used in an OTC context. All of these considerations matter in terms of who has which rights under a contract, but also in terms of the enforcement of that contract and against any assets. It also impacts who has a right to value assets and when. Where (reliable) market values are not available, including in the absence of an auction process (whether arranged by a market operator or market dealers) counterparties may need to ensure they have policies and protocols in place on how to mark-to-market relevant exposures where there is a risk that no market may exist both for a temporary but also a prolonged period.

Moreover, in master agreement documentation, in particular those used for OTC derivatives, repos and securities lending transactions, the right of who can terminate a trading relationship, when and on what grounds including with what speed and with what consequences, is crucial to risk management. So too is the issue of who may deal with collateral assets or any forms of security interest and on what basis and for how long. This matters for both recipient of the collateral assets and/or security interest as well as the provider. Equally, these considerations apply in what is set out contractually, as influenced by each parties’ priorities. This may have knock-on effects both for unwinding of exposures pre-default but also in situations of default and/or cross-default in one relationship cascading across other exposures, transactions and collateral assets that may be linked to one another.

If geopolitical risk along with pandemics are here to stay for the foreseeable future, firms will likely need to strengthen their identification, mitigation and management of risks and the remedial action they can take (contractually as well as otherwise) in the event trading slows (engineered slowdown) more generally or becomes subject to a stoppage. Aside from a power outage incapacitating the ability to trade, or suspensions ceasing the legal possibility to trade, further changes could result from prescriptive bans on short selling or bans on trading by overseas participants (who may face threats of expropriation or nationalisation of assets in such jurisdictions) or measures enabling a domestic counterparty to walk-away from its obligations – as has already been evidenced in the recent and further past in non-EU markets.

Consequently, market participants may, to the extent they have not already done so, want to create and periodically monitor an inventory of “their” exposures to relevant counterparties, custodians and financial market infrastructure providers, segmented by the governing law of the contract and the jurisdiction of the counterparty and/or execution venue, as well as the booking centre for relevant transactions, and therefore assess:

1. types of:
    a. **relationship-specific documentation** such as (prime-) brokerage (or other general terms and conditions) as well as clearing and netting arrangements;
    b. **transaction-specific documentation** such as those that are transacted under or based on a master agreement (for example GMRA, GMSLA, ISDA, DRV and other)

[15] While much of financial markets regulation in the EU-27 (and the UK while it was part of the EU) may be shaped and harmonised by EU regulatory standards and common rulemaking principles, a large part of the contractual documentation governing the trading, settlement and custody of financial instruments is still subject to principles of national laws. The level of harmonisation differs also to the type of transaction i.e., whether on-market or OTC as well as to asset class, type of counterparty inasmuch as it also does to the area of law – some areas, such as insolvency law or netting are still very much cemented around concepts that are directed primarily by national law even if they build upon common EU-wide principles.

documentation suites, but equally may also include bilateral agreement (for example LMA) documentation, as well as any array of protocols, side letters and any other documented or undocumented arrangements that are relevant to the exposure(s);

  c. **industry association curated definition sets,** where they exist, as is the case for ISDA documentation, and any amendments undertaken in the documents in (a) and (b) above;

2. the hierarchy of documentation described in point 1, to establish where one exists, and if yes, which documents and/or specific terms take precedence over one another i.e., transaction specific documentation is typically subject to the terms of relationship specific documentation but may also include carve-outs for certain types of transactions. Firms will want to assess whether linked arrangements i.e., hedging and loan documentation terms are connected;
3. whether there are any material divergences in agreed terms to those that are considered market standard – in particular regarding grace periods and/or waivers as well as for additional termination events – including material adverse change (**MAC**) clauses;
4. whether the documentation described in point 1 has the following clauses, and whether they refer to business/market disruption caused by pandemic or crisis/conflict situations and what they mean for one's own exposure and counterparties:
   a. market suspension and/or market disruption;
   b. cross-acceleration and/or cross-default;
   c. force majeure clauses – see also below regarding doctrine of frustration; and/or
   d. non-performance clauses and punitive damages or penalty clauses (which may be held void by certain courts);
5. which positions are marked-to-market and which are marked-to-model. Where (reliable) market values and/or market makers are not available, including in the absence of an auction process (howsoever arranged) counterparties may need to ensure they have fallbacks in place as well as to deal with the risk that no market may exist, including for a prolonged period
6. how margining would work in the event of a market shutdown, does a collateral receiver have a right to refuse accepting non-cash collateral marked-to-model and not to market, and if yes, on whose model, as reference points to the model may be missing?
7. timing, thresholds and extent of margin call requirements to be provided, by whom, along with what type of collateral and whether any haircuts need to be amended;
8. the amount of collateral assets provided/ received and whether actual or potential rights of re-use and/or rehypothecation apply as well as the amounts of segregated assets (and what type of segregation). Firms should also consider how much of its own and/or its counterparty's funding is reliant on collateral assets rehypothecated from others and the possibility that such collateral assets may be withdrawn;
9. differing business day count conventions for valuation and payment dates, as well as what likely fallbacks might mean;
10. whether service of notice is required and the differing permitted methods of notification for:
    a. trading and reconciliation relevant communications;
    b. close-out notices; and/or
    c. other contractual and dispute resolution notices;

    and whether email is permitted for the above, if not (as is the default case for most ISDA documentation, unless amended), whether postal/courier services are likely to be reliable and/or whether fax or other permitted electronic notification means (incl. SWIFT) are permitted and reliable. It is likely that even where documentation hierarchy may dictate that (prime-) brokerage documentation terms supersede those of transaction-specific documentation, that parties will still need to follow the latter to ensure valid service;
11. what a party may wish to do if it can continue its own performance of obligations but its counterparty cannot. This may include taking other proactive risk management and mitigation steps (including rebooking exposures[16]); and
12. any scope of protection arising from the EU's Settlement Finality Directive, as implemented in each EU-27 jurisdiction and in the UK.

While transactions can be closed-out, the termination of the master agreement is usually only due to a breach or an inability to perform. Termination for cause, i.e., because the contract is no longer profitable, is generally not permitted unless contractually catered for. This is typically not problematic as parties can simply choose not to trade. Importantly, if a party decides to abandon performance, or otherwise deprive the other party of the whole or substantially the whole of the benefit that was the intention of the parties as expressed in the

[16] Both in terms of traded financial instruments but also collateral assets.

contract, this may amount to repudiation or anticipatory repudiation and thus may constitute a breach for which damages may be due and thereby give rise to legal in addition to market and counterparty credit risks.

Outlook and next steps

Financial services firms will want, to in addition to the specific points above review their operational resilience frameworks more generally. As financial services firms and supervisory authorities have had to rapidly pivot their priorities for preparing for beyond the pandemic to focussing on geostrategic risks, the responses and options are very different. Firms will want to review their existing prolonged pandemic preparedness plans as well as draft new plans for new risks and in doing so:

- Identify their important business services and critical economic function.
- Set impact tolerances for each important business service and critical economic function and remain within them.
- Revisit resilience of place strategies, processes and systems to enable them to comply with their obligations.
- Conduct mapping exercises including documentation hierarchy and stress test ability and effects of termination events and/or force majeure or material adverse change clauses being triggered in a wide-spread fashion.
- Assess and reduce over-dependency on third party suppliers.
- Have an agile communications strategy.
- Ensure that their boards and senior management give certain approvals and review their operational resilience documentation.
- Assess availability of cyber-risk insurance as well as business disruption insurance where relevant.

About us

PwC Legal is assisting a number of financial services firms and market participants in forward planning for changes stemming from these proposals.

If you would like to discuss any of the developments mentioned above, or how they may affect your business more generally, please contact any of our key contacts or PwC Legal's RegCORE Team via de_regcore@pwc.com or our website.

Dr. Michael Huertas
Tel.: +49 160 973 757-60
michael.huertas@pwc.com

www.pwclegal.de