



International Swaps and Derivatives Association, Inc.
One Bishops Square
London E1 6AD
United Kingdom
Telephone: 44 (20) 3088 3550
Facsimile: 44 (20) 3088 3555
email: isdaeurope@isda.org
website: www.isda.org

BY E-MAIL

Banking Reform consultation responses
Banking Reform Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

E-mail: banking.reform@hm-treasury.gov.uk

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Dear Sirs

UK consultation document on special resolution regime

The International Swaps and Derivatives Association, Inc. (ISDA)¹ is grateful for the opportunity to comment on and to respond to some of the questions raised in the consultation document “Financial stability and depositor protection: special resolution regime” (July 2008) issued by the Bank of England, HM Treasury and the Financial Services Authority (the **Consultation Document**).

ISDA defers, of course, to national experts in the United Kingdom on the appropriateness of the proposals in the Consultation Document to address issues and longer term concerns arising out of the recent market turmoil and, in particular, the difficulties faced by Northern Rock. ISDA defers, in particular, to national legal experts as to the technical details of the proposals and whether they are consistent with existing principles of English law and with the European and international obligations of the United Kingdom.

¹ ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry, a business that includes interest rate, currency, commodity, credit and equity swaps, options and forwards, as well as related products such as caps, collars, floors and swaptions. ISDA currently has more than 800 member institutions from 56 countries on six continents. More than half of the total membership is based in the European Union and neighbouring countries and a significant portion of the rest active participants in the European financial markets as dealers, service providers or end users of derivatives. Promoting legal certainty for cross-border financial transactions through law reform has been one of ISDA's core missions since it was chartered in 1985.

We are aware that, among others, the British Bankers' Association, the London Investment Banking Association and the Financial and Insolvency Law Committees of the City of London Law Society are examining the Consultation Document closely and will be responding in detail to the policy and technical aspects of the proposals. Based on our contacts with members of those groups, we believe that our comments in this letter are broadly consistent with the views of the working groups currently finalising preparing their respective responses. In this letter, however, we are of course only representing the views of our own members (although many, if not most, of the members of those other associations are also members of ISDA).

We are also aware that the Financial Markets Law Committee will be responding in relation to the aspects of the proposals that raise issues of potential legal uncertainty, which as discussed in more detail below is also our area of principal concern in relation to the proposals in the Consultation Document.

Therefore, although our own response will not address each of the questions raised in the Consultation Document, for the reasons given above, ISDA would nonetheless like to respond from an international financial market perspective to the aspects of the Consultation Document that have the potential to affect cross-border privately negotiated or "over-the-counter" (OTC) derivative transactions. We believe that our comments will also be relevant to closely related financial transactions such as securities lending and securities repurchase (repo) transactions, spot foreign exchange (FX), securities and commodity trading contracts, prime brokerage and other international financial market trading activities.

As you know, in our letter to you of 23 April 2008, we responded to your earlier consultation "Financial stability and depositor protection: strengthening the framework" (January 2008). Some of the points we raised in our 23 April 2008 letter appear to us to remain open, including in particular our concern that radical changes and broad government powers are contemplated by the proposals and yet inadequate time has been allocated to the consultative process to consider the wide-ranging impact of those changes and powers.

In this letter, however, we wish to focus principally on the aspects of the proposals that we believe will have the most important and direct effect on OTC derivative transactions (and related financial markets such as those mentioned above). Given that one of our core missions to strengthen the legal infrastructure of the international financial markets for OTC derivatives, we are particularly concerned about the potential impact of the proposals on the enforceability of early termination rights, close-out netting, set-off and financial collateral arrangements.

Aspects of the proposed regime threatening legal certainty

The aspects of the proposed regime that raise the greatest risk of legal uncertainty for early termination, close-out netting, set-off and financial collateral arrangements are:

1. the proposed restriction of the right to terminate contracts early as the result of the commencement of the special resolution regime (**SRR**);

2. the Bank of England's partial transfer powers, which, in the absence of clear and appropriate safeguards could permit the Bank of England to "cherry-pick" rights and obligations under an ISDA Master Agreement entered into by a trouble bank, therefore disrupting the net position of the solvent counterparty; and
3. the proposed powers under the special resolution regime permitting the Bank of England to amend or nullify contractual rights or obligations in order to achieve the purposes of the SRR.

Paragraphs 3.67 to 3.75 of the Consultation Document propose that set-off and close-out netting arrangements should be subject to special safeguards, and this is very welcome. Unfortunately, beyond discussing that the safeguards would use the concept of "qualified financial contract", in a manner similar to the legislation in the United State and a number of other countries, the Consultation Document does not give much further detail as to scope and terms of the relevant safeguards or how they would be implemented. These aspects, however, are key.

The potential impact of the proposals on regulatory capital

From the point of view of prudential supervision of regulated institutions (such as other UK and foreign banks, investment firms and insurance companies) dealing with UK banks, an absolutely crucial point will be whether such an institution can continue to calculate its credit exposure to a UK bank on net basis and, where that exposure is collateralised, whether the risk-reducing effect of the collateral arrangement can be taken into account for purposes of determining the capital it must allocate against its positions with that UK bank.

A supervised institution will not be able to recognise close-out netting or a related collateral arrangement unless it can satisfy its supervisor that the close-out netting or collateral arrangement is enforceable with a high degree of legal certainty, with no unduly restrictive assumptions or material qualifications. Currently, supervised institutions are able to obtain such legal opinions in relation to UK banks on the basis of standard assumptions. In fact, it is recognised that the current English legal regime for close-out netting and financial collateral arrangements is one of the most robust globally.

If that were to change, the commercial and financial implications for UK banks would be severe. Supervised institutions would be constrained in their ability to extend credit to UK banks, UK banks themselves would find their own ability to conduct business constrained by much heavier capital requirements and their access generally to liquidity would be impaired.

Core principles that should be reflected in the SRR

In order to avoid these consequences, we believe that the SRR should reflect the following principles:

- (a) The safeguards protecting netting agreements and early termination and close-out netting of transactions entered into under those agreements, as well as related financial collateral arrangements, should be contained in primary legislation, as is the case in most other

countries with netting legislation, or, at a minimum, in secondary legislation. To set out such protections in a Code of Practice would not provide the level of legal certainty necessary to permit outside counsel to opine on these issues with sufficient robustness.

- (b) The safeguards should provide that a netting agreement must be transferred as a whole or not at all to a bridge bank or private sector purchaser and that individual rights and obligations under the netting agreement should not be vulnerable to cherry-picking. This safeguard should include any cross-product netting agreement, that is, a netting agreement that nets the close-out amounts due under individual netting agreements, such as an ISDA Master Agreement, a securities lending master agreement (such as the 2000 ISLA Global Master Securities Lending Agreement) and securities repo master agreement (such as the 2000 TBMA/ISMA Global Master Repurchase Agreement). Cross-product netting agreements are an important additional risk mitigant for banks, are recognised for purposes of the Basel II regulatory capital requirements for banks and are protected by netting legislation in the US, France and a number of other jurisdictions.
- (c) Any definition of “qualified financial contract” should be broad enough and clear enough to cover all existing OTC derivatives transactions, including hybrid and exotic variations on such transactions, and flexible enough to accommodate future innovation in the financial markets without the need for further legislation. It should also be broad enough to include related types of financial transactions such as securities and commodities lending and repo transactions, spot trading in FX, securities and commodities and other similar transactions commonly traded between professionals and wholesale market end-users, including prime brokerage agreements and securities and commodities trading agreements. A counterparty dealing with a UK bank should be able to determine easily and with sufficient certainty whether any transaction it has entered into with a UK bank is (or is not) a qualified financial contract.
- (d) The right of a counterparty to terminate transactions as the result of a credit-related event affecting a counterparty should not be subject to a stay or other restriction. Once a UK bank is in trouble, a counterparty to that UK bank should be able to manage its credit and market risk in relation to its positions with the UK bank, in accordance with its view of market conditions and the state of the UK bank. It should therefore be able to move, if necessary, without restriction to insulate itself from further market risk by closing-out existing positions.

We understand that you are proposing to limit the right of a counterparty to terminate transactions early if the sole basis for such termination is the exercise of SRR powers by the Bank of England in relation to the UK bank. We believe, however, that any such limitation should, however, be limited to a netting agreement (and, if relevant, related collateral arrangement) that is transferred as a whole to a bridge bank or private sector purchaser. We do not believe that such a limitation should apply to a master agreement that is not transferred but left with the residual company. Immediate close-out should be possible in those circumstances. Furthermore, it should be clear in relation to any master agreement that is transferred to a bridge bank or private sector purchaser, subject to such a stay on early termination, that the stay does not apply in the case of any subsequent

event or condition affecting the transferee that would otherwise, under the terms of the netting agreement give rise to an early termination right (for example, a failure by the transferee to make a payment or delivery under a transaction).

Drafting appropriate safeguards

In terms of drafting the relevant safeguards discussed above, we believe that the 2006 ISDA Model Netting Act would comply with the principles we have set out above in terms of scope, clarity and flexibility. A copy of the 2006 ISDA Model Netting Act may be downloaded from our website http://www.isda.org/docproj/model_netting.html together with an Explanatory Memorandum intended for use by legislators considering implementing netting legislation (also available for download from the website).

In particular, we would refer you to the definitions of “netting agreement” and “qualified financial contract” in the 2006 ISDA Model Netting Act. We note in relation to the definition of “netting agreement” that it is broad enough to cover both industry standard netting agreements and proprietary or bespoke netting agreements. It is important that all such netting agreements should be protected. In relation to the definition of “qualified financial contract”, we note that the definition is broad enough to cover all of the various types of OTC derivative transactions currently traded in the financial markets, as well as many related forms of financial transaction including securities and commodity lending, repo and trading agreements, prime brokerage agreements, financial collateral arrangements and cross-product netting agreements. The definition includes generic wording toward the end of the definition to ensure that it is flexible enough to accommodate future financial market innovation and development.

Finally, we note that the Consultation Document does not provide any analysis of the potential impact of these proposals on foreign law governed contracts and foreign assets (that is, assets located outside the United Kingdom and/or otherwise subject to foreign law). Yet this will be an extremely important factor in practice, especially for the most systemically significant UK banks. While the doctrine of universal succession might provide an appropriate level of comfort that foreign courts would accept the effect of a transfer under the SRR of the whole of the undertaking of a troubled UK bank, we believe that considerably more analysis needs to be given to the likely international implications of the exercise of partial transfer powers under the SRR. We believe that comity alone is unlikely to be a sufficient basis for a foreign court to recognise the effect of transfers of individual rights or obligations arising under a contract governed by the law of the foreign court’s own jurisdiction or rights or obligations arising in relation to assets located in that jurisdiction. The resulting uncertainty could lead to considerable uncertainties, the risk of inconsistent judgments, conflicting claims and related expense and litigation risk.

We are grateful for the recent opportunities we have had to discuss the issues above with representatives of the Treasury, the Bank and the FSA on various occasions, and we would welcome the opportunity to continue those discussions with a view to ensuring that the SRR is sufficiently clear and robust and protective of the rights of market counterparties on the issues we have discussed in this letter and, of course, that the necessary level of legal certainty is achieved in the final text of the SRR legislation.

If there is further more detailed consultation on any of the issues addressed in the Consultation Document, as we hope there will be, we would be pleased to participate in those discussions as well. In the meantime, please do not hesitate to contact either of the undersigned if we can be of further assistance in relation to these important issues for the UK and European financial markets.

Yours faithfully

Dr Peter M Werner
Director of Policy
pwerner@isda.org

Edward Murray
Chairman
ISDA Financial Law Reform Group
ed.murray@allenovery.com