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27 February 2009

Dear Mr Levendođlu

Banking Act 2009 – Safeguards Order – scope of netting and set-off

The International Swaps and Derivatives Association (ISDA)¹ would like to raise certain concerns regarding close-out netting against UK banks, building societies and insurance companies following the coming into force of the Banking Act 2009 (the Act) on 21 February 2009.

ISDA is grateful for having had the opportunity to respond to the various UK government consultations last year that led to the introduction and eventual enactment of the Banking Bill, including your consultation document “Special Resolution Regime: safeguards for partial property transfers” (November 2008) (the **November 2008 Consultation Document**), to which we responded in our letter dated 9 January 2009 to the Banking Reform Team.

We are conscious of the enormous challenge faced by the UK government in developing, consulting on and bringing to Parliament for enactment the Act and the initial secondary

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.

legislation under the Act, and we are highly appreciative of the hard work of the relevant teams at the Treasury, the Bank of England and the Financial Services Authority and your collective willingness to listen to and engage constructively with the concerns of the financial markets, notwithstanding the enormous pressure created by the on-going financial crisis and the tight timetable for drafting and bringing the Act and the initial secondary legislation under the Act into force.

Scope of the protection of close-out netting under the Safeguards Order

It is perhaps inevitable, given the legislative timetable, that a number of issues would remain to be resolved, clarified or modified after the Act came into force. An issue of fundamental importance to our members and the financial markets more generally is the scope of close-out netting under the Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (the **Safeguards Order**).

The 1992 and 2002 versions of the ISDA Master Agreement (each an **ISDA Master Agreement**) are the most widely used master netting agreements in the global derivatives markets, and the vast majority (if not virtually all) netting arrangements with UK banks and building societies relating to derivatives are governed by an ISDA Master Agreement. Our comments, however, apply to all netting agreements, including any bespoke arrangements.

We believe that the following aspects of the Safeguards Order require **urgent** attention:

- The Safeguards Order does not cover every type of derivative transaction that is currently documented under master netting agreements, including the ISDA Master Agreements. In other words, the scope of netting protection provided by the Safeguards Order is too narrow.
- It appears that the inclusion of a single transaction under a netting agreement that is excluded from protection under the Safeguards Order causes the entire netting agreement to fall outside the protection of the Safeguards Order. In other words, “one bad apple spoils the whole barrel”.

Elaborating on each of these in turn:

- (1) By reliance on the MiFID² definition of “financial instrument”, it appears that the following types of transactions either clearly fall outside the scope of the Safeguards Order or, at any rate, there is material uncertainty about whether or not they fall outside
 - (a) spot and forward foreign exchange (FX) transactions;
 - (b) OTC bullion options that do not comply with the restrictive conditions of Commission Regulation 1287/2006/EC (the **Commission Regulation**), as required by the definition of “financial instrument” in the Safeguards Order;

² In Section C of Annex I to Directive 2004/39/EC of the European Parliament and of the Council on markets in financial instruments (MiFID).

- (c) OTC physically-settled commodity transactions that do not comply with the restrictive conditions of Commission Regulation;
- (d) certain contracts for differences (CFDs) that refer to asset or risk classes not specified in the MiFID definition of “financial instrument”, for example, longevity and mortality derivatives, which have been an important new area of growth in the derivatives markets over the past few years.

By volume, the exclusion (or, at best, uncertainty as to inclusion) of spot and forward FX transactions is the most significant of the foregoing restrictions. These are high volume and relatively “plain vanilla” transactions that represent in aggregate substantial credit risk for counterparties to UK banks and building societies active in the FX market. Currency derivatives such as currency swaps and options are within the MiFID definition of “financial instrument”, however we understand that the Treasury has expressed the view in the past that forward FX transactions are not within the MiFID definition, and we understand that the spot and forward FX market in the United Kingdom is currently regulated by the Bank of England on that basis outside the MiFID regime.

Although spot FX transactions are not derivative transactions, they are commonly included in netting arrangements, and yet they appear to be outside the scope of the MiFID definition of “financial instrument”. This is a very important class of business that is within the netting legislation of the vast majority of countries within netting legislation, including the US. In some countries, although spot FX transactions were initially excluded (or, at least, not clearly included), the local netting legislation was specifically amended to extend it to spot FX.

Regarding the transaction types referred to in (b) and (c), the uncertainty created by the application of the restrictive conditions of the Commission Regulation means that it would be difficult for a supervised institution dealing with a UK bank or building society to include transactions of those types within the scope of their close-out netting with the UK bank or building society for regulatory capital purposes.

The exclusion of transactions falling within (d) above would be a clear brake on innovation and development of the OTC market.

As a drafting matter, we believe that it would be relatively easy to expand the scope of the definition of “relevant financial instrument” to cover all transactions that are typically now included in close-out netting arrangements, and that it is necessary to do this to ensure that the risk-reducing effect of close-out netting is maximized, both for the reduction of counterparty risk and systemic risk and also to ensure efficient calculation and allocation of regulatory capital. We would be happy to discuss our ideas regarding drafting at your convenience.

- (2) The addition of the word “solely” to clause (c) of the definition of “excluded rights” in a late draft of the Safeguards Order introduces a substantial risk for counterparties to UK banks and building societies. The effect of the addition of this word appears to be to

exclude a master netting agreement from the protection of the Safeguards Order if it covers a single unprotected transaction (that is, a transaction of one of the types discussed above). This is a very serious risk given that it is considered good credit risk and regulatory capital management practice to use of master netting agreements with the broadest possible scope in order to reduce all relevant financial exposures between two parties to a single net sum to achieve the maximum possible reduction of credit risk. All of the excluded product types discussed above are routinely included within netting agreements. Any such netting agreement (unless entered into in connection with a financial collateral arrangement, as discussed below) is therefore outside the protection of a the Safeguards Order. This could be a substantial portion of the master netting agreements in the market.

While it may be considered, as a policy matter, that certain types of contracts should be excluded from the benefit of the Safeguards Order (for example, retail deposits and liabilities), a master netting agreement should be effective in relation to all protected rights and liabilities even if there is one or more unprotected transactions. One would simply calculate the net exposure by reference only to the protected transactions. There is no policy justification for having the entire protection lost because of the inclusion, inadvertent or otherwise, of an unprotected transaction.

Netting legislation in some countries has, when initially introduced, sometimes included this so-called “bad apple” risk, and in virtually every case where it has been identified (for example, under the Irish netting legislation) it has been cured by amendment of the legislation.

Financial collateral arrangements

We understand that a netting agreement entered into in connection with a financial collateral arrangement falling within the scope of the Financial Collateral Arrangements Directive³ would be protected by Article 7 of the FCAD as implemented in the United Kingdom, as confirmed indirectly by Article 4 of the Safeguards Order. While this may significantly lessen the impact of the issues relating to Article 3 (and related definitions) of the Safeguards Order that we have identified, it is clearly less than ideal that the basic regime does not provide the full scope of netting of derivatives transactions that previously applied in the United Kingdom in relation to UK banks and building societies and that applies under the netting legislation of the leading developed jurisdictions.

Application of the Act to insurance companies

We understand that the Act potentially applies to insurance companies. The reasoning, we believe, is as follows: the Act applies to any “bank”, which is defined as a “UK institution which has permission under Part 4 of the Financial Services and Markets Act 2000 to carry on the regulated activity of accepting deposits”. A “UK institution” is defined as “an institution which is incorporated in, or formed under the law of any part of, the United Kingdom”. Insurance companies normally have permission to carry on the regulated activity of accepting deposits.

³ Directive 2002/47/EC of the European Parliament and of the Council on financial collateral arrangements.

We note that the Treasury has power under sections 2(2)(c) and 91(2)(c) to exclude classes of institutions from the definition of “bank”. We imagine that the inclusion of insurance companies within the scope of the Act was not intended and that the Treasury will use its power to exclude them. It would clearly be beneficial to the market for this to be done as soon as possible to eliminate an important area of potential legal uncertainty.

England & Wales, Scotland and Northern Ireland remain good netting jurisdictions

We appreciate that England & Wales, Scotland and Northern Ireland⁴ remain “good” netting jurisdictions for regulatory capital purposes in relation to netting agreements that fall wholly within the scope of the protection of the Safeguards Order. So, to that extent, the Safeguards Order effectively achieves its purpose. The difficulties are that (1) the Safeguards Order is not broad enough to reflect the full scope of derivatives business entered into by and with UK banks and building societies and (2) the “bad apple” risk unnecessarily brings netting agreements wholly outside the Safeguards Order, significantly increasing bilateral credit risk as well as systemic risk.

Our comments in this letter are intended to be helpful and to assist you in ensuring that the protection of close-out netting arrangements with UK banks and building societies is as broad and effective as possible, for the benefit both of UK banks and building societies and their wholesale financial market counterparties. We believe that these issues need to be addressed on an urgent basis because market counterparties will be forced by the limitations of the current Safeguards Order to invest significant resources (a process that has, of course, already begun) to investigate each of their master netting agreements with UK banks and building societies, make necessary adjustments to their internal systems and processes and possibly also significantly to adjust their regulatory capital positions, with knock-on effects for UK bank and building society liquidity and cost of access to the derivatives market

We would be pleased to discuss these issues with you at the earliest opportunity. We know that other associations and other bodies will be raising these concerns with you, and we would be happy to participate jointly those discussions with you. For this purpose, please do not hesitate to contact either of the undersigned.

Yours faithfully

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⁴ There is no netting opinion commissioned by and addressed to ISDA in relation to Northern Ireland, but we understand informally that the law in Northern Ireland is favourable to close-out netting, subject to the considerations raised in this letter.