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Dear Sirs

**UK consultation document “Special Resolution Regime: safeguards for partial property transfers”**

The International Swaps and Derivatives Association (**ISDA**)<sup>1</sup> is grateful for the opportunity to respond to the consultation document “Special resolution regime: safeguards for partial property transfers” (November 2008) (the **Consultation Document**). We followed closely the consultation process launched by HM Treasury, the Bank of England and the Financial Services Authority (the **Authorities**) in January 2008 and responded to the January 2008 consultation document in our letter of 23 April 2008 and to the July 2008 consultation document on the special resolution regime in our letter of 15 September 2008. In October 2008, the Banking Bill was introduced in Parliament, and we took the opportunity to make a written submission to the Public Bill Committee of the House of Commons in our letter of 18 November 2008.<sup>2</sup> We and

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<sup>1</sup> 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.

<sup>2</sup> The letter to the Public Bill Committee and our prior consultation responses are available on the ISDA website at [http://www.isda.org/c\\_and\\_a/collateral-Financial.html](http://www.isda.org/c_and_a/collateral-Financial.html).

our members have also been involved in various discussions with other financial market trade associations, and we also had the opportunity to review the various consultation document responses made by the Financial Markets Law Committee, as well as its submission to the Public Bill Committee.

Our membership also includes various international law firms with leading City of London financial law practices. Members of these firms have been involved in discussions of the Banking Bill and the proposed subordinate legislation under clause 48 of the Banking Bill<sup>3</sup> to safeguard netting, set-off, security and title transfer collateral arrangements under the aegis of the Financial and Insolvency Law Committees of the City of London Law Society (the **CLLS**).

We endorse the proposal submitted to the Treasury by the CLLS in relation to clause 48(1) of the Banking Bill as well as the more general comments of the CLLS on the Banking Bill and proposed SRR and related safeguards. In relation to clause 48(1), we believe that it is crucial to define and use the terms “security interests”, “set-off” and “netting” and related terms correctly and with an appropriate degree of precision. Long experience has shown us that distinguishing carefully, for example, between “set-off” and the related but distinct concept of “netting” is important internationally. It is also important to distinguish carefully between security financial collateral arrangements and title transfer financial collateral arrangements, particularly in light of the risk of recharacterisation of the latter as the former, which arises in some countries<sup>4</sup>, although no longer in member states of the European Union to the extent that the Financial Collateral Directive applies. English legislation in relation to financial law has a particular influence given the importance of London as an international financial centre and the leading financial centre of Europe. This is why we stress the importance of getting clause 48(1) right from our perspective as an international financial market trade association.

Although the Consultation Document is not concerned with the text of the Banking Bill, clause 48(1) affects the scope of the draft Order set out in Annex A to the Consultation Document (the **Safeguards Order**). Article 3(6) of the Safeguards Order refers to the text of the Banking Bill for the definitions of “set-off arrangements” and “netting arrangements”. Other provisions of the Banking Bill that potentially affect the scope, content or effectiveness of the Safeguards Order are clauses 22, 38 and 75. We comment on each of these below.

Our principal concern in relation to the Consultation Document is to ensure that the Safeguards Order provides robust protection of netting, set-off, security and title transfer collateral arrangements, in line with our mission to enhance legal certainty, by seeking law reform, for derivatives trading, including arrangements to reduce counterparty and related risks through netting, set-off and collateral arrangements. Accordingly, we focus primarily on those aspects of the Consultation Document.

We would, however, like to make some brief comments on the proposed “no creditor worse off” (**NCWO**) compensation provisions of the Banking Bill, discussed in chapter 4 of the Consultation Document, and the draft “No Creditor Worse Regulations” set out in Annex B of

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<sup>3</sup> We refer to the text published by order of the House of Commons on 4 December 2008, which we understand is the latest publicly available version of the text. The numbering of clauses was different in the text of the Banking Bill as originally introduced, but our references in this letter are to the numbering in the latest text.

<sup>4</sup> Although recharacterisation risk should no longer arise in member states of the European Union to the extent that the Financial Collateral Directive has been implemented in each relevant member state and applies to the specific arrangement.

the Consultation Document. We appreciate that the NCWO provisions are viewed as a safeguard by the Government and these may provide comfort and assurance to market participants that ultimately they will be treated fairly in relation to the resolution of a UK bank, they provide no additional comfort in relation to the legal certainty of netting, set-off and collateral arrangements and instead creates much uncertainty as to what type of insolvency regime will be assumed to apply (that is, administration or liquidation) and as to how contracts will be valued. Also, we understand that the Government is contemplating excluding the benefit of the NCWO provisions in relation to claims of creditors that constitute “foreign property” under clause 39 of the Banking Bill. It seems to us that this is potentially unfair, possibly open to challenge on a European law

Similarly, the Code of Practice, while potentially of significant interest to market participants, provides no legal certainty benefit given that it is merely a Code of Practice and not binding on the tripartite authorities.

We welcome the assurance given by the Government in paragraph 2.16 of the Consultation Document that it intends to protect contracts relevant for regulatory capital purposes from the threat of disruption under a partial transfer. We note that “this consideration will outweigh any of the carve-outs listed above [in the Consultation Document]”. A contract, such as an ISDA Master Agreement, will only be relevant for regulatory capital purposes (or, more specifically, effective under the Basel II capital regime to reduce the regulatory capital charge associated with derivatives positions held under that master agreement) if certain conditions stipulated by the financial supervisors under the Basel II capital regime are satisfied.

In this context, the key requirement is that a supervised institution seeking to reduce its capital requirement by relying on close-out netting under a master agreement and/or on financial collateral taken under a financial collateral arrangement must have a legal opinion from each “relevant jurisdiction”<sup>5</sup> that confirms that close-out netting is enforceable under the master agreement (or financial collateral is enforceable under the financial collateral arrangement) in any insolvency proceeding that might be instituted in respect of the counterparty against whom the supervised institution is seeking to net. The legal opinion must confirm to a high degree of legal certainty that the relevant agreement or arrangement would be enforceable in each such proceeding and any assumptions or qualifications to the opinion must be reasonable, specific, adequately explained and not materially undermine the principal conclusions of the opinion.

Current English law provides a robust legal regime for the enforceability of close-out netting and financial collateral arrangements. It has historically been an advantage of the English regime for close-out netting, for example, that it is based on general principles and not on specific legislation. This has meant, for example, that market innovations have not troubled the legal analysis for netting, which therefore has not constrained market activity, innovation or growth. In contrast, the netting regimes for most other leading jurisdictions have depended on a specific netting statute and, particularly in the early days of such statutes (in the late 1980s and early 1990s), often included a product-specific condition (for example, the requirement that each

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<sup>5</sup> Broadly speaking, the term “relevant jurisdictions” for this purpose in relation to a netting agreement includes the jurisdiction of the law governing the master agreement and each transaction, the jurisdiction that would conduct the principal insolvency proceedings in relation to the counterparty against whom the supervised institution is seeking to net and the jurisdiction of each branch through which the counterparty would operate for purposes of the master agreement.

transaction to be netted be a “qualified financial contract” in US netting legislation). This has led to difficulties where a new product has not fit comfortably within any existing product category in the legislation.

The introduction of a partial property transfer tool as part of the UK special resolution regime (**SRR**) makes it necessary that the UK introduce a specific broad-based statutory regime for netting for the first time, in relation to UK banks.<sup>6</sup> The Safeguards Order is intended to set out that regime. In order for supervised institutions from around the world to continue to obtain regulatory capital relief due to close-out netting as against UK banks, it is essential, therefore, that the Safeguards Order be sufficiently broad and sufficiently clear in its application. Needless to say, it is also crucial that the Safeguards Order be brought into effect no later than the time that the new Banking Act comes into effect.

In order to ensure that the Safeguards Order meets the requirements of sufficient breadth and certainty support a robust legal framework for netting and financial collateral, we believe that the following issues should be addressed:

1. **Clause 48(1).** As discussed above, clause 48(1) should be clarified as proposed by the CLLS. This sets the parameters of the Safeguards Order and is therefore an important threshold issue.
2. **Effect of a breach of the Safeguards Order.** We note that the only specified consequence of a breach of the Safeguards Order is the remedy provided for in article 6 of the Safeguards Order. However, this would not be sufficient to permit a law firm to opine that netting under an ISDA Master Agreement is enforceable in all relevant circumstances as required by banking supervisors under the Basel II capital regime. A transfer order in breach of the Safeguards Order would have the effect of disrupting netting, even if subsequently such an order might be amended pursuant to article 6.

It would be preferable to provide that an transfer order is invalid to the extent that it purports to transfer a right or obligation that is protected by the Safeguards Order. This would provide the greatest degree of legal certainty for the market. If, however, this is not acceptable to the Government from a policy point of view, there should at least be an explicit statement that any right or liability covered by the Safeguards Order that is nonetheless transferred by a partial property transfer order would remain subject to any right to set off or otherwise net the right or liability against any other right or liability subject to the relevant netting or set-off agreement (such as, of course, an ISDA Master Agreement).

3. **Foreign property.** Articles 2 and 3(3) of the Safeguards Order relating to foreign property should be amended or deleted. We understand that a partial property transfer order that purports to transfer “foreign property” (including rights and liabilities under a financial contract governed by foreign law) as defined in clause 39 of the Banking Bill might not be recognised as effective under the law governing the relevant foreign property. Nonetheless, by not extending the protection of the Safeguards Order to

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<sup>6</sup> Other UK entities, in particular, non-bank corporates are, of course, unaffected by the proposed regime and will therefore continue to benefit from the current robust regime based on general principles.

foreign property, a netting agreement that encompasses both foreign and English law governed rights and liabilities will not be fully enforceable under English law. It will therefore not be possible to obtain a sufficiently robust English legal opinion in those cases, which are not uncommon. We note that similar regimes in other countries, for example, the US, do not carve out foreign law rights and liabilities from the benefit of the local netting statute.

Accordingly, we recommend that Articles 2 and 3(3) of the Safeguards Order be amended and that foreign property rights and liabilities under a netting or set-off arrangement be included in a transfer of that netting or set-arrangement to a transferee under a partial property transfer order, on the assumption that the parties will comply with their statutory obligation under clause 39(3) of the Banking Bill.

Of course, in some cases, there may be some difficulty in practice effecting the transfer of the foreign property under relevant foreign law, but we suggest that this is likely to be less commonly the case in relation to rights and liabilities under, for example, an ISDA Master Agreement than it might be in relation to foreign property in other contexts. (In other words, we acknowledge that making foreign property subject to a partial property transfer order may in other contexts create more serious problems, due to a possible lack of recognition of the transfer under foreign law.)

Our suggested approach might be bolstered by the parties including in their netting or set-off arrangement a provision that, in the event of a partial property transfer order being made, the parties agree to take whatever steps are necessary to effect the transfer of any foreign law rights or liabilities covered by the arrangement in accordance with the applicable law. This contractual obligation, in addition to the statutory obligation under the future Banking Act, may improve the chance that the foreign court will recognise and/or give effect (*de jure* or *de facto*) to the transfer.<sup>7</sup>

4. **Transfer of liabilities only.** Article 3(4) of the Safeguards Order should be deleted. We understand that the rationale of this provision is that a counterparty to a failed bank will not normally object to becoming a creditor of a putatively stronger transferee, while remaining a debtor to the failed bank. While this may be true in specific cases, there is, of course, no assurance that the transferee would necessarily be stronger. It would appear that the powers under the Banking Bill are sufficiently broad that a relevant Authority could use them to strip toxic assets and burdensome liabilities out of a failing bank to create a “bad bank”, leaving the original bank in a better financial condition. Furthermore, even if the transferee is a stronger credit than the transferor, there will be a degree of credit risk attached to those claims against the transferee, which means that the claims against the transferee will be less valuable (due to the credit risk discount) than the claims would have been had they remained with the transferor and subject to the netting or set-off arrangement (and so discharged at their full value to the extent, of course, that offsetting liabilities within the netting or set-off arrangement are owed to the transferor).

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<sup>7</sup> This may, in particular, be the case if the foreign court recognises a principle comparable to the English maxim of equity that “equity looks on that as done which ought to be done”.

The more important point, however, from our perspective, is that the existence of this carve-out would make it impossible for a counterparty to obtain an English legal opinion that was sufficiently robust for regulatory capital purposes on any netting arrangement with a UK bank. This is because the possibility would always exist that at some point in the future the Authorities might choose to transfer only liabilities of a failed bank, effectively “cherry-picking” any master agreement between the counterparty and that UK bank.

5. **General approach of the Safeguards Order, “excluded rights” and “excluded liabilities”.** We welcome the general approach of the Safeguards Order, which provides for a general protection of netting and set-off arrangements, subject to specific exclusions. Naturally, of course, it is important that each exclusion be justified on a policy basis and clearly and precisely drafted.

Regarding the various categories of “excluded rights”:

- (a) In relation to clause (a), wholesale deposits (that is, deposits other than a deposit taken from a retail customer) are frequently subject to netting and set-off arrangements, used both for general credit risk management and, by supervised institutions, to obtain a regulatory capital reduction. For example:
- (i) Cash pooling arrangements within corporate groups involve deposits of various group companies being “pooled” on a net basis (so that positive balances are netted against deposit account overdrafts) in order to reduce banking charges and allow for more efficient cash management by the group treasury. These arrangements also substantially reduce risk for the bank operating the cash pooling arrangement. Such an arrangement may involve a single company operating various accounts for different purposes with a single bank or may involve various group companies operating different accounts with a single bank.<sup>8</sup>
  - (ii) It is not uncommon for a loan made and deposit taken (or vice versa) to be linked by a bespoke contractual set-off arrangement, not only to reduce credit risk on the borrower under the loan, but also to reduce for the lender the regulatory capital charge associated with the loan. While such an arrangement may, in any event, be protected as a financial collateral arrangement by the Financial Collateral Arrangements (No. 2) Regulations 2003 (**FCA Regulations**), and therefore presumably article 4 of the Safeguards Order (discussed further below), market participants would normally expect this to be a set-off arrangement within the protection of article 3 of the Safeguards Order.

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Other possible cash pooling structures exist, but these two examples are sufficient to illustrate the point. Cash pooling arrangements may involve periodic movement of actual balances, for example, end-of-day (so-called “sweep” arrangements) or merely “notional” pooling, where balances are not moved, but an overall net position is achieved by use of contractual set-off, cross-guarantees, conditional clauses or other techniques or combinations of techniques. The detail of these arrangements is not important for purposes of the point discussed here.

Accordingly, excluding deposits would appear to be a significant erosion of the commitment in paragraph 2.16 to protect contracts relevant for regulatory capital purposes. While this is not strictly a derivatives matter, ISDA members are involved in arrangements of the type described above in lines of business closely related to their derivatives business and so these issues are of concern to ISDA members. We understand that other financial market trade associations will make similar points in relation to wholesale deposits and set-off arrangements. We understand that other financial market trade associations will be proposing that this exclusion be deleted or limited to retail deposits.

- (b) In relation to clause (b) of the definition of “excluded rights”, we have no specific comment.
- (c) In relation to clause (c) of the definition of “excluded rights”, we believe that this exclusion may be broader than intended. The phrase “in the course of carrying on its business as a banking institution” uses the defined term “banking institution”, which in turn is defined by reference to the regulated activity of deposit-taking. Arguably, therefore the limitation to the exclusion could be construed as relating only to contracts entered into in connection with the deposit-taking business, which presumably is not the intention. Most of the derivatives business of a bank, for example, is not strictly part of its deposit-taking business, although it would constitute a normal part of its broader financial business. We believe that this is essentially merely a question of drafting and would propose that the words “in the course of carrying on its business as a banking institution” be amended to read substantially as follows: “in the course of its business relating to financial transactions”.
- (d) In relation to clause (d) of the definition of “excluded rights”, we understand that our members do enter into set-off arrangements under which securities of an issuer are set off against debts owed to the issuer, for example, a close-out amount due by the securities holder to the issuer. We therefore respectfully disagree with the suggestion in the first sentence of paragraph 2.12 of the Consultation Document. Regarding the point raised in the second sentence about subordinated securities effectively being raised in ranking by the exercise of a contractual set-off against senior claims owed to the issuer, our understanding is that as a matter of construction such a set-off would not work as a matter of English law in any event. We see no problem, however, with this exclusion being limited to subordinated securities of the banking institution. We are not sure why it would be necessary to refer to any securities of the counterparty “P”, but if the exclusion is limited to subordinated securities, we would raise no particular objection.
- (e) In relation to clause (e) of the definition of “excluded rights”, it would be helpful to know if any specific additional exclusion is contemplated by the Government. We are not aware of any category of rights that ought to be included here.

Regarding the definition of “excluded liabilities”, it would be helpful if these were spelled out rather than defined by reference to “excluded rights”.

6. **Financial collateral arrangements.** We do not understand the reason for sub-paragraph (3) of article 4 and would suggest that this be deleted. It would provide greater legal certainty if it were confirmed that compliance with the FCA Regulations were sufficient to bring an arrangement within the protection of the Safeguards Order. If the Government is concerned about any aspect of those Regulations, we note that clause 245 of the Banking Bill provides the Treasury with the power to make additional regulations in relation to financial collateral arrangements, which presumably can be used to address any concerns about the existing FCA Regulations. Clearly, we would welcome the opportunity to participate in any public consultation on any such proposed changes.
7. **Secured liabilities.** We note that the reference to “title transfer security” arrangements does not reflect market usage, given the sensitivity of market participants to preserving the distinction between security and title transfer approaches to establishing collateral arrangements. This is, of course, reflected in the twin track approach of the Financial Collateral Arrangements Directive, which deals with each approach separately, and this, of course, is also reflected in the FCA Regulations.
8. **Structured finance transactions.** We welcome the assurance of the tripartite authorities that the integrity of structured finance arrangements should be preserved and not disrupted by a partial property transfer order, as discussed in chapter 3 of the Consultation Document. We understand that there is some difficulty framing the safeguard to ensure that it is sufficiently wide and yet preserves sufficient flexibility for the authorities. Most capital markets issues are to some degree structured compared to debt issues of even two decades ago, including related hedging and credit risk mitigation measures. The principle should, of course, be that the whole of such arrangements should be transferred or none. We would be pleased to comment on any specific drafting that might be proposed for this safeguard, which we consider to be an important one.
9. **Other Banking Bill issues.** Apart from clause 48(1), we are also concerned about the provisions of the Banking Bill overriding early termination rights in relation to protected netting and set-off arrangements and also with the so-called “Henry VIII” clause.
  - (a) **Clauses 22 and 28.** Clauses 22 and 38 of the Banking Bill permit the Authorities to make an order overriding the effect of an early termination provision in a contract. This raises various issues:
    - (i) We believe that any netting or set-off agreement protected by the Safeguards Order should be protected from the effect of these provisions, since early termination is an essential pre-condition to netting.
    - (ii) In any event, it should certainly be the case that any netting or set-off agreement not transferred by a property transfer instrument should be exempt from this override power. A market counterparty should not be

required to continue performing to a failed bank, and the existence of this override in such a case would make it impossible for a supervised institution dealing with the failed UK bank to obtain a satisfactory legal opinion for regulatory capital purposes.

- (iii) We can understand, however, that a limited override of early termination may be justified to ensure that an ISDA Master Agreement transferred (as a whole, of course) to a bridge bank or private sector purchaser continues in effect, but it should be absolutely clear that any subsequent default by the bridge bank or private sector purchaser would trigger the early termination provisions in the normal way. In that regard, we are concerned that sub-paragraph (5) of each of clauses 22 and 38 may be overbroad.
  - (iv) Clauses 22 and 38 as currently drafted appear broad enough to prevent a party to a derivative (such as a credit, equity or bond derivative) that merely references a failed UK bank, but to which the UK bank is not a party, from triggering its protection under the derivative. We assume that this is not the intention, but would urge the Government to clarify this point by proposing an amendment to each of these clauses to make it clear that they relate only to agreements to which a UK bank is a party.
- (b) **Clause 39.** We would be grateful for further clarification of what is meant by “foreign property” in clause 39 of the Banking Bill. If the exclusions of foreign property that are currently in the Safeguards Order are maintained, then it will be crucial for market participants to ensure that they understand what is covered and what is not covered by the definition. Of course, if those exclusions are dropped, as we have suggested above, then this is no longer an issue for the netting and set-off safeguard, although the scope of the definition would clearly remain an issue for a number of other aspects of the Banking Bill.

Our concern about the definition of “foreign property” arises principally because of the reliance on the concept of location to determine whether property is foreign, which immediately suggests difficulties in relation to intangible property, such as interests in intermediated securities and monetary claims. The market would welcome further guidance on how the definition applies in these cases.

- (c) **Clauses 64(2) and 67(2).** We believe that clauses 64(2) and 67(2) of the Banking Bill could inadvertently raise difficulties for opinions in relation to a particular sub-set of netting agreements in the market, namely, netting agreements between a UK bank and an overseas group company that is an overseas bank. Such intragroup netting agreements are relatively common, for example, to manage large exposures for purposes of the large exposure rules under the Basel II capital regime. Clauses 64(2) and 67(2) permit the Bank of England to modify any contracts between the UK bank and the group company to give full effect to property transfer orders and share transfer orders, respectively. As clauses 64 and

68 are not limited to partial property transfers, there is a concern that they are not captured by article 3(1) of the Safeguards Order.

Clauses 64(2) and 67(2) of the Banking Bill could also affect a group company that is an issuance vehicle for a structured financing. The proposed structured finance safeguard should therefore also protect against the exercise of these powers.

- (d) **Clause 75(8).** We note that clause 75 (the so-called “Henry VIII clause”) has been amended since the first version of the Banking Bill was published in October 2008 to clarify that it may not be used to modify the Banking Bill itself or any subordinate legislation under the Banking Bill. It is possible, however, that it might be used to modify other legislation that is, nonetheless, relevant to the enforceability of a netting or set-off agreement. As long as any subordinate legislation under clause 75 requires the approval of Parliament, an English legal opinion can be given without qualification by reference to this clause where no relevant subordinate legislation has been made. This is because a legal opinion normally only opines as to the state of the law on the date it is given.

Unfortunately, sub-clause (8) empowers the Treasury to make an order without the approval of Parliament and the lapse of an order under clause 75 does not invalidate anything done while the order was in effect nor does it prevent the bringing forward of a new order following the lapse of a prior one. Accordingly, sub-clause (8) permits the Treasury to modify the law of England without the approval of Parliament or, in other words, purely by executive action. This power must arguably therefore always be considered part of the present law of England while it remains in effect. A legal opinion on a netting agreement may therefore need to be qualified by reference to this power. Without wishing to express a definitive view on the point at this stage, such a qualification might be considered a material and adverse qualification, and the question would then arise whether it is acceptable to financial supervisors in the context of their legal opinion requirements under the Basel II capital regime for the recognition of close-out netting for regulatory capital purposes and similar requirements in relation to on-balance sheet netting and credit risk mitigation for regulatory capital purposes.

We would strongly urge that sub-clause (8) of the Banking Bill be deleted or amended to require Parliamentary approval for all orders made under it, even if it is necessary to agree some form of streamlined procedure for such approval.

We hope that these comments from the perspective of the international financial markets will assist you in finalising the Safeguards Order and related issues dealt with in the Consultation Document. If you would find it helpful to discuss these or any other issues relating to the Banking Bill or related subordinate legislation, please do not hesitate to contact either of the undersigned.

Yours faithfully

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