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BY POST AND BY E-MAIL

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18 November 2008

Dear Mr Hamlyn

**UK consultation document on special resolution regime**

The International Swaps and Derivatives Association, Inc. (**ISDA**)<sup>1</sup> is grateful for the opportunity to make a written submission as evidence to the Banking Bill 2008 Committee (the **Committee**). We have been following closely the consultation process launched by HM Treasury, the Bank of England and the Financial Services Authority (the **Authorities**) earlier this year, which led to the drafting of the Banking Bill 2008, and we have previously responded to the Authorities in relation to issues potentially affecting the cross-border derivatives and similar financial transactions. We intend to respond in detail to the recent consultation document "Special Resolution Regime: safeguards for partial property transfers" (November 2008) issued by HM Treasury. We would also, however, like to submit some brief comments on the Banking Bill for consideration before the text of the Banking Bill is finalised.

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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.

ISDA defers, of course, to national experts in the United Kingdom on the appropriateness of the Banking Bill to address issues and longer term concerns arising out of the recent market turmoil and, in particular, the difficulties faced by the UK banking sector.

We are aware that, among others, the British Bankers' Association (the **BBA**) and the London Investment Banking Association (**LIBA**) have submitted evidence to the Committee and, based on our discussions with the BBA and LIBA, we would support the views that they have expressed to the Committee on the Banking Bill.

We are also aware of the evidence submitted to the Committee by the Financial Markets Law Committee (the **FMLC**), which is limited to issues of legal uncertainty, and we also support the views expressed by the FMLC. A core part of ISDA's mission is to strengthen the legal infrastructure of the financial markets. ISDA seeks to do this in several ways, including strengthening legal certainty by promoting appropriate law reform.

The issues raised by the FMLC in relation to the Banking Bill go to the heart of the concerns of international market participants who are currently actively engaged in the City of London. In particular, we are concerned about (1) the potential impact of the Banking Bill on netting, set-off, security and other forms of financial collateral arrangement and (2) the breadth of the power to change the law conferred on the Treasury under clause 65 of the Banking Bill.

We also believe that there are likely to be significant difficulties in practice with the exercise of partial property transfer powers in relation to foreign law governed assets and liabilities of a UK bank. Clause 36 of the Banking Bill attempts to address this, but we are not convinced that clause 36 contains a complete solution to the question, which raises a number of private international law issues and may be beyond the power of the UK to deal with wholly and adequately by domestic legislation.

As you have already received detailed submissions on these points, we will not repeat those arguments here. We principally wish to note that the detail of the secondary legislation under clause 43 of the Banking Bill will be crucially important (and so, as noted above, we will be commenting on this in some detail in our response to the Treasury's recent consultation). It will also be important that the relevant secondary legislation comes into effect on the same day that the provisions of the Banking Bill are enacted. If that is not the case, the necessary legal certainty will no longer exist for banks and other financial firms subject to regulatory capital requirements to report their derivatives, securities repurchase (repo) transactions, securities lending transactions and similar financial transactions with UK banks on a net basis. The drastic consequences of this for the UK banking sector have, we know, already been described to the Committee in other submissions.

We therefore wish to reserve our final comments for some technical observations on the drafting of clause 43(1):

1. Sub-clause (a) of clause 43(1) sets out a definition of "security interests" that includes bracketed language that is incorrect as a matter of current English law and also as a description of commercial usage. A title transfer financial collateral arrangement does

not create a security interest and is never, to our knowledge, described by market participants or their lawyers as "title transfer security". Although the latter is sometimes referred to as "quasi-security", the market primarily uses the terms "title transfer arrangement [or agreement]", "title transfer collateral arrangement [or agreement]" and "title transfer financial collateral arrangement".

Unlike a security interest, a title transfer arrangement does not create an interest of one person in the property of another person. Instead, oversimplifying somewhat, it involves the transfer of collateral assets from one party to the other, giving rise to a debt of the transferee to the transferor that is then available for set-off or netting by the transferee if the transferor defaults under related obligations owed to the transferee.

A crucial difference between the two approaches is that, unlike security, if the transferee of the collateral becomes insolvent, the transferor is not able to claim back its collateral, but is merely an unsecured creditor (although it will normally have its own set-off right against the transferee).

The European Financial Collateral Arrangements Directive and the Financial Collateral Arrangements Regulations (No. 2) 2003 (the FCA Regulations), which implement the Directive in the United Kingdom, carefully distinguish security and title transfer arrangements, which are based on different legal concepts. It has always been a strength of English law that it gives parties the freedom to choose whether to use security or title transfer to provide credit support for financial dealings, each approach with its own advantages and disadvantages.

It has long been accepted that there is no significant risk that an English court would recharacterise a title transfer arrangement as a form of security arrangement, whereas recharacterisation risk was a problem, creating significant legal uncertainty, in a number of other European jurisdictions until the European Collateral Directive was implemented in those jurisdictions.

We would strongly urge that clause 43(1)(a) of the Banking Bill be amended to eliminate this unfortunate potential erosion of the certainty that has previously existed on this issue under English law, as well as to bring the terminology of the Banking Bill in line with European legislation. One relatively simple way to do this would be to:

- (a) delete the bracketed language from the definition of "security interests";
- (b) introduce a new definition of "title transfer collateral arrangement"; and
- (c) introduce a new definition of "collateral arrangement" to be defined by reference to security interests and title transfer collateral arrangements.

The term "collateral arrangement" could then be used wherever the Banking Bill intends to cover both approaches. We believe that some references are intended to be limited to

"security interests" and so that the definition could continue to be used for that purpose, where appropriate.

2. In relation to sub-clauses (b) and (c) of clause 43(1), set-off and netting are treated as synonyms, whereas this is not the case. The term "netting" is both broader, in certain respects, and narrower, in other respects, than the term "set-off".<sup>2</sup> "Netting" refers to a contractual or (where occurring by operation of law) statutory provision under which a net amount is determined relative to gross amounts owed between two parties.<sup>3</sup> This may be achieved in various ways, but even restricting oneself to contractual netting, contractual set-off is only one way of effecting the determination of a net amount. Another is by novation and a third, although related, way is by use of conditional clauses (sometimes referred to as a "flawed asset" approach). Indeed, the principal mechanism of close-out netting under an ISDA Master Agreement governed by New York or English law is the use of the "flawed asset" approach. Other market master agreements, such as those used in the securities repurchase (repo) and securities lending markets, base close-out netting on contractual set-off. But the key point is that the terms are not synonymous.

We note that the definition of "close-out netting provision" in the European Collateral Directive is drafted broadly to reflect that the close-out netting may not be based on set-off, and this is reflected in the implementation of the European Collateral Directive across the EU, including in the UK implementation under the FCA Regulations.

This point is relatively easily addressed, we believe, by inserting the words "or netted" after the words "set off" in each of sub-clauses (b) and (c).

We would be happy to discuss these issues with you, including our drafting comments on clause 43(1), if that would be helpful. If so, please do not hesitate to contact either of the undersigned if we can be of assistance.

Yours faithfully

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<sup>2</sup> The term "netting" is narrower than "set-off" in the sense that set-off encompasses non-contractual set-off, for example, equitable set-off, set-off under the Civil Procedure Rules and rules of court and statutory insolvency set-off.

<sup>3</sup> Or potentially more than two under a multilateral netting arrangement, but for present purposes it is sufficient to consider the normal case of bilateral netting.