ISDA® Safe, Efficient Markets

BY E-MAIL

4 April 2014
Resolution Regime Consultation
Financial Services Branch
Financial Services and the Treasury Bureau
24/F, Central Government Offices
2 Tim Mei Avenue, Tamar, Hong Kong

E-mail: resolution@fstb.gov.hk

Ladies and Gentlemen

An Effective Resolution Regime for Financial Institutions in Hong Kong

The International Swaps and Derivatives Association (**ISDA**)[1] is grateful for the opportunity to respond to the Consultative Paper "*An Effective Resolution for Financial Institutions in Hong Kong*" jointly published by the Financial Services and the Treasury Bureau, the Hong Kong Monetary Authority, the Securities and Futures Commission and the Insurance Authority in January 2014 (the **Consultation Paper**).

The issues considered in the Consultation Paper are of great importance to the safety, efficiency and stability of the financial markets, including the over-the-counter (**OTC**) derivatives markets. We are supportive of a strong, internationally consistent resolution regime for financial institutions and one that is aligned with the Financial Stability Board's (**FSB**) Key Attributes of Effective Resolution Regimes. The release of the Consultation Paper is a significant step made by Hong Kong in implementing the Key Attributes to contain the risks posed to financial stability by a non-viable financial institution without exposing the taxpayer to the risk of loss.

Scope of this response

In this response, we primarily address the issues of bail-in, the proposed temporary stay and cross-border coordination, although we also take the opportunity to make some observations about issues raised in other parts of the Consultation Paper. While we agree that the issues dealt with throughout the Consultation Paper are closely interrelated, we believe, given our focus on the OTC derivatives markets, that other respondents, in particular, other international financial trade associations with a broader and less sector-specific focus and mission than ours, are better placed to comment in detail on other parts of the Consultation Paper.

Our membership includes the leading global, regional and national financial institutions as well as leading end-users and many other important financial market participants. Our leading financial institution members are members of the other international financial trade associations to which we refer above, and their views on those other issues will be represented to you through those associations.

Consistent with our mission, we are primarily concerned in this letter with the effect of the proposed resolution tools and powers on the safety and efficiency of the derivatives markets, by considering the direct impact of the proposals on the rights of a market counterparty under its derivatives transactions with a failing financial institution (**FI**) and under related netting and collateral arrangements. In particular, we are concerned with the legal uncertainty that will be created if the proposed resolution powers are not adequately defined and circumscribed and if any related safeguards are not clearly defined in terms of their scope or effect.

[1] Information regarding ISDA is set out in Annex 1 to this response.

International Swaps and Derivatives Association, Inc.
Suite 1502 Wheelock House
20 Pedder Street,
Central, Hong Kong
P 852 2200 5900 F 852 2840 0105
www.isda.org

NEW YORK WASHINGTON
LONDON BRUSSELS
HONG KONG SINGAPORE
TOKYO

All capitalized terms used but not defined in this letter have the meaning ascribed to such term in the Consultation Paper.

Answers to Consultation Questions

We agree that, the existing supervisory intervention powers available to the Hong Kong regulators are insufficient to achieve all of the outcomes required by the Key Attributes. We also agree that an effective resolution regime requires a designated administrative authority with a statutory mandate to promote financial stability and with a range of resolution objectives, tools and powers along the lines set out in Annex 1 to the Key Attributes.

1. Chapter 4 - Scope of Proposed Resolution Regime

Question 1

Do you agree that a common framework for resolution through a single regime (albeit with some sector-specific provisions) offers advantages over establishing different regimes for FIs operating in different sectors of the financial system? If not, please explain the advantages of separate regimes and how it can be ensured that these operate together effectively in the resolution of cross-sectoral groups.

While we agree with the proposal that a common framework for resolution across different sectors of the financial system could work, given that each sector has a different business model, balance sheet structure and methodology for the assessment of risks the regime should be able to accommodate sector specific provisions.

Question 4

Do you agree that it would be appropriate to extend the scope of the proposed resolution regime to FMIs which are designated to be overseen by the MA under the CSSO (other than those which are owned and operated by the MA) and those that are recognized as clearing houses under the SFO?

While we agree that it would be appropriate to extend the scope of the proposed resolution regime to FMI's (other than those that are owned and operated by central banks) that are considered as systemically significant, we believe that a distinction should be made for the purpose of applying Key Attributes, between types of FMIs that assume credit risk through exposures to participants and those that do not. In addition, we would want any Hong Kong regime to be a broadly level playing field with regimes in other countries. We recommend and support the Hong Kong regulators in making rules that take account of international rulemaking and are in-line with the FSB and IOSCO work on FMI resolution. In particular, we support the following principles with regards to FMIs:

- The criteria for entry of an FMI into resolution, and for who will make the determination that such criteria have been met, should be clearly defined. Resolution power should only be imposed where it is determined that the non-viable condition is fulfilled and restricted to securing continuity of critical financial services of the FMI. Although rapid decision-making may be necessary, it should be recognized that too-early intervention by the resolution authorities could disrupt market confidence and the expectations of participants.

- There should be an affirmative obligation on the home supervisor of the FMI to work closely with the authorities of other jurisdictions with a direct interest in the operation of the FMI in reviewing its

resolution procedures, and to give prior notice to such authorities as well as to the supervisors of the principal participants in the FMI, if the FMI is entering resolution.

- Provision should be made for temporary liquidity during an FMI's resolution, either to be provided to the FMI itself or, possibly, to the direct participants in the FMI as a market-wide facility to enable such participants to meet their obligations to the FMI. Any resolution regime should contain appropriate measures to assure that the provider of such liquidity is protected.

- Any proposed resolution regime should not challenge the criteria which CCP participants need to satisfy in order to net cleared exposures for accounting and regulatory capital purposes. Any provision that would undermine participants' ability to attain netting or set-off in accordance with market practice would render participation in the FMI unviable.

- The imposition of any proposed resolution power should respect the default waterfall and loss allocation arrangements that the FMI has made with its participants. There should be a strong presumption in favor of carrying out a resolution in accordance with the FMI's agreed rules in order for market participants to sustain confidence in the FMI, both in normal circumstances and in resolution.

- Liabilities of participants to the FMI must be predictable and limited. Rules governing resolution should not create potential liabilities that are unlimited or unquantifiable liabilities. No financial entity can support nor would such an entity be authorized by its prudential regulator to participate in an activity where exposures are unlimited and unquantifiable.

- Transparency and certainty for direct and indirect participants is essential as to (i) the nature and operation of the default management process and any default waterfall, (ii) the nature of loss allocation in all circumstances including the exhaustion of the default waterfall, and (iii) the relevant decision makers (i.e., risk committee, FMI management, or the resolution authority) at each step of any default management process or recovery and resolution measures.

ISDA, together with other trade associations, has made submissions in respect of FSB consultation document, *Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions* and CPSS-IOSCO consultative report, *Recovery of financial market infrastructures* in which we discussed key principles regarding FMI resolution in detail.[2]

Question 5
Do you agree that it is appropriate to set the scope of the regime to extend to some LCs?

Question 6
If so, and in order to capture those LCs which could be critical or systemic, should the scope be set with reference to the regulated activities undertaken by LCs? Are the regulated activities identified in paragraph 144 those that are most relevant? Is there a case for further narrowing the scope through the use of a minimum size threshold?

Yes, we agree that it is appropriate to set the scope of the regime to extend to some LCs. Scope of the LCs subject to the regime could be set with reference to the economic function guidance provided by the Financial Services Authority in the UK in its "*RRP Guidance pack for firms*" published on 9 August 2011. Further apart from a minimum size threshold, consideration should also be given to other qualitative criteria like interconnectedness or contagion to other market participants, existence of alternate providers in determining which LC's should be included within scope of the regime. For the purpose of defining the scope

[2] See response to the CPSS-IOSCO consultative report *Recovery of financial market infrastructures* (Oct. 11, 2013) and Response to FSB Consultation on *Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions* (October 15, 2013), available at http://www2.isda.org/functional-areas/risk-management/page/2

of LCs to be captured, it should be limited to the extent their regulated activities pose a severe risk to the financial stability of Hong Kong. In general, reference to regulated activities undertaken by the LCs would be appropriate and the regulated activities as identified in paragraph 144 are the most relevant.

Question 7

Do you agree that the scope should extend to LCs which are branches or subsidiaries of G-SIFIs? Do you see a need for the scope to extend to LCs which are part of wider financial services groups, other than G-SIFIs, whether those operate only locally or cross-border?

In most cases, G-SIFI's would have comprehensive recovery and resolution plans that are closely monitored by their respective home regulators. To the extent to which these plans can be leveraged to facilitate resolution being undertaken by a home authority or support a local resolution would be, in our opinion, the most efficient and effective way to deal with LC's that are branches or subsidiaries of G-SIFI's. In order to facilitate resolution undertaken by home authority, branches and subsidiaries of foreign financial institutions could be brought within the scope of the proposed regime. As noted in paragraph 157, bringing branches within the scope of the proposed resolution regime for Hong Kong would be a more proportionate approach than requiring that all foreign FIs, whose failure could pose systemic risks locally, convert into subsidiaries. As provided in Key Attributes 7.5 and the EU Bank Recovery and Resolution Directive (**RRD**), we would strongly recommend that the proposed regime in Hong Kong should allow for the recognition of resolution proceedings being undertaken in the home country as well as other third countries. As correctly noted in paragraph 327, failure to recognise the actions of a home resolution authority can result in a real risk that some groups reduce their footprint in such host jurisdictions. In this respect, we note FSB Key Attributes states that Global Systemically Important Financial Institutions (**G-SIFIs**) should have an overall group plan and the resolution for such an entity should be led by the home regulator.

2. Chapter 5 - Governance Arrangements

Question 15

Are the objectives which it is proposed should be set for resolution suitable to guide the delivery of the desired outcomes?

In line with FSB Key Attribute 2.3, the duty to consider the potential impact of its resolution actions on financial stability in other jurisdictions should be explicitly added as a resolution objective under the proposed resolution regime. To this end, we strongly support the proposals in Chapter 8 that a coordinated and cooperative approach to the resolution of a cross border firm is critical to protect financial stability across home and host jurisdictions. In particular, we agree with the observation in paragraph 321 that requiring global financial institutions to hold significantly more liquidity and capital in each jurisdiction would increase the costs of operating cross-border with potentially significant implications for economic development and growth.

3. Chapter 6 – Resolution Powers

Question 19

Do you have any views on the factors which should be taken into account in drawing up proposals for the provision of a bail-in option for the resolution regime in Hong Kong?

General comments

We support the principle of statutory bail-in within resolution as this will align the regime in Hong Kong to the regimes in the US, UK and EU, provided that it only applies as a last resort after all other feasible

measures to rescue the failing firm (that is, to prevent it from reaching the point of non-viability) have, in the reasonable determination of the relevant authorities, been exhausted. Its scope of application must also be clear and its basis legally certain. Numerous legal issues will need to be addressed in some detail, including (but not necessarily limited to) company, securities, property, insolvency, commercial and private international law issues.

There will also, of course, be issues as to the interaction between the bail-in resolution tool and other resolution tools, change of control provisions in contracts entered into by the FI and regulatory restrictions on investors. For example, a regulated fund that has previously invested in debt obligations of the FI could find itself in breach of its own investment restrictions following a statutory conversion of that debt to equity.

Also, very careful attention needs to be paid to the cross-border aspects and the relative responsibilities of home and host country. As a general principle, bail-in should only be exercised by the authority with primary responsibility for resolution of the entity, for example, the home authority in relation to a parent FI.

We believe that bail-in must respect, as far as possible, *pari passu* treatment of creditors and the statutory order of priorities. In relation to the application of bail-in, recapitalization should be effected by starting at the bottom of the capital structure, that is, with the equity level and then moving up the structure in reverse order of priority. Senior debt should only be subject to statutory bail-in after exhaustion of subordinate levels of capital. And, of course, senior debt should only be bailed in to the extent necessary to recapitalize a FI or, as the case may be, the portions of its business transferred to a bridge institution, at a reasonable level.

We agree that a statutory bail-in regime should respect the principle of "no creditor worse off than in liquidation", should provide an appropriate mechanism for compensation where this principle can be shown to be breached and should provide for expedited judicial review of bail-in decisions, where appropriate (but in a manner that does not interfere with the speed or flexibility of the use of the tool that the authorities will need when implementing an actual resolution).

Derivatives market impact

The foregoing are general comments, which we believe are in line with the comments of other industry bodies and market participants, and a number of these points are, of course, acknowledged by the Consultation Paper. In relation to the specific impact of a statutory bail-in power on the derivatives markets, there are two aspects:

(1) First, there is the question of the impact of bail-in on a FI equity or debt instrument that is the subject of or referenced by a derivative transaction. The principal concern of market participants in this regard is to ensure that there is sufficient clarity and certainty as to the rules that will apply and as to the full legal and tax effects, as mentioned above, so that market participants can analyse the market and other risks of the transaction, structure and document it properly, price it accurately and hedge it effectively and reliably. It is also important, in relation to any actual exercise of such a power by a resolution authority, that there is clarity and transparency as to the timing and effect of the exercise. Market participants should be notified promptly of the exercise via an appropriate market information mechanism with details of the terms of the exercise so that parties to a transaction referring to the securities of the failing firm are quickly in a position to assess the impact of the exercise, determine their rights under the relevant contract and take any appropriate actions, for example, in relation to any hedge positions to protect their financial and commercial interests. This clarity and transparency is important not merely to the individually affected market counterparties but to the market as a whole, as any shock caused by uncertainty as to the timing or effect of the exercise could have contagion effect and/or could result in market counterparties taking unnecessary actions (for example, liquidating hedge positions or establishing new ones) based on inaccurate or incomplete information.

(2) Secondly, there is the question of whether and, if so, how statutory bail-in could be applied to a derivative transaction itself as a form of debt of a FI. This is part of the more general question as to the scope of the application of the statutory bail-in power.

Should derivative transactions be within the scope of a statutory bail-in power?

There are a number of cases of liabilities of a FI where the beneficial effect of the application of statutory bail-in may be outweighed by negative effects for the FI itself (particular in terms of its access to credit and liquidity), for counterparties to FIs and for systemic stability. As noted in paragraph 235 of the Consultation Paper, potential special cases include (but are not necessarily limited to) deposits (in particular, retail deposits), inter-bank borrowings, foreign exchange transactions, liabilities relating to unsettled securities trades (that is, securities trades initiated and still in the course of settlement), trade debt and liabilities under derivative transactions.

As a general rule, liabilities of a party to a derivative transaction are largely or wholly contingent while the transaction is outstanding. Derivative transactions contemplate both payment obligations and, where physical settlement is permitted or required, delivery obligations, that is, obligations to deliver an agreed form of asset. For present purposes it is sufficient to focus on payment obligations.

While an amount may, after satisfaction of relevant conditions precedent, become due and payable on a particular payment date, for example, under a swap transaction, liabilities will remain contingent in relation to subsequent payment dates. The amount of any future payment obligation under the swap transaction will also potentially be subject to payment netting against any amount due on the same day by the same party and potentially also to netting against amounts due on the same day by the same party under other transactions under the same master agreement.

Given the foregoing and given also the wide variety of possible derivative product types (swap, forward, option, cap, collar, floor and many variations and sub-variants of these product types) as well as the wide range of possible underlying assets and other measures of value that can be used to determine the value of a derivatives transaction (including rates, prices and indices relating to interest rates, foreign exchange rates, equities, debt securities, credit risk, commodities, bullion, emissions allowances, inflation and other economic and monetary statistics, meteorological data, freight forward rates, bandwidth and so on), it is likely that there would be severe practical difficulties in applying a statutory bail-in power to a "live" derivative transaction, that is, a derivative transaction still in effect, with obligations remaining to be performed, at the time the power is exercised.

The difficulties would include valuation and operational difficulties, without considering the disruptive impact on related positions (which are either hedges for or hedged by the transactions subject to the bail-in power). These difficulties would be magnified where there are dozens, hundreds or even thousands of trades between a G-SIFI, and a major counterparty. The possibility of the application of bail-in to derivative transactions still in effect would also probably have negative implications for regulatory capital that would need to be worked through very carefully.

The foregoing points apply to derivative transactions of a FI that are traded "over-the-counter" or off an organized market or exchange and not cleared through a clearing house or other clearing system. Where derivative transactions are exchange-traded and cleared or traded OTC and cleared, as is increasingly required by legislative changes in effect or under way in the G20 economies and presumably in other countries as well, then additional operational and other difficulties are likely to arise in applying the bail-in power. In this respect, we note that cleared derivatives transactions are exempted from the bail-in tool under the EU RRD.

It would, of course, be considerably simpler to apply a statutory bail-in power to a net amount due under the close-out netting provisions of a master agreement, such as the ISDA Master Agreement. Such an amount, once determined, is normally simply an unconditional debt owed by the party that is "out of the money" on a net basis under the relevant master agreement, whether the party is the defaulting party or the non-defaulting party. That debt is capable, therefore, of being written down or converted to equity without the difficulties and complexities referred to above in relation to applying bail-in to "live" transactions.

Two points to note immediately, however, are: (1) all transactions under the master agreement would need to be terminated and valued and this is a process that can take some time depending on the nature, number and complexity of the transactions then outstanding and the state of the market at the time of close-out; and (2) the FI will not necessarily be debtor in such a case and therefore the resulting net amount following close-out might therefore not be available to be bailed in.

Regarding the first point, the timing of the process of close-out is unlikely to be sufficiently rapid to meet to accommodate the speed with which the authorities will want to recapitalize a FI in order to minimize disruption to the market and to allow the FI to continue trading.

Regarding the second point, although in the circumstances described the net amount, being owed to the FI, would represent an asset of the FI and therefore strengthen (however, minimally) its balance sheet, the benefit of realising that asset may be outweighed by the disadvantage of losing the on-going risk protection offered by the transactions under the master agreement. Early termination for this purpose is also directly at odds with the general aim, discussed in paragraph 250 of the Consultation Paper, to prevent early termination occurring in the event of the exercise of certain resolution tools.

In addition to the foregoing considerations, there are cogent reasons of principle why derivative transactions should be excluded from the scope of the bail-in power. Bail-in is concerned with recapitalization. Liabilities under derivatives transactions do not form part of the capital of a FI, other than, perhaps, in the very limited case where a specific derivative transaction is closely related to a capital transaction of the FI. The vast majority of derivative transactions constituting the normal derivatives trading of the FI would not fall into this category.

This is similar to the position of trade debt, and indeed for a FI liabilities under derivative transactions are functionally trade debt. We think it unlikely that G20 ministers intended that bail-in could apply to day-to-day claims such as those of a landlord under a lease of a building to a FI or of a supplier in relation to the supply of goods or services to a FI. The potential application of a statutory bail-in power to trade debt could have a significant effect on a FI's ability to access goods and services on credit and on the cost to the FI of those goods and services. Similarly, the potential application of bail-in to liabilities under derivative transactions could have a disruptive effect on the availability and cost of derivatives trades to a FI.

Question 22
Do you have any views on how best to provide for a stay of early termination rights where these might otherwise be exercisable on the grounds of an FI entering resolution or as a result of the use of certain resolution options?

General comments

One preliminary point we would make is that it is not necessarily currently the case that entry into a resolution regime would, of itself, trigger early termination rights in most financial contracts. Only that aspect of the resolution regime that could be characterised as either a form of liquidation or reorganization proceeding for the benefit of all creditors or related or preparatory acts would normally be caught by existing "bankruptcy" events of default, such as the Bankruptcy Event of Default in Section 5(a)(vii) of the ISDA Master Agreement. Thus, the exercise of a resolution power to transfer the shares of a troubled bank into temporary public ownership or to a private sector purchaser would not, of itself, trigger an Event of Default under either the 1992 or the 2002 version of the ISDA Master Agreement, at least as far as the standard form as published by ISDA is concerned.

Of course, parties are free to amend the existing provisions of the ISDA Master Agreement and to supplement it as they see fit, and it is both possible and perhaps likely that as resolution regimes become more common and more extensive in the powers granted to public authorities that parties will seek to develop additional early termination rights specifically to address the exercise of resolution powers beyond the commencement of special bank liquidation, administration or other reorganization procedures.

The first point to note, which is essentially a technical point in relation to the scope of the proposed suspension, is that the stay should only relate to the right of a counterparty under a derivatives master agreement, such as the ISDA Master Agreement, with a failing FI subject to the resolution regime to terminate transactions early as a result of the triggering of the resolution regime against the FI. Early termination of transactions is the essential first step in the process of close-out netting, the other steps being valuation of the terminated transactions and then determination of the net balance owing by or to the defaulting party under the close-out provisions. Every master netting agreement operates on this basis, even if the details of the close-out mechanism vary.

It is not necessary, in other words, to suspend a counterparty's "right to enforce" or "rights to close-out netting". Nor is it, in our view, necessary or desirable, to stay the rights and obligations of the parties under the relevant contract, subject to some qualifications discussed below.

During the period of the temporary stay, the market counterparty's rights and the failing firm's obligations (and, of course, vice versa) under the master agreement should not otherwise be affected. Throughout this period, the counterparty should (bearing in mind the necessity to protect the enforceability of close-out netting mentioned in paragraph 291 of the Consultative Paper) be permitted to consider its exposure to the failing FI to be fully net. In that important sense, the proposed suspension should not "suspend" close-out netting. At most, it should simply stay temporarily the initiation of the close-out netting process, namely, the early termination of transactions following an event of default.

Also, where a master agreement is collateralised, it should be clear that the temporary stay has no effect on the obligations of each party under the collateral arrangement. Collateral calls should be capable of being made and should be complied with in the agreed manner, including the operation of any relevant dispute resolution mechanism.

Thus, a failure by a FI to make a payment that is due during the period of the temporary stay should constitute an event of default (assuming the appropriate notice has been given and any relevant cure period elapsed), and the other party should be free to exercise its early termination rights in relation to that event of default notwithstanding the temporary stay.

How best to provide for a stay of early termination rights

We strongly support FSB Key Attributes 4 and the related guidance in Annex IV, which was developed after a careful and detailed consultation with all relevant stakeholders, including ISDA and its members.

If such a power to suspend early termination rights is to be included in Hong Kong's regime for financial institution resolution, we believe that it must be made subject to certain conditions, namely that:

- The stay only applies to early termination rights that arise for reasons only of entry into resolution or in connection with the use of resolution powers;
- the ability of the resolution authority to suspend early termination rights is strictly limited in time (ideally for a period not exceeding 24 hours and should not exceed two business days in all circumstances);
- where the relevant contract permits a counterparty to the FI not to perform as a result of a default or potential event of default in relation to the other party (as is the case, for example, under Section 2(a)(iii) of the ISDA Master Agreement), that provision should be unaffected by the stay;
- the relevant master agreement and all transactions under it are transferred to an eligible transferee as a whole or not at all, together with any related collateral (there is no possibility of "cherry-picking" of transactions or parts of transactions or divorcing the collateral from the obligations secured or supported by it);

- the proposed transferee is a financially sound entity with whom the counterparty would prudently be able to contract in the normal course of its business (including a bridge institution backed by appropriate assurances from the resolution authority and its government) and the transferee should be subject to the same or a substantially similar legal and tax regime so that the economic (apart from the issue of credit quality) and tax position of the counterparty is not materially affected by the transfer;

- the early termination rights of the counterparty are preserved as against the FI entering resolution in the case of any default by the FI occurring during the period of the stay that is not related to the exercise of the relevant resolution power (for example, a failure to make a payment, as discussed above, or the failure to deliver or return collateral, in either case, on a due date occurring during the period of the stay);

- the early termination rights of the counterparty are preserved as against the transferee in the case of any subsequent independent default by the transferee; and

- the counterparty retains the right to close out immediately against the failed financial institution should the authorities decide not to transfer the relevant master agreement during the specified transfer window

We note that most of these conditions are acknowledged in paragraph 252 of the Consultation Paper.

In relation to the length of the temporary stay, we note that the US has successfully operated its resolution regime for US banks for many years with a 24-hour suspension period and that this is reflected in the resolution provisions of the Dodd-Frank Act (in relation to the Orderly Liquidation Authority) which cover other systemically important financial institutions.

In relation to the fourth bullet point, we note that the term "master agreement" should be taken to include a cross-product master agreement, that is, a netting agreement providing for a further netting of amounts due under individual master agreements. These are also sometimes called "umbrella" or "master-master" netting agreements.

We also note in relation to the fourth bullet point that under the US regime the US resolution authority, the FDIC, must transfer all "qualified financial contracts" (**QFCs**) to a transferee or none, regardless of whether the QFCs are linked by a common master agreement. In addition, it must transfer all QFCs not only of the counterparty but also all QFCs of all of that counterparty's affiliates with the failing firm. Although these requirements may restrict the flexibility of the authorities in relation to the restructuring of the failing firm's business, there are clearly risk management advantages to both of these additional features, which maximize available set-off rights (subject to some legal uncertainty about the full enforceability of cross-affiliate set-off). In this respect, we note that the existence of a limited power of the US resolution authority, the FDIC, to suspend contractual early termination rights for 24 hours has not prevented supervised institutions from obtaining, in relation to US banks subject to the FDIC regime, legal opinions that are sufficiently robust to comply with current requirements for recognition of close-out netting for regulatory capital purposes. We stress that any regime implementing the power of suspending early termination rights must clearly limit such power in order to maintain the necessary legal certainty of netting for regulatory capital purposes.

The Consultation Paper also suggests in paragraph 252 that safe and orderly operations of certain classes of counterparty, specifically, FMIs should be protected from compromise by a temporary stay. While the principle as formulated is uncontroversial, we believe that how, precisely, a temporary stay would operate (if at all) in relation to transactions, for example, cleared through a CCP requires more detailed study and discussion.

ISDA's discussion with policymakers on a contractual stay of early termination rights

As you may be aware, ISDA has been discussing with policymakers and OTC derivatives market participants issues related to the early termination of OTC derivatives contracts following the commencement of an insolvency or resolution action. We have developed and shared papers that explore

several alternatives for achieving a suspension of early termination rights in such situations. One of those alternatives, which is supported by a number of key global policymakers and regulatory authorities, would be to amend ISDA derivatives documentation to include a standard provision in which counterparties agree to a short-term suspension. While there are limitations on what may be achieved contractually, ISDA believes that it is important that supervisors and the private sector should maintain a dialogue on these critical issues. We would welcome the opportunity to discuss this topic with Hong Kong regulators.

4. Chapter 7 – Safeguard and Funding

Question 29

What types of "financial arrangements" do you consider as important to protect in resolution? Why is it important that those arrangements be protected?

We support the proposal set out in paragraph 291 and 292 about providing a safeguard which restricts the use of resolution powers in a manner that effectively undermines the purpose and economic effect of the types of financial arrangements to be protected. We agree that the financial arrangements identified in paragraph 291 should be protected by the suggested safeguards. As mentioned in FSB Key Attributes 4.1, the legal framework governing set-off rights, contractual netting, collateralisation agreements and the segregation of client assets should be clear, transparent and enforceable during the resolution of a FI. We would welcome greater detail as to how safeguards to ensure this would be framed. Experience with existing resolution regimes has already shown that the detail of the safeguards is crucial.

Legal certainty must be ensured. As far as possible, private law contractual and property rights must be respected. The remedy for a breach of a netting or collateral safeguard must also be clear, and it must not be a purely administrative remedy, for example, one requiring an application to an authority, a period for determination by the authority and, if the application is granted, the payment of compensation or award of other relief only at the end of that period. The remedy must be immediate and self-executing. For example, a netting safeguard should ensure that netting is enforceable notwithstanding the transfer by the resolution authority of some but not all of the rights or obligations under a master netting agreement. Similarly, in relation to security, the safeguard should provide that a transfer of secured obligations is legally ineffective unless the related security arrangement together with the security assets are also transferred to the transferee (the new obligee).

Paragraph 290 notes there is a need to strike an appropriate balance as the greater the restrictions imposed on the resolution authority, the more the obstacles to carrying out a successful resolution increase. We would like to point out that ensuring the certainty and effectiveness of netting and collateral arrangements and the clarity and transparency of client asset segregation arrangements will reinforce the effectiveness of a resolution regime by inspiring confidence in market participants that they are being dealt with fairly and in a predictable manner consistent with their expectations.

Where it is considered necessary to suspend or otherwise affect any private law right, there is clearly a balancing that needs to be to occur. Any such suspension or other effect should be the absolute minimum necessary to achieve the policy goal of the relevant resolution tool or power. This principle is relevant to our discussion above of the proposed temporary stay on contractual early termination rights.

5. Chapter 8 - Cross-border Coordination and Information Sharing

Question 32

Do you agree that it is important that the resolution regime in Hong Kong supports, and is seen to support, cooperative and coordinated approaches to the resolution of cross-border groups given Hong

Kong's status as a major financial centre playing host to a significant number of global financial services groups?

We agree that it is important that the resolution regime in Hong Kong supports cooperative and coordinated approaches to the resolution of cross-border groups. We strongly support FSB Key Attributes 8 which requires home and key host authorities of all G-SIFIs to maintain Crisis Management Groups to facilitate the planning and management of the resolution of a cross-border financial crisis. There is a growing consensus amongst all international regulators that a coordinated and cooperative resolution of a cross-border group has the potential to better protect financial stability across home and host jurisdictions.

Given the global nature of the derivatives markets, the cross-border issues are crucial. We underline the importance for the derivatives markets of ensuring, in particular, that there is:

(1) no ring-fencing of local assets of a foreign FI in the event of its local branch being made subject to resolution in the host jurisdiction; and

(2) no discrimination against foreign creditors in the host jurisdiction.

Each of these is objectionable on a number of grounds, including grounds of efficiency, equity and systemic stability in the financial market as a whole. The precise impact of each will depend on how it operates both *de jure* and *de facto* and on its scope of application. Specifically from a derivatives perspective, the existence of either in Hong Kong as a host jurisdiction will have a potential adverse impact on the enforceability of close-out netting and any related financial collateral arrangement entered into with a multibranch FI with a local branch in Hong Kong.

Question 33

Do you agree that the model outlined in paragraphs 331 to 333 to support and give effect to resolution actions being carried out by a foreign home resolution authority would be effective in supporting coordinated approaches to resolution where it is in the interests of Hong Kong to do so?

Need for mutual recognition

Irrespective of the model that is adopted to ensure cross border coordination, it is imperative that home and host jurisdictions provide for transparency over processes that would give effect to foreign resolution measures, or indeed, initiate local resolution powers. These processes should include, amongst other things, the basis of the assessment to use local resolution powers, clarity around treatment of local creditors, treatment of assets and liabilities and/or rights and obligations located in host countries in the event a transfer to a third party or bridge institution is being considered by the home authorities and so on. Any alternative model has the potential to descend to a disorderly break up and significant value destruction in the financial stability across multiple jurisdictions.

Also, although there are difficulties in achieving this in the short-term, the longer term goal must be to ensure that any action taken in a resolution is recognised as legally effective under the laws of all other jurisdictions relevant to the particular case. For example, a statutory transfer by the Hong Kong resolution authority, during the resolution of a Hong Kong bank, of an ISDA Master Agreement governed by New York law must be recognised as effective by the New York courts. Similarly, a temporary stay imposed by the Norwegian resolution authority, during the resolution of a Norwegian bank, on a counterparty's right to designate an Early Termination Date under an English law governed ISDA Master Agreement must be recognised as effective by the English courts.

In each case, we understand that there is currently doubt about whether that would be true under the current state of the law. It may take a binding international agreement to ensure that the necessary mutual recognition is achieved not only as between the various G20 countries but also as between the many other

ISDA® Safe, Efficient Markets

jurisdictions, including emerging market countries, where active participants in the global derivatives market are based.

Home country versus host country

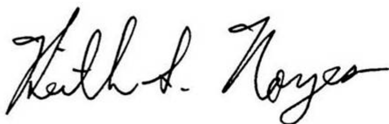
We would strongly recommend that the proposed regime in Hong Kong should allow for the recognition of resolution proceedings being undertaken in the home country as well as other third countries. As correctly noted in paragraph 327, failure to recognise resolution actions of a home authority can result in a real risk that groups reduce their footprint in such host jurisdictions.

We agree with the principle set out in the Key Attributes that the home country of the parent should have primary responsibility for the resolution of the parent and any subsidiary of the parent located in the home country. Each host country resolution authority (and other relevant host country authorities such as the host country central bank, financial regulator or Ministry of Finance) should cooperate and coordinate with the home country resolution authority effectively to ensure that all creditors of and counterparties of a particular class are, as far as possible, given equal treatment. As there is no special derivatives aspect to these issues, we do not comment further here.

We look forward to continuing our dialogue with you. Please do not hesitate to contact either of the undersigned if we can provide further information about the OTC derivatives market or other information that would assist the work of Hong Kong regulators in relation to effective resolution of systemically important financial institutions.

Yours faithfully,

On behalf of the International Swaps and Derivatives Association, Inc.



Keith Noyes
Regional Director, Asia Pacific
knoyes@isda.org

Jing Gu
Assistant General Counsel, Asia
jgu@isda.org

Annex 1

ABOUT ISDA

Since its founding in 1985, the International Swaps and Derivatives Association has worked to make over-the-counter (OTC) derivatives markets safe and efficient.

ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. The Association has been a leader in promoting sound risk management practices and processes, and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool.

Today, ISDA has over 800 member institutions from 62 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers.

ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – show the strong commitment of the Association toward its primary goals; to build robust, stable financial markets and a strong financial regulatory framework.