ISDA Safe, Efficient Markets

9 May 2014

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BY EMAIL

Ladies and Gentlemen

ISDA comments on HM Treasury's open consultation on bail-in published 13 March 2014

The International Swaps and Derivatives Association, Inc. (**ISDA**)[1] is grateful for the opportunity to provide input to HM Treasury's open consultation on bail-in published 26 September 2013 (the **Consultation**).

Consistent with our mission, we are primarily concerned in this letter with the impact of the proposed bail-in tool on the safety and efficiency of the financial markets, by considering the direct impact of the proposals on the rights of a market counterparty under its derivatives and other financial transactions with a failing firm and under related netting and collateral arrangements. We are aware that a number of other market associations and professional bodies will be responding on some of the broader issues raised by the Consultation.

ISDA supports HM Treasury's intention to implement bail-in ahead of the 1 January 2016 implementation date mandated by the newly adopted (but not yet in force) Bank Recovery and Resolution Directive (**BRRD**).

However, in common with other stakeholders, we have some concerns with HM Treasury's proposed approach to implementation of bail-in, which HM Treasury has indicated is not considered to constitute implementation of the bail-in provisions of the BRRD. We understand that HM Treasury intends to consult separately, and later this year, on the future changes that will be needed to the Banking Act 2009 (the **Act**) and related legislation to transpose the BRRD. Bail-in is a complex and novel area of law, and multiple changes to underpinning legislation risks confusing the markets' understanding of it. Further, the legislative framework for bail-in is only part of the picture required to ensure market certainty – a clear understanding of how bail-in will operate in practice is essential to ensure financial stability. For this reason, we consider that the Consultation should have regard to the need for the annex to the

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

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Code of Practice (a draft of which was published in November 2013 in conjunction with the draft bail-in related amendments to the Act) to be finalised and to be fully aligned with both the primary and secondary legislation; industry should be consulted on the provisions of the Code of Practice.

We hope that you find our comments useful in your continuing deliberations on the implementation of bail-in. Please do not hesitate to contact either of the undersigned if we can provide further information about the derivatives market or other information that would assist HM Treasury in its work in relation to the effective resolution of financial institutions.

Yours faithfully

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Question 1: Do you agree that it is appropriate for members to lose control of a building society (i.e. a demutualisation) where a society enters resolution and the Bank of England considers use of the bail-in powers to be appropriate?

No comment.

Question 2: Do you agree with the proposed approaches for demutualising a failing building society?

No comment.

Question 3: Do you think that there are any circumstances where demutualisation would not be appropriate? If so, how could bail-in be made to work in these circumstances?

No comment.

Question 4: Do you think that any other modifications (beyond those included in the draft Order) are required to ensure that the successor bank can be bailed-in effectively?

No comment.

Question 5: Do you agree that it is desirable to allow the creation of a holding company structure for the successor bank?

No comment.

Question 6: Does any special provision need to be made to deal with building societies where members have agreements in place to assign any windfall benefits to charitable organisations?

No comment.

Question 7: Do you agree that early transposition of the BRRD is the best approach for aligning creditor hierarchies, and ensuring that the bail-in tool is effective?

We are concerned that early transposition of Article 108 of the BRRD[2] will create an uneven playing field with regard to those Member States that do not implement this aspect of the Directive until the 1 January 2015 deadline. Counterparties to financial contracts with UK credit institutions will therefore be disadvantaged, both in relation to their positions held with other EU credit institutions, and also in relation to any risk assessments undertaken prior to finalisation of the BRRD. Given that the provisions around depositor preference were not settled until late in the BRRD negotiation

[2] For the purposes of this response, we have referred to the text of the BRRD adopted by the European Parliament in its plenary session on 14 April 2014.

process, we consider that early transposition may not allow counterparties sufficient time to replace pre-existing positions, should they wish to do so.

Article 108 of the BRRD requires that: (a) "eligible deposits" and deposits of a similar nature which are held in a non-EEA branch rank above the claims of ordinary unsecured, non-preferred creditors and (b) "covered deposits" (including the deposit guarantee scheme when subrogated to such deposits) rank above those at (a). It is does not specify how either category (a) or (b) should rank relative to other preferred creditors, or floating charge holders. Transposition of the BRRD therefore requires a policy decision to be made by HM Treasury, and HM Treasury have not publicly disclosed the policy they propose to adopt.

Further, Schedule 6 of the Insolvency Act 1986 (**IA 86**) presently provides for only one category of preference. Article 108 of the BRRD implies that, in future, two or three separate categories will be required where the insolvent entity is a bank. In order to understand HM Treasury's intentions for transposition of depositor preference from the BRRD and how the various preferences will work in practice, it will be necessary to consider the proposed draft amendments to Schedule 6 of the IA86.

We consider that HM Treasury should enter into a public consultation on the precise form of legislation that it proposes to implement.

Question 8: Do you agree that the list of excluded liabilities provides sufficient protection for the holders of these liabilities, so that no further provision is necessary in this Order?

Whilst we believe that the list of excluded liabilities should provide sufficient protection to the relevant creditors and counterparties of the institution (or other entity) in resolution, in that excluded liabilities will not be bail-inable, we have some concerns around how this protection will operate in practice.

In particular, there is a question around the interpretation of "so far as it is secured" (section 48B(8)(b) of the Act), as used to describe the exclusion of secured liabilities. We understand that a secured liability will be an excluded liability to the extent that it is secured, and that any remaining 'excess' liability above the value of that security will be eligible for bail-in.[3] This will necessarily involve a valuation of the relevant security over the course of the 'resolution weekend'. At present, there are limited requirements and no guidance as to how and on what basis this valuation will be

[3] It is our understanding that the authorities will have discretion under the Banking Act 2009 to exclude certain liabilities from bail-in subject only to the requirement to report on any departure from the insolvency treatment principle under section 48E – the conditions for such discretionary exclusion set-out in Article 44 of the BRRD have not as yet been transposed in the UK law. We anticipate that there will be circumstances where difficulties around valuing security may cause the authorities to exclude the secured liability from bail-in in its entirety. It would be helpful if the authorities could provide clarity as to the circumstances when such an exclusion might be made, perhaps in the Code of Practice.

conducted. Consequently, the extent to which a liability will be excluded from bail-in cannot be estimated. In order to provide certainty for market participants, it would be helpful if HM Treasury, in conjunction with the Bank of England, could clarify the method of valuation it proposes to be used, in the Draft Safeguards Order or, at the very least, in the Code of Practice.

The manner in which a special bail-in provision is intended to be drafted so as to take account of these excluded liabilities also remains unclear. Under section 48B(4)(b) "a power to make special bail-in provision may not be exercised so as to affect any excluded liability", but the Act provides no further guidance as to how the exclusion will work in practice. It would be helpful if the government could clarify whether, for example, a bail-in order will explicitly specify any liabilities which are excluded from its scope or if section 48B simply operates so as to imply into any bail-in order that it will not take effect insofar as it purports to affect liabilities listed under section 48B(8).

Question 9: Do you agree with limiting the scope of this safeguard to those "protected liabilities" defined in the draft Order?

ISDA welcomes HM Treasury's approach, consistent with the BRRD, that derivatives may only be bailed-in on a net basis and also HM Treasury's view that "it is appropriate to require that all liabilities under certain other types of financial contract subject to set-off or netting may only be bailed-in on a net basis, together with certain master agreements."

We agree that the scope of the safeguard should be limited to "protected liabilities" and we interpret the provisions as being sufficiently wide to capture derivatives transactions documented under an ISDA master agreement. However, the provisions may not capture all arrangements that are subject to netting and set-off provisions, on which many financial counterparties are reliant for *inter alia* determination of regulatory capital requirements. Other stakeholders will be better placed to comment on these concerns.

There are also some aspects of the definition of "protected liabilities" that require clarification.

- Article 5(3) specifies when a "master agreement" will be a "qualifying" one for the purposes of the Order, but "master agreement" is not a defined term. This gives rise to potential uncertainty as to what might constitute a "qualifying master agreement".

- Article 5(1) defines a "derivative" by reference to Article 2(5) of Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories (**EMIR**). There is currently ongoing consultation on the definition of "derivative" provided for in EMIR, following comments made by ESMA as to differing interpretations across the EU.[4] This uncertainty as to the definition of a "derivative", which will subsist until clarity is provided at the EU level, will be carried across into the definition under the Draft Safeguards Order.

Further guidance as to how this safeguard is intended to work in practice would be helpful, again perhaps by way of amendment to the Code of Practice.

Question 10: Do you agree with the definition of "financial contracts"?

The definition of "financial contract" under Article 5(2) of the Draft Safeguards Order appears to have been adapted from the BRRD definition of a "financial contract". However, there are a number of differences between the two definitions. Guidance on HMT's intentions and reasoning behind these departures from the BRRD would be helpful to clarify the intended scope and functioning of the safeguard. It would also be helpful to understand whether HMT intends to amend this definition when it comes to transpose the BRRD.

In addition, we note that the definition of "derivative" under Article 5(1) and EMIR may include those contracts described at (c)(ii) and (d) of the Article 5(2) definition (being swaps and options on commodities and futures contracts), where such contracts are entered into for investment purposes. This is because the definition of a derivative contract under EMIR is drawn from the definition of financial instruments in Annex 1 of MiFID. A financial instrument will only be caught under MiFID where it does not satisfy the various tests for 'commercial purposes', as further described in the Regulated Activities Order. The definition of "financial contract" in the Draft Safeguards Order is therefore drafted in such a way as to 'sweep up' any contracts entered into for 'commercial purposes' (and which are not therefore caught as derivatives), and ensure these are still protected under the Draft Safeguards Order. This scope is certainly welcome. However, in order to avoid the risk of confusion, it would be helpful if HM Treasury could confirm that this was the intention of the drafting and provide further explanation regarding the scope of, and interaction between, these definitions in the Explanatory Note to the Draft Safeguards Order.

Question 11: Do you agree that the Order should prevent special bail-in provision being made in respect of a protected liability subject to set-off or netting?

Yes. It is essential that any bail-in measures are exercised in such a way as to uphold netting and set-off arrangements.

[4] See the European Commission's consultation document dated 10 April 2014, available at: http://ec.europa.eu/internal_market/consultations/2014/foreign-exchange/docs/consultation-document_en.pdf.

However, in relation to protected liabilities subject to set-off or netting, we have the following concerns:

(a) As currently drafted, Article 4(4) provides for what is effectively a mandatory close-out but does not specify the method which should be followed when valuing derivative liabilities. In order to promote certainty and consistency, we recommend that the Draft Safeguards Order be amended to provide clear, consistent valuation standards. We understand that the Bank of England is currently considering how this close-out provision should operate. For the avoidance of doubt, implementation of the bail-in stabilisation option in the absence of such guidance risks uncertainty and should be avoided.

(b) Whilst we support the inclusion of this mandatory close-out provision, the Code of Practice requires amendments to bring it in line with the Draft Safeguards Order. As currently drafted, the bail-in annex to the Code of Practice states that the Bank of England would "ordinarily" expect to close out derivatives before bail-in. This does not reflect the mandatory nature of close-out under the BRRD and the Draft Safeguards Order.

(c) More generally, in the interests of market certainty and thus financial stability, it is critical for the market to understand the circumstances in which the authorities are likely to seek to apply bail-in to the unsecured excess of a secured liability. Such clarity could be set out in the Code of Practice.

Question 12: Do you agree with the proposal to amend the regulations implementing FCAD in advance of the BRRD transposition deadline, and to amend the Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 to ensure consistency?

Yes, subject to our comments in response to questions 8 – 11 above.

The proposed amendments to the FCAD contemplated by Article 118 of the BRRD seek to ensure that the provisions of FCAD which require that:

- financial collateral arrangements will be enforceable,
- rights of use under security financial collateral arrangements will be exercisable,
- title transfer collateral arrangements will be recognised, and
- close-out netting provisions will take effect in accordance with their terms,

will not apply in the case of restrictions imposed by virtue of a resolution action taken in accordance with the BRRD. In particular:

(a) in light of Article 70 of BRRD, which provides the resolution authorities with the power to restrict enforcement of security interests for a period ending at midnight on the business day following the publication of notice of the resolution action, implementation of the BRRD will mean that a financial collateral arrangement may not take effect in accordance with its terms for such temporary period; and

(b) financial collateral arrangements, as a form of secured liability, will only be excluded from bail-in to the extent that the value of the collateral does not exceed the value of the security, thus allowing for some potential bail-in of the liability that forms part of the financial collateral arrangement.

However, the safeguards provided for under the BRRD will apply. Such safeguards include requirements for "appropriate protection" for *inter alia* title transfer collateral arrangements, security collateral arrangements and netting arrangements. Therefore, in effect, the protections provided by the FCAD are to be replaced by those provided for in the BRRD.

Carrying this analysis across into the UK context, it follows that the (very important) protections provided for under the Financial Collateral Arrangements (No 2) Regulations 2003 are to be effectively replaced with those provided for in, primarily, the existing Safeguards Order and the Bail-in Safeguards Order. It is recognised that in advance of the transposition of the BRRD, the Act does not allow for the temporary suspensions contemplated by Article 70 (or those in Articles 69 and 71 of the BRRD) and so the relevant impact of the amendments to the FCAD should only arise in the context of a bail-in. It is therefore essential that the Bail-in Safeguards Order provide for appropriate and comprehensive protections.

ISDA would appreciate the opportunity to comment on the proposed amendments to the Financial Collateral Arrangements (No 2) Regulations 2003 prior to the relevant statutory instrument being made or, if an affirmative procedure is required, being laid before Parliament.

Question 13: Do you consider the suggested remedy – that the Bank of England uses its powers in order to remedy the breach – is suitable?

The appropriate remedy depends on the nature of the relevant breach of the safeguard. An administrative remedy of the type proposed in the Consultation is not a sufficient or effective safeguard in relation to close-out netting. It potentially increases legal uncertainty in relation to a close-out netting arrangement potentially affected by bail-in. It requires an application to be made by the affected counterparty to the Bank of England. The Bank will then need to take time to consider whether a remedy is appropriate and, if so, what that remedy should be. Until a decision is reached by the Bank, the counterparty will be uncertain as to the outcome. The counterparty may not agree with the Bank's ultimate decision or may consider that the remedy is insufficient fully to remedy the breach.

This is why the remedy in article 11 of the 2009 Safeguards Order for a breach affecting close-out netting or set off is that the exercise of a partial property transfer does not affect the right to set off or net. Nothing less than that will, in our view, be sufficiently robust and sufficiently certain to meet, for example, the high standard of legal certainty required under the regulatory capital rules for the recognition of close-out netting.

In relation to other types of breach, the proposed administrative remedy may be sufficient, but the whole procedure needs to be efficient and transparent and there should be a robust and cost-effective procedure for review of such decisions by an independent arbiter, to avoid the need to have recourse to judicial review.

Question 14: Do you agree that the provisions relating to the assessment of the insolvency treatment should mirror, with the necessary differences, the existing provisions in the 2009 Regulations for partial property transfers?

We make no comment, save and except to note that the practical operation of the existing valuation provisions are somewhat opaque, and could benefit from some clarification, perhaps in the Code of Practice.

Question 15: Do you agree that the Regulations should allow the relevant compensation order to specify the value of relevant securities, or the methodology (or methodologies) for determining value of relevant securities, in order to determine the actual treatment of pre-resolution shareholders and creditors?

No comment.

Question 16: Do you agree that, for building societies which are demutualised as part of the bail-in, the relevant persons are the shareholding members and creditors of the building society before the demutualisation occurs?

No comment.

Question 17: Do you think that any additional provision is required to effectively apply the Regulations to building societies?

No comment.

Question 18: Do you agree, where a company in the same group as a bank subject to bail-in is subject to a resolution instrument at a later date than the resolution instrument in respect of the bank, the pre-resolution shareholders and creditors of the group company should be those who are shareholders and creditors at the time the resolution instrument in respect of the group company is made?

No comment.

Question 19: Do you consider that this approach could have any unintended consequences or cause problems for the resolution? If so, please give details of the risks and any suggestions on how to mitigate them.

No comment.

Question 20: Should covered bond vehicles and securitisation vehicles that are not "financial institutions" or "investment firms" be within the scope of the bail-in stabilisation option? Do you agree with the proposal to amend the regulations implementing FCAD in advance of the BRRD transposition deadline, and to amend the Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 to ensure consistency?

No comment.

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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, the Association has over 800 members from 64 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses 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.

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More information about ISDA is available from our website at http://www.isda.org, including a list of our members, the address of our head office in New York and other offices throughout the world and details of our various Committees and activities, in particular, our work in relation to financial law and regulatory reform.