ISDA Safe, Efficient Markets

BY EMAIL

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Dear Ms Andreicut,

ISDA responds to PRA Consultation Paper CP8/16 - The contractual recognition of bail-in: amendments to Prudential Regulation Authority rules (March 2016)

The International Swaps and Derivatives Association, Inc. (**ISDA**)[1] is grateful for the opportunity to provide feedback on the Prudential Regulation Authority (the **PRA**) consultation paper on the contractual recognition of bail-in: amendments to Prudential Regulation Authority rules published in March 2016 (the **Consultation**). ISDA's response is primarily focussed on the impact on derivatives markets.

ISDA wishes to provide feedback, in particular, in respect of the non-exhaustive list of examples of impracticability set out in the PRA's draft Supervisory Statement (as to which see further below).

Additionally, whilst ISDA broadly supports efforts for cross-border recognition of resolution action (including contractual recognition of bail-in), significant concerns remain with the terms of the Article 55 RTS adopted by the European Commission on 23 March 2016 (the **Article 55 RTS**) in respect of the impact on derivatives markets. We appreciate the limits of the PRA's mandate and understand that, whilst the PRA may be sympathetic to many of the concerns raised, the PRA has limited scope for interpretation when transposing such provisions into its rulebook. Nonetheless, given the significant client outreach issues, ISDA would also like to take this opportunity to reiterate its existing concerns in respect of the Article 55 RTS (which are necessarily reflected in the revised PRA rules).

More generally, we note that there does not appear to be consistent application (and, thus, a level playing field) across the EU in respect of how Article 55 of the EU Bank Recovery and Resolution Directive (the **BRRD**) is being interpreted by the relevant authorities in different EU jurisdictions in terms of which liabilities are within scope. Whilst it is acknowledged that the proposed amendments to the PRA rules, which disapply the contractual recognition of bail-in requirement in respect of liabilities where compliance is impracticable, are helpful, the feedback we have received from our members institutions indicates that the overall approach taken by the PRA in respect of the scope and application of the rules may nonetheless be more demanding than in other EU jurisdictions.

In addition, it is noted that the PRA states in the Consultation that it does not consider loss of competitiveness or profitability to be grounds for an impracticability judgment as this is not in line with the policy intent of the contractual recognition of bail-in rules. Whilst this approach appears to be reasonable

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

per se, ISDA is concerned that this policy may not be consistent across the EU. Thus, there appears to be a risk that entities within scope of the PRA rules could be at a competitive disadvantage to the extent that they are required to push for inclusion of such language in certain liabilities whereas their non-UK EU competitors (as well as their non-EU competitors) are not so required. Consequently, harmonisation of the contractual recognition of bail-in rules on a pan-EU basis is extremely desirable.

PRA'S DRAFT SUPERVISORY STATEMENT: NON-EXHAUSTIVE LIST OF EXAMPLES OF IMPRACTICABILITY

In general (subject to the caveats relating to consistent EU application detailed above), ISDA welcomes the non-exhaustive list of examples of where it may be impracticable to comply with the contractual recognition of bail-in requirement (set out in paragraph 2.2 of the draft Supervisory Statement) which it believes will help provide greater clarity and certainty on the rules for market participants.

However, ISDA is of the view that it would be helpful for the market, and would not detract from the purpose of the contractual recognition of bail-in requirement, if the PRA could consider extending the non-exhaustive list of examples of impracticability. In particular, it would be helpful if the PRA could consider the following for specific inclusion:

- **Low value contracts** - The inclusion of low value contracts or liabilities, perhaps below a *de minimis* value, in the list of examples set out in paragraph 2.2 of the draft Supervisory Statement. Such contracts will have little or no impact on resolvability and, thus, such an exclusion would be consistent with the PRA's approach to supervision (as set out in section 4 of the Consultation) where the PRA states that it aims to supervise and enforce in a "proportionate, judgement-based and risk-based manner" and that, together with the Bank of England, it will look to the impact of not including Article 55 wording on resolvability. It is difficult to see how such contracts would have any meaningful impact in the context of a resolution.

- **Contractual recognition of bail-in language not permitted or illegal** - The scope of the first two bullets in paragraph 2.2 of the draft Supervisory Statement is unclear. For example, it is unclear whether the reference to illegality means 'unenforceable' as a matter of the relevant (third country) governing law. We suggest that the bullet points are clarified/expanded upon to include circumstances

    (i) where it would be illegal for the regulated entity or its counterparty (as the case may be) to include the language in a particular liability or type of liability under any relevant law applicable to it (i.e. not just the law of the relevant third country);

    (ii) where a regulated entity or its counterparty (as the case may be) have been informed (regardless of whether or not in writing) by a regulator or other third country authority that they are not permitted (whether as a regulatory matter or otherwise) to include the relevant language in a particular liability or type of liability (i.e. regardless of the governing law of the liability); and

    (iii) where, as a matter of the governing law of the relevant liability, it would be unenforceable and/or inclusion of the relevant language in a particular liability or type of liability could affect the enforceability of the relevant liability (i.e. to confirm that unenforceability is intended to be addressed in addition to illegality).

- **Liabilities which will be WGMR compliant** – As discussed further below, if it is the intention that a WGMR compliant collateral arrangement causes the contractual recognition of bail-in requirement to fall away from September 2016 (or other relevant WGMR compliance date, as the case may be), the significant compliance burden created as a result of requiring the inclusion of the contractual recognition of bail-in requirement in those liabilities which will ultimately be subject to WGMR requirements (and, thus, will be out of scope of the contractual recognition of bail-in requirement within a few months) is disproportionate to the benefits of including contractual recognition of bail-in wording for such a limited period of time.

- **Liabilities to supranational entities** - Additional clarity could also be provided in relation to liabilities to supranational entities where a supranational entity is protected by international agreements with sovereigns and to which a BRRD firm is not a party. These international agreements may, for example, include provisions protecting the assets of a supranational entity from seizure by executive or legislative action. As such, it would be impracticable for a BRRD firm to comply with the requirement to include contractual recognition of bail-in language in any liability to such a supranational entity given that supranational entities may refuse to include such provision or may seek to amend the clause such that it does not apply to any privileges or immunities granted to them pursuant to international agreements or international law.

CONCERNS WITH THE ARTICLE 55 RTS

As outlined above, the PRA's technical amendments to the contractual recognition of bail-in rule to ensure consistency with the Article 55 RTS do not alleviate the areas of concern which are present in the Article 55 RTS themselves and which have been transposed into the PRA rules. In particular:

1. There is significant uncertainty relating to use of the secured liabilities exemption

Perhaps the most significant problem in the application of contractual recognition of bail-in to derivatives is the lack of clarity over the "secured liabilities" exclusion. Based on the Article 55 RTS, it is not clear which derivatives liabilities (if any) may benefit from an exclusion from the contractual recognition of bail-in requirement by virtue of the "secured liabilities" exemption.

The main problem with the formulation is the requirement that any collateralisation be "on a continuous basis in compliance with regulatory requirements". The proposed amendments to the PRA's rule consequently provide that the contractual recognition of bail-in requirement does not apply to contracts for a liability "*which, at the time it is created, is fully secured and governed by contractual terms that oblige the debtor to maintain the liability fully collateralised on a continuous basis in compliance with regulatory requirements of EU law or of the law of a third country achieving effects that can be deemed equivalent to EU law*". There are at least two potential readings:

(a) It is only possible to fall within the exclusion if the debtor is required to collateralise the contract on a continuous basis in accordance with regulatory requirements - if there are no applicable regulatory requirements, the contractual recognition of bail-in requirement applies, even if the contract is fully collateralised (for example, in accordance with an ISDA Credit Support Annex (**CSA**)) and/or even if the relevant "regulatory requirements" are not yet applicable (for example, WGMR collateral requirements). So effectively there is no safe harbour unless and until the "regulatory requirements" are effective; or

(b) It is possible to fall within the exclusion if the debtor is required to fully collateralise the contract on a continuous basis (for example, in accordance with an ISDA CSA) even if there is currently no applicable regulatory requirement, provided that if there is an applicable regulatory requirement in future, collateralisation must comply with such requirement at that time. So if there are no applicable regulatory requirements (including in the case where WGMR collateral requirements are not yet applicable), the contractual recognition of bail-in requirement does not apply if the contract is collateralised (for example, in accordance with an ISDA CSA) as long as it is fully collateralised.

Reading (b) is likely to provide the most comfort for derivatives contracts which are fully collateralised. However, the consensus view would appear to be that reading (a) (i.e. the more conservative approach) should be taken. This approach leads to unexpected issues in practice. For example, liabilities under in-scope securities financing transactions which would be regarded by the relevant counterparties as "fully collateralised" would not be within scope of the exemption. Additionally, derivatives liabilities that would typically be regarded by the relevant counterparties as "fully collateralised" may, until the WGMR requirements apply, be within scope of the contractual recognition of bail-in requirement (for example, liabilities under a New York law-governed ISDA Master Agreements incorporating a New York law-governed CSA). It will be difficult to negotiate the insertion of a bail-in clause in such arrangements.

It may also legitimately be asked (assuming a WGMR compliant collateral arrangement does cause the contractual recognition of bail-in requirement to fall away from September 2016 (or other relevant WGMR compliance date, as the case may be), which would presumably make sense from a policy point of view) if it is worth the significant effort required to insert a bail-in recognition clause for just a few months? Compliance efforts would be greatly assisted if the timing of the contractual recognition of bail-in requirement and the WGMR requirements were aligned.

Even when the WGMR requirements do apply, it is also unclear what "fully collateralised on a continuous basis" is intended to mean in a derivatives context. For example, whether thresholds, settlement timing and minimum transfer amounts would mean that a liability would not be regarded as being "fully collateralised" even if such thresholds, settlement timing and minimum transfer amounts were permitted under the relevant WGMR requirements. It would therefore be helpful if the PRA could confirm that WGMR compliant arrangements would satisfy the secured liabilities exclusion. In a WGMR context, the draft regulations explicitly allow for a minimum transfer amount and a threshold amount so it would be a strange result indeed if including these caused an arrangement to fall outside of the safe harbour. Also, the acceptable frequency of collateralisation under derivatives contracts is unclear.

2. There is uncertainty relating to treatment of client cleared derivatives liabilities

As the contractual recognition of bail-in requirement only applies to non-EEA law governed liabilities (thereby excluding most (if not all) contracts between EEA clearing members and EEA CCPs), it is more likely that the requirement will be of relevance to non-EEA CCPs (for example, CCPs established in the US or in Asian jurisdictions). Whilst, at least in a UK context, we have clarity that liabilities to non-EU FMIs (eg CCPs) fall in the category of liabilities which it would be impracticable to amend (the PRA has expressly referred to liabilities to non-EU FMIs in its Modification by Consent of Contractual Recognition of Bail-in rules (November 2015) and has included contractual terms imposed on firms by virtue of their membership of non-EU bodies in the non-exhaustive list of impracticable examples in the draft Supervisory Statement), the position in respect of client cleared derivatives liabilities is unclear even though, typically, the collateral arrangements between a client and clearing member match the collateral arrangements between the clearing member and the CCP.

Not being able to rely on impracticability, however, in a client cleared context, the parties would need to seek to rely on the secured liabilities exclusion. However, it is unclear whether the secured liabilities exemption could be relied upon in the client cleared context (or indeed in a clearing member/CCP context) because it is less obvious that the collateralisation is "in compliance with regulatory requirements".

3. The scope of liabilities subject to the contractual recognition of bail-in requirement is very broad and lacks clarity

The term "liability" is not defined in the BRRD. However, the PRA has sought to define this term. Due to the broad definition of "liability" in the PRA rules which may extend to non-monetary/contingent obligations, there is also scope for mismatch of application in this regard vis-à-vis other members states who may have taken a narrower approach to interpretation.

We hope that you find our comments useful in your continuing deliberations. Please do not hesitate to contact the undersigned if we can provide further information about the derivatives market or other information that would assist the PRA in its work in relation to the effective implementation of the contractual recognition of bail-in requirements.

Yours sincerely

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ISDA

Annex 1

ABOUT ISDA

Since 1985, the International Swaps and Derivatives Association has worked to make the global derivatives markets safer and more 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 850 member institutions from 67 countries. These members comprise of a broad range of 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, such as exchanges, intermediaries, clearing houses 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.

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Our registration number in the relevant EU register is 46643241096-93.

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.