ISDA®

International Swaps and Derivatives Association, Inc.
One Bishops Square
London E1 6AD
United Kingdom
Telephone: 44 (20) 3088 3550
Facsimile: 44 (20) 3088 3555
email: isdaeurope@isda.org
website: www.isda.org

BY E-MAIL

European Commission
Directorate-General Internal Market and Services
B - 1049 Bruxelles/Brussel
Belgium

E-mail: markt-h1-crisismanagement@ec.europa.eu

20 January 2010

Ladies and Gentlemen

Commission Communication on Cross-Border Crisis Management in the Banking Sector

The International Swaps and Derivatives Association (**ISDA**)[1] is grateful for the invitation to comment on the Commission's Communication "An EU Framework for Cross-Border Crisis Management in the Banking Sector" issued on 20 October 2009. The issues considered in the Consultation Document are of great importance to the financial markets in general and the privately negotiated or over-the-counter (**OTC**) derivatives markets in particular. Our comments below take into account the documents accompanying the Communication, in particular, the Commission Staff Working Document (SEC(2009) 1407) and the Impact Assessment (SEC(2009) 1389) (the Communication, together with the other documents, being referred to below as the **Consultation Documents**).

We note that the Consultation Documents encompass the Commission's report following its consultation in 2007 on Directive 2001/24/EC of 4 April 2001 on the reorganisation and winding-up of credit institutions (**WUDCI**), to which we responded by our letter to the Commission dated 28 September 2007.[2]

[1] 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 840 member institutions from 58 countries on six continents. More than half of ISDA members are based in the European Union and neighbouring countries and most of the other members are 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.

[2] A copy of this letter is available on the ISDA website at http://www.isda.org/speeches/pdf/EU_WUD_ISDAResponse_28Sep07.pdf

Since the recent financial crisis began, ISDA has followed closely national, regional and international efforts to address the legal framework for resolution of financial institutions. For example, we were closely involved in the consultative process leading to the introduction of the Banking Act 2009 in the United Kingdom and the related secondary legislation designed to protect close-out netting, set-off, security and title transfer collateral arrangements and financial market infrastructure.[3] ISDA is represented on the Banking Liaison Panel, a statutory body established under the Banking Act 2009 to advise the UK Treasury on the impact of the legislation on the financial markets.

As you know, through informal contacts with the Commission over the past few months, we have expressed an interest in your work leading to the Consultation Documents, and we have informally shared with you the views of our members on the aspects directly touching the derivatives markets. We have also recently responded to the consultation by the Basel Committee on Banking Supervision (**BCBS**) on the Report and Recommendations of the Cross-border Bank Resolution Group, much of which strongly overlaps with issues and analysis in the Consultation Document.[4] We understand, of course, the need for the European Union to frame its own regime for the effective cross-border resolution of banks, with regard to the particularities of the constitution of the European Union and the nature and structure of the European single market, but we strongly urge that, as far as possible, the EU work in this area should be coordinated with the international work on these issues of the BCBS, the Financial Stability Board and the G20.

ISDA continues to monitor national legislative initiatives on resolution of banks, investment firms and other financial institutions in various countries around the world. And, of course, ISDA has a long familiarity with the existing resolution regimes in a number of leading jurisdictions, most notably the FDIC regime in the United States.

In light of this, ISDA strongly welcomes the Commission's work on these issues and supports most of the broad objectives expressed in the Consultation Documents, as discussed further below. Recent events have shown that this is necessary and important work, and we stand ready to assist in relation to the aspects of this work with potential impact on the derivatives markets.

We particularly welcome the acknowledgement at various points in the Consultation Documents of the importance of protecting current risk mitigation techniques such as netting, set-off, title transfer collateral arrangements, security arrangements and related financial market infrastructure such as clearing and settlement systems. This is critical to financial stability. We also welcome the acknowledgement that property rights must continue to be respected notwithstanding expanded governmental powers to effect a bank resolution and the aim of ensuring as far as possible that no creditor is worse off under any future cross-border resolution regime.

At the heart of all of the initiatives that we have followed and are following, including the proposals set out in the Consultation Documents, is the tension between the need to give

---

[3] ISDA was heavily involved in the consultative process, run through the Banking Liaison Panel, that led to a considerable strengthening of the protective secondary legislation in July 2009, the Banking Act 2009 having itself come into effect in February 2009.

[4] Our response letter dated 31 December 2009 to the BCBS is available on our website at: http://www.isda.org/speeches/pdf/BCBS-CBRG-ISDA-response.pdf

sufficient powers and flexibility to the authorities to ensure the effectiveness of any resolution, which will normally occur under severe time constraints, and the need to protect the rights and legitimate expectations of financial market participants by, among other things, protecting legal certainty and respecting private law contractual and property rights.

We note, as the Communication itself acknowledges, that various points of principle must be commonly agreed before concrete proposals can be made. Our experience shows, not surprisingly, that quite difficult problems can arise in the detailed implementation of a new resolution regime even where the broad principle is agreed.[5]

As we are primarily concerned with a sector of the financial markets, namely, the OTC derivatives market, rather than with financial institutions in all of their aspects and markets, we defer to other international trade associations concerned more generally with the whole of a financial institution's business to comment in detail on a number of issues in the report, in particular group resolution and insolvency arrangements, restoration and resolution planning (for example, in the form of so-called "living wills"), intra-group asset transfers, bank shareholder rights and financing of a cross-border resolution. We touch on some of these issues below, but we refer you to responses we anticipate you will be receiving from other European and international trade associations for more detailed consideration of those issues, in particular the response that we anticipate you will be receiving from the Association for Financial Markets in Europe (AFME) and from the Institute of International Finance (IIF). There is a strong overlap between ISDA's membership and the membership of these associations, and their responses (of which we have seen drafts) will therefore undoubtedly have the support of our members on the broader issues.

In light of our mission as the global trade association for the OTC derivatives markets, our principal areas of concern regarding the proposals in the Consultation Documents are the need to:

- ensure adequate safeguards in relation to any resolution powers granted to governmental or judicial authorities (in particular, any partial property transfer power) in relation to netting, set-off, title transfer collateral arrangements, security arrangements and clearing and settlement systems

- ensure adequate safeguards in relation to any powers to ensure continuity of the operations of a troubled financial institution, in particular strictly limiting in time and effect any suspension of the right to terminate transactions to facilitate a business transfer

- resolve existing issues of uncertainty regarding the interpretation of certain provisions of the WUDCI relating to financial contracts, set-off and netting and inconsistencies between the provisions of the WUDCI and other European instruments affecting the financial markets

- strengthen close-out netting in the European financial markets by an appropriate legislative measure to promote convergence of the European legal framework for

[5] This was illustrated, for example, by the technical issues arising under the first version of the protective secondary legislation referred to in footnote 3 above.

close-out netting on a set of common principles, as proposed to the Commission jointly ISDA and the European Financial Markets Lawyers Group by our letter dated 14 April 2008.[6]

Although we focus on the areas above, we touch in passing on the broader issues where appropriate.

1. Scope of the proposals

The need for incremental reform

The Communication sets out a number of potential lines of law reform in relation to cross-border resolution. Some of these are expressly framed as alternatives, and it will be necessary at a further choice for Member States to decide which approach to take. Some of the proposed lines of reform are highly ambitious (for example, introducing a European procedure for cross-border resolution of a group and harmonisation of insolvency regimes), while other proposals are less ambitious and possibly, also, less problematic. Some of those lesser proposals, some of which we discuss further below, are worthy of consideration and implementation in the near term. We urge the Commission when formulating more detailed proposals in the months ahead to consider planning for incremental reform to ensure that beneficial change is not held up by the debate on the broader more sweeping changes to company and insolvency law offered by the Commission for consideration.

Specifically, in relation to the discussion of cross-border resolution of a group, we note that the Commission refers in the Consultation Documents to the work of UNCITRAL in relation to the insolvency treatment of corporate groups, although that work does not, as far as we are aware, address the special characteristics and systemic importance of financial institutions.

Investment firms and other non-bank financial institutions

We note that the Communication and other Consultation Documents make clear that the principal focus of the current consultation is on deposit-taking banks. The Consultation Documents do, however, raise the question (for example, in paragraph 4.5 of the Communication) as to whether a harmonised EU resolution framework should also extend to investment firms[7] and possibly to insurers.

We note the Commission's observation that the risks raised by the failure of a deposit-taking bank are different in kind from the risks raised by the failure of an investment firm, although the magnitude of the impact on the financial markets depends on the specific case. Depositor protection will be a core objective, of course, in relation to the deposit-taking banks, while protection and rapid return of client assets will be a key aspect of the resolution of an investment firm.

---

[6] A copy of this letter is available on our website at: http://www.isda.org/speeches/pdf/ISDA_EFMLG_Netting_Directive.pdf

[7] We use the term "investment firm" in preference to "investment bank", given that the former term is broader than the latter, as it is commonly understood in the market.

Nonetheless, partly for the reason mentioned by the Commission itself, namely, that many bank groups (in particular, the largest and most systemically important) include investment businesses, we urge the Commission to expand the scope of its work to include the issues raised by the failure of an investment firm, thrown into such dramatic relief by the collapse of Lehman Brothers. We acknowledge and agree that an appropriate set of resolution tools for a deposit-taking bank will not be the same as an appropriate set of resolution tools for an investment firm, but the regimes need to be considered together and need to be, as far as possible, compatible.

One of the points we made in our response letter to the Commission's WUDCI consultation in 2007[8] was that there is a gap in current European legislation, with investment firms and collective investment undertakings falling outside the existing European measures for cross-border recognition of and mutual support for restructuring and insolvency proceedings, such as the WUDCI, Directive 2001/17/EC of 19 March 2001 on the reorganisation and winding-up of insurance undertakings (**WUDIU**) and Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings (the **Insolvency Regulation**) for companies. We believe that the opportunity should be taken to address this and put in place an appropriate regime, tailored to investment firms, to achieve the objectives of mutual recognition and enhanced cross-border cooperation as for banks under WUDCI, insurance companies under WUDIU and companies under the Insolvency Regulation.

Regarding whether insurance companies should be within scope of the Commission's work on cross-border resolution, we leave it to others to comment in detail, but we are not aware of there being a compelling case for their inclusion.

We note that the recent BCBS consultation, to which we referred above,[9] includes investment firms as well as banks, but not insurance companies.

2. Asset transfers

The proposals in the Consultation Documents in relation to intra-group transfers are part of the larger agenda regarding resolution of bank groups and necessary corollary of an agreement among Member States on burden-sharing. Others will comment in more detail on the larger agenda, but we note regarding asset transfers that the Commission has acknowledged the difficult issues this proposal would raise under current corporate and insolvency law principles. Any eventual measures in this regard would need to safeguard existing netting and set-off arrangements as well as protect the integrity of title transfer and security financial collateral arrangements, ensuring that collateral assets are not divorced from the liabilities that they secure or otherwise support.

3. Objectives of a bank resolution regime

We support the formulation of a European framework for bank resolution based on agreed and common objectives. We would urge the Commission to promote

---

[8] See footnote 6 above and the related text.

[9] See text to which footnote 4 above relates.

convergence on common objectives even in the context of current single-entity resolution regimes as well as convergence of national frameworks, as this will enhance predictability and help to promote a level playing field for banks within the European financial market. We also strongly support enhanced cooperation and information-sharing between governmental, regulatory and judicial authorities in the context of the resolution of a financial firm with cross-border activities.

4. Early intervention and resolution powers

Early intervention measures

ISDA would support the promotion of common measures for early intervention in relation to a troubled financial institution prior to the institution of a formal resolution procedure. This is subject to the caveat that the conditions under which early intervention may occur as well as the aims and potential outcomes of any such early intervention are sufficiently clear, while preserving an appropriate degree of flexibility and discretion for the relevant authority to deal with specific and potentially fast-developing cases.

Resolution powers

Similarly, ISDA would support the development of a common set of formal resolution powers for use by national authorities across the EU, although this would inevitably require a degree of convergence of the background law, particularly insolvency law, which could controversial, as it has in the past in relation to European financial law reform efforts. The Consultation Documents outline the sorts of powers that are likely to be required and, among these, highlight the importance of a partial property transfer power, for example, to allow profitable parts of the business of a troubled bank to be saved, to create, where appropriate, a "good bank" and insulate it from a "bad bank" and so on. The existence of a partial property transfer power, however, particularly needs to be subject to appropriate safeguards for certain classes of financial contract, as discussed further below.

Foreign property and the location of intangible assets

One advantage of coordinated action at the EU level on financial firm resolution is the ability to deal, at least within the EU, with the otherwise potentially difficult issue of foreign property, including foreign rights and liabilities and foreign law governed contracts. By "foreign" in this context, we simply mean property, rights, liabilities and contracts that are not located in or otherwise governed by the law applicable to the resolution of the financial firm. A question that has arisen in the past in relation to national resolution regimes is whether a court in country A would recognise the effect of a statutory transfer under the laws of country B in relation to property situated in country A or otherwise subject to the laws of country A.

Outside the context of a universal succession, many jurisdictions, perhaps most, will not recognise the effect of a statutory transfer under a foreign law of a piece of property or right or liability governed by local law. In fact, it is right and proper that local law

property, rights and liabilities should, as a matter of general principle, be protected from the effect of mandatory transfers under foreign laws. If that were not the case, certainty and security of tenure of property and maintenance of contractual rights would be seriously undermined. International convergence on agreed principles would allow carefully crafted national exceptions to be created that did recognise statutory transfers of local property, rights and liabilities under a foreign law in connection with a financial firm resolution.

While any EU proposals would clearly provide for mutual recognition between Member States of transfers of local property occurring under the law of another Member State. But the EU should also bear in mind the international dimension, and we therefore urge the EU to remain committed to international law reform efforts that will help to promote mutual recognition of resolution powers.

Of course, the foregoing raises the potentially difficult issue of determining what law governs property in intangible form, which is the case for the vast majority of financial assets, particularly those traded in the financial markets. In this regard, we note that the Hague Securities Convention, which has yet to come into force, deals directly with the legal aspect of this issue in relation to intermediated securities, namely, what law governs, very broadly speaking, the proprietary effect of the holding or transfer of intermediated securities.

Accordingly, we once again urge the EU and its Member States to renew their consideration of the Hague Securities Convention with a view to its being brought into effect as soon as possible and, of course, with as wide a scope as possible in terms of adherent countries.

We similarly recommend, in relation to the recently signed Geneva Securities Convention produced under the auspices of UNIDROIT, which deals with the substantive law aspects of intermediated securities, that the Geneva Securities Convention be swiftly ratified or otherwise formally approved by the EU and each of its Member States, so that it can be brought into effect as soon as possible. The strengthening and convergence at regional and international levels of the private international law and substantive law aspects of intangible financial assets will enhance the effectiveness of any national or EU cross-border resolution regime.

Safeguards for close-out netting, set-off, financial collateral and related infrastructure

Any triggers for early intervention and the conditions for entry into a formal resolution procedure should be clear and, as far as possible, predictable. The exercise of any early intervention powers or any resolution powers should be, as far as possible, clearly defined, and no broader than necessary. Finally, and most importantly, such exercise should be subject to appropriate safeguards for close-out netting, set-off, title transfer collateral and security arrangements and for financial market infrastructure. We commend the Commission for recognising the importance of the systemic importance of ensuring that such credit risk mitigation techniques and related financial arrangements and infrastructure, including clearing and settlement systems, are protected from

disruption by the exercise of early intervention or resolution powers, in particular, any partial property transfer power. This is a crucial point and essential to maintaining financial stability, moderating the cost of credit and maximising the efficiency of the financial markets.

Continuity powers and limitation of early termination rights

Regarding the suggestion in the Consultation Documents that the authorities should, in the context of the resolution of a financial firm, have the ability to impose a brief delay on the exercise of early termination and netting rights in certain circumstances, we understand the reason for the proposal and accept that this is justifiable on systemic grounds, subject to certainly conditions, namely, that:

- the ability of the authorities to override early termination rights is strictly limited in time (ideally for a period not exceeding 48 hours)

- the relevant master agreement and all transactions under it are transferred to an eligible transferee as a whole or not at all (there is no possibility of "cherry-picking" of transactions or parts of transactions)

- 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

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

- 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 provisions complying with the above conditions currently apply in the US in relation to the resolution regime administered by the FDIC. We also note that the existence of this limited power of the resolution authority to suspend early termination and close-out netting has not prevented supervised institutions from obtaining legal opinions in relation to US banks subject to the FDIC regime that are sufficiently robust to comply with current requirements for recognition of close-out netting for regulatory capital purposes. But we stress that any regime implementing such a power must clearly limit the power if the necessary legal certainty is to be maintained.

'Living wills'

Regarding the requirement that firms prepare firm-specific contingency and resolution plans, there has, of course, been much discussion of this topic over the past few months. This is not specifically a derivatives issue, but we can see the value of firms preparing "business information packs" to ensure that a resolution authority or insolvency official has immediately available key information to allow it to exercise its powers, take control of the business of the financial institution and deal with employees, shareholders,

creditors and other stakeholders. Of course, the related requirements need to be proportionate and practical and ensure the confidentiality of the information collected. The information needs to be capable of being gathered and updated without an undue burden on the resources of the firm. Beyond the question of such business information packs, we believe that considerably more analysis and discussion are required before the case for such resolution plans can be said to have been established.

5. Public consultation on the WUDCI

We note that Annex IV to Consultation Document SEC(2009) 1389 (Impact Assessment) is intended to summarise the responses received by the Commission in relation to its consultation in 2007 on the WUDCI. Although the summary refers, in passing, under the heading "Problems, ambiguities in the current text" to our comment in our response letter of 28 September 2007 (and discussed above in this letter) regarding the gap in the legislative framework for investment firms and collective investment undertakings, it does not mention our concerns regarding interpretation of Articles 23, 24, 25 and 26 of WUDCI, which are the provisions of most immediate concern to the derivatives markets. In that regard, we think it is probably most useful simply to reproduce the relevant portion of our response to the 2007 consultation:

> "A couple of questions which arise, for example, regularly in discussions of Article 25 of the Directive are the precise scope of the definition of "netting agreement" and the proper interpretation of the reference to the "law of the contract". In the latter case, there is some debate as to whether what is intended is the insolvency law of the jurisdiction whose law is applicable to the netting agreement (which in most cases would be the law expressly chosen by the parties to govern the netting agreement, but might in some circumstances be the law applicable under Article 4 of the Rome Convention of 1980 on the law applicable to contractual obligations in the absence of choice), or whether it is the general law of that jurisdiction including its law of contract and its law of insolvency and other relevant laws, or whether it is the general law of that jurisdiction excluding its insolvency law, or whether it is merely its law of contract, excluding other areas of general law applicable prior to insolvency and its insolvency.
>
> The foregoing debate regarding the scope of the term "law of the contract" appears to be more active in some EU member states than others, and this may be partly due to differences in the different official language versions of the Directive.
>
> We also agree that the provisions of Articles 23, 24, 25 and 26 of the Directive do not appear to cohere with the treatment of these and related issues in other European instruments, most notably the Insolvency Regulation, Directive 2001/17/EC on the reorganisation and winding up of insurance undertakings and Directive 2002/47/EC on financial collateral arrangements (the **Collateral Directive**). We have raised this point previously with the Commission, and we are aware that others have as well, including the European Financial Markets Lawyers Group, which produced a fairly extensive study of the treatment of the concepts of "set-off" and "netting" in the various official language versions of a number of European instruments a couple of years ago.
>
> In various prior communications and meetings with the Commission, we have urged the Commission to consider developing and proposing a European instrument on contractual

> netting, to establish a set of base principles comparable to the set of base principles established by the Collateral Directive, which have proved so successful in converging, simplifying and therefore strengthening the legal framework for financial collateral across the Community. In connection with this, we have suggested that the treatment of the concepts of close-out netting and set-off should be made consistent where they apply across the *acquis communautaire*."

In relation to the last point made in the excerpt above, we subsequently made a formal proposal to the Commission jointly with the European Financial Markets Lawyers Group, in our letter to the Commission of 14 April 2008, as previously mentioned in this letter.

What is good for the EU financial markets is also good for the global financial markets. We have therefore also made a proposal to UNIDROIT to consider the framing of an international convention, complementary to the recent Geneva Securities Convention (which includes an optional Chapter on financial collateral arrangements and an Article strengthening rights of set-off in relation to intermediated securities), to establish general principles for close-out netting and related collateral arrangements. We note that the Governing Council of UNIDROIT is currently actively considering this proposal, which could help to extend the benefits of close-out netting and collateral arrangements to, among others, emerging market jurisdictions, which would be beneficial for European firms dealing with firms organised in those jurisdictions. Obviously, we would urge there to be a close coordination of the EU and UNIDROIT projects in relation to close-out netting.

We would be pleased to meet with you to continue our discussions with you regarding the issues arising out of the Consultation Documents. We look forward to receiving and will study with close attention any more detailed proposals that emerge as a result of this consultation. In the meantime, please do not hesitate to contact either of the undersigned if we can be of assistance in relation to these issues.

Yours faithfully

Dr Peter M Werner
Senior Director
pwerner@isda.org

Edward Murray
Chairman
ISDA Financial Law Reform Committee
ed.murray@allenovery.com