ISDA Safe, Efficient Markets

BY E-MAIL

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Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
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Per e-mail to: fsb@bis.org

Ladies and Gentlemen

Assessment Methodology for the Key Attributes of Effective Resolution Regimes

The International Swaps and Derivatives Association, Inc. (**ISDA**) is grateful for the opportunity to respond to the consultative document (the **Consultative Document**) of the Financial Stability Board (**FSB**) on a proposed methodology for assessing the implementation of the Key Attributes of Effective Resolution Regimes for Financial Institutions (the **Key Attributes**), which were published in October 2011. We set out in Annex 1 to this letter information regarding ISDA, our members and our activities.

We have been pleased to contribute from an early stage to your work on standards for effective resolution, both informally and formally, as for example in our letter to you dated 1 September 2011 on your consultative document of 19 July 2011. We fully support the Key Attributes, and we have made regular reference to them in our on-going dialogue with national and regional authorities in relation to financial institution resolution. We welcome the development of a proposed methodology for assessing implementation of the Key Attributes, as we believe it is highly important, for a variety of reasons, that there be consistency of rules and standards for financial institution resolution globally. These reasons include promoting a level playing field internationally and enhancing legal certainty, and therefore market stability, through common, and therefore commonly understood, rules and standards.

At the same time, we recognise that implementation of the Key Attributes requires careful calibration of common rules and standards to the specific characteristics of individual jurisdictions and the financial markets operating there. We note that the Consultative Document provides for this. We agree that the most important preconditions for the effectiveness of resolution regimes are those set out in part VI of the Consultative Document.

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Given our mission as the global trade association for the over-the-counter derivatives markets, we focus in this letter on question 3 of the Questions for Consultation on page 3 of the Consultative Document, given its direct relevance to the netting and collateral arrangements that lie at the heart of credit risk mitigation in the derivatives markets.

We believe that other international financial market associations will be responding to the Consultative Document, including the other questions, which affect financial institutions and financial markets more globally.

Before turning to Question 3, we note in passing the helpful definitions set out in part I of the Consultative Document. Two definitions of immediate relevance to our concerns are "early termination rights" and "financial contract", each of which seems to us correct (including the footnote to the definition of "early termination rights") and sufficiently comprehensive. "Legal framework" is another critical definition for our purposes (in particular in relation to the consideration of KA4 in the Consultative Document), which also seems correct and sufficiently comprehensive.

Question 3 of the Consultative Document includes four related questions. Our responses are as follows:

(1) *Does KA4 regarding set-off, netting, collateralisation and the segregation of assets require additional explanation or interpretation?*

This is a difficult question to answer out of context. Some potential readers of the Key Attributes might benefit from additional explanation or interpretation of what are basic and well-known concepts not only in the derivatives markets but also in the financial markets generally. It should certainly be the case that those officials charged with carrying out assessments of individual jurisdictions using the proposed assessment methodology understand these concepts, and have recourse to appropriate expertise where assistance is required in relation to specific cases or unusual circumstances. We would be happy to be consulted where appropriate to provide further information that may be of assistance to such officials or to officials of the jurisdiction being assessed. We do not, however, see the need for further elaboration of the concepts in the assessment methodology.

(2) *What should be the appropriate length of the temporary stay of early termination rights provided for in KA 4.3?*

We strongly support KA4 of the Key Attributes 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. We believe that it provides valuable guidance and an appropriate benchmark for the implementation of an effective resolution regime that does not undermine legal certainty or financial stability. There is clearly a balance to be struck between ensuring sufficient flexibility for resolution authorities to carry out and achieve the aims of resolution and providing appropriate protection for credit risk mitigation techniques that are fundamental to systemic risk reduction.

We are therefore somewhat surprised that the question of the length of the stay, which is a key point of principle, has been raised in the context of a consultation on assessment methodology for implementation of the Key Attributes. This should be a settled point. It is fundamental that any stay be strictly limited in time. In our letter of 1 September 2011 to the FSB, we had urged that it be no more than 24 hours. The Key Attributes document does not mandate a specific period, but it suggests that the stay should be no more than two business days.

In our view the stay should not exceed two business days. Anything longer would create unacceptable market uncertainty and therefore risk and instability. It would be extremely difficult for market participants properly to manage the market risks of their positions not knowing whether they were to be transferred to a creditworthy new entity (for example, a bridge bank or private sector purchaser) or left with an insolvent residual entity.

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.

We also note that KA 4.2 provides that, subject to adequate safeguards, entry into resolution and the exercise of a resolution power should not trigger early termination or similar rights, provided that institution in resolution continues to perform its substantive obligations. This is not time-limited and provides adequate assurance to resolution authorities that the entry of the firm into resolution will not <u>of itself</u> lead to a mass close-out against the firm in resolution.

In fact, it would not normally be in the interest of market participants to close out immediately against a firm that has just entered resolution if there is a reasonable chance that the positions will be transferred to a healthy entity. But if that is to happen, it is essential to maintaining market confidence that the decision be taken swiftly, hence the need for a strictly limited short time period for a general suspension of early termination rights of counterparties to the firm in resolution.

In case it is helpful by way of background and to provide additional detail, we have reproduced in Annex 2 to this letter, the section of our letter to you of 1 September 2011 that dealt with these issues.

(3) *Should authorities have the power to extend the temporary stay?*

For the reasons we have given above, we believe that it is neither necessary nor desirable for resolution authorities to have the power to extend the temporary stay. Any extension of the temporary stay beyond one or two business days, particularly if it is accompanied by any doubt as to the duration of the extension, would raise serious doubt as to whether a close-out netting or collateral arrangement with a firm in a jurisdiction with such a resolution regime would be capable of satisfying the high standard of legal certainty necessary under the Basel Capital Accord for the recognition of such arrangements for purposes of determining regulatory capital requirements. If, as a result, the jurisdiction did not satisfy the legal certainty standard, there would be a significant impact on the access of supervised firms in that jurisdiction to credit, and on the cost of that credit, for wholesale financial market transactions due to the increased cost of capital for institutions dealing with those firms.

(4) *If so, what additional conditions or safeguards should apply?*

If, despite our views, a resolution authority were given the power to extend the temporary stay, it is critical that the resolution authority guarantees the full and timely performance of all substantive obligations of the firm in resolution during the period of the temporary stay. It is also critical that the extension be for a short and clearly defined period announced in advance and that the power only be exercised once.

We hope that the above responses are of some assistance. We look forward to our continuing dialogue with you and remain at your disposal for any further information or assistance we can provide regarding the issues above or any other matter relating to cross-border resolution of financial institutions or, indeed, anything else potentially affecting the global derivatives markets.

Yours faithfully

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ISDA®

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 60 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.

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, including our work in relation to financial law and regulatory reform.

Annex 2

Excerpt from letter dated 1 September 2011 from ISDA to the FSB responding to the Consultative Document "Effective resolution of systemically important financial institutions"

Temporary stay of contractual early termination rights

On pages 21-22 of the Consultative Document there is a brief introduction to the proposal that a resolution regime should allow for a brief suspension of contractual early termination rights "pending the use of resolution tools", as well as various questions for public consultation. Reference is made to a discussion note setting out the issues and various proposals and related considerations in Annex 8 to the Consultation Document.

One preliminary point we would make is that it is not necessarily currently the case that entry into a resolution regime would, of itself, currently 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 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 SIFI to terminate transactions early as a result of the triggering of the resolution regime against the SIFI. 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, as the Consultative Document invites us to do in paragraph 5.1 of Annex 1, the necessity to protect the enforceability of close-out netting) be permitted to consider its exposure to the failing SIFI 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 SIFI 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.

We note that the foregoing points are acknowledged in paragraph 4 of Annex 8, and we expand upon them above principally to underline their importance and to reinforce your conclusions in this regard.

We should note that a significant number of financial market participants, including a number of our members, oppose any suspension of early termination rights and believe that a suspension even for a limited period of 24 hours would create unacceptable market uncertainty. Those financial market participants are not convinced that the case has been made for depriving market participants of flexibility, particularly given the strong incentive that most market participants will have to preserve value and continuity by not exercising early termination rights where there is a good chance that the failing SIFI will be replaced by a stronger counterparty (the argument being that there is no need, given this “carrot”, of the “stick” in the form of the temporary stay).

Nonetheless, we also note that there is considerable momentum behind this idea, partly inspired by the inclusion of a 24-hour suspension period in the US FDIC regime (and, more recently, in the Dodd-Frank Act in the provisions relating to the Orderly Liquidation Authority). This proposal was also included as Recommendation 9 of the Report and Recommendations of the Cross border Bank Resolution Group of the Basel Committee on Banking Supervision, published in March 2010, and has been raised by the European Commission in the context of its own consultations on financial firm resolution.[3]

Accordingly, if such a power to suspend early termination rights is to be included in an agreed international framework for financial firm resolution, we believe that it must be made subject to certain conditions, namely that:

- the ability of the resolution authority to suspend early termination rights is strictly limited in time (ideally for a period not exceeding 24 hours)

- where the relevant contract permits a counterparty to the SIFI 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

[3] See, for example, the European Commission DG Internal Market and Services Working Document on “Technical details of a possible EU framework for bank recovery and resolution” (January 2011). Our reply to this consultation is available on the ISDA website at: http://www.isda.org.

(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 SIFI in the case of any default by the SIFI 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

- 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 5 of Annex 8 to the Consultative Document.

In relation to the third 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 third bullet point that under the US regime the US resolution authority, the FDIC, must transfer <u>all</u> "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.

While there are clearly advantages to the US approach both in terms of certainty and in terms of maximizing available set-off rights (subject to some uncertainty about the full enforceability of cross-affiliate set-off), that approach would also appear to restrict the flexibility of the authorities in relation to the restructuring of the failing firm's business.

In the case of the Scottish building society, Dunfermline Building Society (**DBS**), which went into resolution in March 2009, some parts of the business and operations of DBS were transferred to Nationwide Building Society, other parts were transferred to a bridge entity and other parts were left in the residual entity. A resolution that contemplates more than one transferee as part of the restructuring of the business will, at least to some extent, be hampered by a requirement that all (or none of the) relevant financial contracts must go to a single transferee.

Accordingly, we believe that the full scope of any statutory transfer of relevant financial contracts under a resolution regime should be the subject of further study and consultation with industry in order to determine the proper scope and balance of flexibility versus certainty.

On the positive side, 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. But we stress that any regime implementing such a power must clearly limit the power if the necessary legal certainty is to be maintained.

The Consultative Document also suggests in paragraph 5(viii) of Annex 8 that "safe and orderly operations" of certain classes of counterparty, specifically, regulated exchanges~~,~~ central clearing counterparties (CCPs) and other financial market infrastructures (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. It may well not be necessary to exempt such entities from the effect of the stay, but, as noted, this requires further study and debate.

Regarding whether the temporary stay should be discretionary or automatic in its operation, we have no particularly strong view at present. The principal point is that it should be clear and certain in its operation. The advantage, however, may lie on the side of a discretionary stay, as this can be used in a thoughtful and targeted way, backed, as proposed in the Consultative Document, by a public announcement by the resolution authority. The discretionary stay would avoid possible unintended consequences of an automatic stay. The making of a public announcement would provide a clear signal to the market and therefore, potentially, greater certainty as to the commencement of the stay than might be the case with an automatic stay. (This depends, in turn, on whether the trigger of the automatic stay is itself public and clear as to timing.)

Where parties have included in their contractual arrangements, automatic early termination provisions, such as Automatic Early Termination under an ISDA Master Agreement, they will wish to consider whether it applies in relation to the exercise of a resolution tool and, if so, whether it should be amended, for the sake of certainty, to accommodate the principle of a temporary stay. It will only be possible for parties to do this effectively once the precise scope and operation of such a stay under a specific resolution regime are known.