ISDA Safe, Efficient Markets

BY E-MAIL

13 April 2015

Resolution Regime Consultation
Financial Services Branch
Financial Services and the Treasury Bureau
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Ladies and Gentlemen,

An Effective Resolution Regime for Financial Institutions in Hong Kong

The International Swaps and Derivatives Association (**ISDA**)[1] is grateful for the opportunity to respond to the second-stage public consultation on "*An Effective Resolution for Financial Institutions in Hong Kong*" jointly published by the Financial Services and the Treasury Bureau, the Hong Kong Monetary Authority (**MA**), the Securities and Futures Commission and the Insurance Authority on 21 January 2015 (the **Consultation Paper**).

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

Scope of this response

Consistent with our mission, we are primarily concerned in this letter with the effect of the proposed resolution tools and powers on the safety and efficiency of the derivatives markets, by considering the direct impact of the proposals on the rights of a market counterparty under its derivatives transactions with a failing financial institution (**FI**) and under related netting and collateral arrangements. In particular, we are concerned with the legal uncertainty that will be created if the proposed resolution powers are not adequately defined and circumscribed and if any related safeguards are not clearly defined in terms of their scope or effect. While we agree that the issues dealt with throughout the Consultation Paper are closely interrelated, we believe, given our focus on the OTC derivatives markets, that other respondents, in particular, other international financial trade associations with a broader and less sector-specific focus and mission than ours, are better placed to comment in detail on other parts of the Consultation Paper.

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

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

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

Answers to Consultation Questions

1. Chapter 1 - Scope of the Resolution Regime

*Financial Market Infrastructures (**FMI**s)*

We agree that all FMIs which are designated to be overseen by MA under the Clearing and Settlement Systems Ordinance (other than those which are owned or operated by the MA) and those that are recognized as clearing houses under the Securities and Futures Ordinance (**SFO**) be brought within scope of the resolution regime. In this respect, we note that it is important for the resolution regime in Hong Kong to adhere strictly to the objectives highlighted in the new Annex on FMI resolution to the Key Attributes published on 15 October 2014 (the **Annex on FMI resolution**).

In relation to FMIs that are CCPs, ISDA believes the recovery of a CCP is preferable to its closure.[2] As a result, recovery efforts should continue so long as the CCP's default management process is effective, even if pre-funded resources have been exhausted. In the event that the default management process is unsuccessful in re-establishing a matched book – signaled by a failed auction – the CCP may have to consider the closure of the clearing service. At this point, it is likely that resolution authorities will be evaluating whether this is a trigger for resolution. Although we are broadly supportive of the proposals set out in the Consultation Paper regarding FMI resolution, we query when and how it would be determined as "necessary or appropriate for achieving the resolution objectives… to initiate resolution" before the FMI's own rules and procedure for loss mutualisation or allocation have been exhausted. [3] Any powers to allocate losses or allocate or terminate contracts or impose any other resolution powers outside or prior to the exhaustion of the FMI's own loss allocation rules would create uncertainty for FMI participants and should therefore be clearly considered and more defined scope and transparency is needed for market participants.

*Licensed Corporation (**LCs**)*

Question 1

Do you agree with the revised scope of the regime in respect of LCs as set out in paragraph 29?

We agree with the revised scope of the regime in respect of LCs as set out in paragraph 29. However, in respect of LCs which are subsidiaries or branches of groups which are identified as being (or containing) G-SIFIs, where group resolution plans are in place, any resolution of the Hong Kong branch or subsidiary should be reflective of those plans. To the extent to which these plans can be leveraged to facilitate resolution being undertaken by a Hong Kong authority would be, in our opinion, the most efficient and effective way to deal with LC's that are branches or subsidiaries of G-SIFI's.

Question 3

With a view to ensure that all FIs which could be critical or systemic on failure are within scope of the regime, and recognising that the risks posed by any given types of FI may change over time, do you agree that providing the Financial Secretary with a power to designate additional FIs as being within scope is appropriate?

[2] ISDA published a position paper titled "CCP Default Management, Recovery and Continuity paper" in November 2014 that sets out a proposed recovery and continuity framework for CCPs. See http://www2.isda.org/news/isda-proposes-ccp-recovery-and-continuity-framework.

[3] See paragraph 19 of the Consultation Paper with a reference to paragraph 4.4 of the Annex on FMI resolution. Paragraph 4.4 of the Annex on FMI resolution provides that "Where the FMI has rules and procedures for loss mutualisation or allocation, those rules and procedures should generally be exhausted prior to the entry into resolution of the FMI unless it is necessary or appropriate for achieving the resolution objectives (paragraph 3.1) to initiate resolution before those rules and procedures have been exhausted."

We agree that providing the Financial Secretary (**FS**) with a power to designate additional FIs as being within scope is appropriate. Identification of systemically important FIs should be based on clear and consistent guidelines and this principle should be upheld at all times. Therefore, a set of clear, transparent and consistent guidelines should exist to govern how the FS could exercise his discretionary power to designate additional FIs as being within the scope.

*Locally incorporated holding companies and affiliated operational entities (**AOEs**)*

Question 5

Do you agree with the proposed definition of, and approach to, setting the regime's scope in respect of AOEs?

Yes, we agree that AOEs should be subject to resolution powers only where (i) one or more FIs in the same group are to be resolved; and (ii) using powers in relation to the AOEs is justified to secure operational continuity and achieve the orderly resolution of the affiliated FI(s). We also agree that when AOEs are subject to the proposed resolution regime, the objective should be solely to ensure that the resolution authority could exercise powers available under the regime in relation to AOEs with a view to securing provision of essential services, where this cannot otherwise be achieved and where doing so is justified to secure an orderly resolution of one or more FIs. We believe that clear guidance is required on what makes an entity an AOE in scope for the purpose of resolving an FI.

*Lead resolution authority (**LRA**)*

Question 10

Do you agree that an LRA should be designated for each cross-sector financial group containing "in scope" FIs by the FS once the legislation establishing the regime has passed?

Question 11

Do you agree that the designation of the LRA should be based upon the resolution authorities' assessment of the relative systemic importance of the individual 'in scope' FIs within a cross-sector financial group and that the resolution authority of the FI assessed to pose the greatest systemic risk be designated as the LRA for that group?

Question 12

Do you agree that the role of the LRA should be one of coordination and, when required, ultimate decision-maker?

We agree that an LRA should be designated for each cross-sector financial group containing 'in scope' FIs by the FS once the legislation establishing the regime has passed. Having multiple resolution authorities may impede resolution especially in circumstances where timely resolution is critical. A designated LRA may aid in timely and effective resolution. We also agree that the role of the LRA should be one of coordination and, when required, ultimate decision-maker.

We agree that the designation of the LRA should be based upon the resolution authorities' assessment of the relative systemic importance of the individual 'in scope' FIs within a cross-sector financial group. We would request that the authorities provide more clarity on how to objectively assess the relative systemic importance of the individual FIs within a cross-sector group.

2. Chapter 3 - Resolution Powers

Execution of a bail-in

Question 14

Do you have any views on the steps and processes, outlined in paragraphs 104 to 106, with a view to making the bail-in process operational?

We expect that a preliminary valuation to be conducted by the resolution authority relating to bail-in would be a complex and difficult exercise and we are concerned that this would cause undue timing delays and additional uncertainty to creditors and shareholders of a failing FI. It may be counter-productive to resolution objectives if the period of valuation is not limited to a reasonably short time, as during the valuation process, the capital structure of a failing FI is essentially uncertain and trading of securities of such failing FI may also be suspended. Furthermore, it may be necessary for creditors and shareholders to have a right to challenge such valuation, before the terms of the bail-in are finalised (Please also refer to our comment relating to NWCOL compensation scheme mechanism below).

Scope of write-down and conversion

Question 15

Do you have views on the scope of the bail-in power within the resolution regime and specifically on (i) the list of liabilities identified in paragraph 108 which would always be excluded from bail-in and (ii) the grounds for excluding further liabilities from any bail-in on a case-by-case basis as identified in paragraph 110?

Question 16

Do you have views on how the list of excluded liabilities in paragraph 108 should be expanded to ensure that the bail-in option is suitable for use with FIs other than banks, and specifically in relation to insurers, FMIs and NBNI FIs?

Question 17

Do you have views on the proposed approach to bail-in of liabilities arising from derivatives as outlined in paragraph 111?

We welcome the exclusions set out in paragraph 108 of the Consultation Paper. We note that the exclusions are broadly consistent with the exclusions under the Bank Recovery and Resolution Directive (**BRRD**) of the European Union.

In terms of application of bail-in option to FMIs, we believe that the exclusion of "liabilities which are secured, collateralized or otherwise guaranteed" should not preclude the use of gains-based haircutting (e.g., variation margin haircutting) as a recovery tool for CCPs.

In terms of application of paragraph 108(iii)[4] to liabilities arising from derivatives transactions, we would consider that any liabilities arising from derivatives which are collateralized (whether as cleared or non-cleared derivative transactions) would be considered as excluded from bail-in on that basis. Moreover, regarding paragraph 108(iii), we understand that a secured liability will be an excluded liability only to the extent that it is secured and any remaining excess liability above the value of that security will be eligible for

[4] Paragraph 108(iii) provides that "liabilities which are secured, collateralized or otherwise guaranteed" will be excluded from bail-in.

bail-in. This will necessarily involve a valuation of the relevant security over the course of the "resolution weekend". The Consultation Paper contains no guidance as to how and on what basis this valuation will be 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 the regulators could clarify that method of valuation to be used in the third consultation paper.

When bail-in is applied to derivative transactions, we would request the final legislation specifically stating that a bail-in measure can only be applied in respect of the net amount following the termination of an agreement (whereby the termination, valuation and determination of the net sum are effected following the contractually agreed method) and after the application of any security. [5] Although applying bail-in to a net sum due following termination of derivatives transactions is less complicated than applying bail-in to "live" transactions, it is not without challenges. In this respect, we note that (1) all transactions under the master agreement would need to be terminated and valued, and the timing of the process of close out is unlikely to be sufficiently rapid to meet the speed with which the authorities will want to recapitalize a FI in order to minimize disruption to the market and to allow the FI to continue trading; and (2) the benefit of realising that asset may be outweighed by the disadvantage of losing the on going risk protection offered by the transactions under the master agreement.

As to paragraph 111 of the Consultation Paper regarding bail-in of derivatives, we request for further clarity on the resolution authority's power to subject other derivatives liabilities to bail-in on a case-by-case basis "taking into account the criteria outlined in paragraph 110[6] above and the need to adhere to the safeguards protecting certain financial arrangements." This could potentially create uncertainty, if such case-by-case determination by the resolution authority is not defined in scope or the factors for consideration are not made transparent to derivative market participants.

In relation to paragraph 113 of the Consultation Paper, we request for further clarity on which instruments or liabilities would the inclusion of contractual clauses recognizing the exercise of bail-in powers by a foreign resolution authority be expected. Also, very careful attention needs to be paid to the cross-border aspects and the relative responsibilities of home and host country. As a general principle, bail-in should only be exercised by the authority with primary responsibility for resolution of the entity, for example, the home authority in relation to a parent FI.

Conditions for a temporary stay

Question 19

Do you agree with the scope, timing and conditions proposed for temporary stays on early termination rights in financial contracts?

We agree with the scope, timing and conditions proposed for temporary stays on early termination rights in financial contracts which are consistent with the proposals in the Key Attributes. We support the proposal that temporary stay is limited in time, i.e. effective from publication of notice of resolution until, at the latest, midnight in Hong Kong on the business day following that publication. Regarding the conditions proposed for temporary stays set out in paragraph 121, we note that the Consultation Paper has incorporated the recommendations we made in our response dated 4 April 2014. We view those conditions as critically important to safeguarding the interests of parties to financial contracts and to maintaining the necessary legal certainty of netting for regulatory capital purposes.

[5] Footnote 64 to paragraph 111 of the Consultation Paper acknowledges that to effect a bail-in, the resolution authority would first need to terminate and close-out the relevant derivative transactions.
[6] Paragraph 10 sets out certain criteria which must be met if liabilities are to be wholly or partially excluded from bail-in.

Powers in relation to the filing of a wind-up petition

Question 26

Do you agree with the proposal that the resolution authority should be notified of an intention to petition for an in-scope FI's winding-up and be afforded a maximum 14 day notice period to determine whether or not to initiate resolution before that winding-up petition can be presented to the court?

We are concerned that the proposed time period of 14 days for the resolution authority to make a determination for initiation of resolution prior to filing of a winding-up petition is unduly long and would create uncertainty for creditors intending to manage its credit risk exposure to failing FIs.

Supporting the transferred business

Question 27

Do you have views on which of the approaches outlined in paragraph 141 above might best deliver continuity of services from a residual FI and which are essential to secure continuity of the business transferred to an acquirer?

We are of the view that option (a) (i.e. the appointment of a person to the residual FI to take control of, and manage, the residual FI, and who would be set a primary objective of securing the provision of the essential services and may be granted powers similar to those provided for in relation to a Manager under Section 52 of the Banking Ordinance (Cap. 155)) is more viable and easier to implement operationally. We also agree with the comment that one potential disadvantage of approach (b) is that it may not readily accommodate any adjustments to the assets and liabilities transferred in resolution. Adjustments may be necessary if the partial transfer of business inadvertently breach a protected financial arrangement such as netting or set-off.

Power to suspend certain obligations

Question 28

Do you agree that the regime should empower the resolution authority to impose a temporary moratorium on payments to unsecured creditors and to restrict the enforcement of security interests in line with proposals set out above? Do you have any views as to the exclusions to which this power should be subject?

We are supportive of the resolution authority's power to impose a temporary moratorium on payments to unsecured creditors and to restrict the enforcement of security interests as long as the proposal is in line with the FSB Key Attributes, in particular, subject to the condition that such powers should not affect the enforcement of eligible netting and collateral agreements.

We agree that payments and delivery obligations to an FMI and payment due by an FMI to its participants or to any linked FMI that would affect the ordinary flow of payments, settlements and deliveries being processed by the FMI in the course of its core functions should be excluded from the moratorium. We also agree that the security interests of FMIs over assets pledged or provided by way of margin or collateral by the FI under resolution should not be subject to the proposed restriction on enforcement of security interests.

3. Chapter 4 - Safeguard and Funding

*No credit worse off than in liquidation (**NCWOL**)*

Whilst we support the NCWOL principle and the importance of providing a compensation mechanism for NCWOL, we expect that a NCWOL valuation would be a complex exercise based on various assumptions (which may be subject to challenge). We are also concerned that the process of appointing an NCWOL valuer and conducting an NCWOL valuation, which should only begin after formal resolution proceedings have been initiated, may create additional uncertainties and timing delays on the resolution process. We would welcome more clarity on how the NCWOL valuation process is intended to be run separately but in parallel to the bail-in valuation process and to what extent the two valuation processes could create inter-dependencies and/or knock-on impact on the resolution plan and powers.

NCWOL Valuation Principles

Question 39

Do you agree that the three overarching valuation principles identified in paragraphs 176 (i) to (iii) should be applied each time an NCWOL valuation is undertaken? Do you have views on other valuation principles that should underpin an NCWOL valuation?

We suggest that the valuation reference date should be the date when the public notice announcing the formal commencement of resolution proceedings is issued as it is less subjective and is clearly defined compared to the date on which an FI would otherwise have entered into liquidation.

Funding NCWOL compensation

According to paragraph 179 of the Consultation Paper, NCWOL compensation would need to be met though recourse to the wider financial services industry. Our members would like to have more clarity on how the cost of funding NCWOL compensation is proposed to be met by the industry. Similarly, our members also query whether the costs of establishing and maintaining a Resolution Compensation Tribunal (referred to in paragraphs 180-181) is also considered as a resolution cost to be funded by the financial services industry.

Protecting other types of financial arrangement

Question 46

Do you have any further comments on the way in which it is proposed that the various types of protected financial arrangement would be safeguarded and remedies for inadvertent breaches executed?

We agree that the financial arrangements identified in paragraph 192 and Annex IV of the Consultation Paper should be designated as the "protected arrangements". We are supportive that there should be remedies available where the exercise of resolution powers (including transfers) have breached protected arrangements. We welcome the proposed self-executing remedy for breaching set-off and netting arrangements.[7] 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. We note, however, the proposed remedy for a breach of a secured or title transfer arrangement is still administrative in nature which requires an application to be made by the affected party to the resolution authority. The resolution authority will need to take time to consider whether a remedy is appropriate and, if so, what the remedy should be. Until a decision is reached by the authority, the affected party will be uncertain as to the outcome. To reduce the uncertainty, we believe that 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 a judicial review.

[7] Paragraph 197 of the Consultation Paper provides that set-off and netting are enforceable notwithstanding a transfer of some but not all of the rights and obligations under a master netting agreement.

Regarding identification of protected arrangements ahead of exercising resolution powers, we would require more clarity on the proposal for establishing Management Information Systems (**MIS**) to monitor arrangements which may constitute protected arrangements. Our members submit that the development of any MIS should be subject to a full cost-benefit analysis. The exact requirements and obligations on FIs relating to MIS as well as technical details of financial arrangements (and exclusions) and remedies should be provided as early as possible, so that FIs can assess the impact of such rules, particularly from an infrastructure and operational perspective.

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

Statutory approaches to support cross-border resolution

The Consultation Paper sets out how the Hong Kong's authorities' early thinking maps to the FSB's consultative document on a proposed approach to the cross-border recognition of resolution action published on 29 September 2014 (the **FSB cross-border CP**). Many of the issues raised in the Consultation Paper have been discussed in ISDA's response to the FSB cross-border CP and we would refer you to the response for a detailed analysis of the cross-border issues.[8] We would like to highlight the following points made in the ISDA response to FSB:

(a) We broadly agree with the themes of the FSB cross-border CP, including, that a contractual approach to the cross-border recognition of resolution measures has certain limitations and a legislative approach is preferable.

(b) We see the need to enshrine within any legislative approach the protection of safeguards whilst ensuring transparency and clarity for the market and the resolvability of firms. The immediate and automatic recognition of any such resolution measure on a cross-border basis is preferred provided certain specified safeguards are satisfied.

(c) A coordinated approach is needed between jurisdictions to identify a primary regulator responsible for resolution and also to address group questions (i.e. the risk that multiple resolution authorities implement conflicting resolution measures). Existing laws in Hong Kong do not provide for an appropriate cross-border recognition framework.

(d) We propose the exploration of alternative legislative solutions as set out in the ISDA's response to FSB which aim to achieve the immediate and automatic recognition of a resolution measure to the extent that the specified safeguards are satisfied.

Question 52

Do you agree that it would be appropriate to set specific "cross-border conditions" which must be met before the local resolution regime may be used to support foreign resolution measures?

Question 53

Are the conditions identified in paragraph 239 above appropriate? Do you consider that in addition to being satisfied that foreign resolution measures are consistent with the objectives set for resolution locally, a further requirement should be set with regard to considering the fiscal implications?

Question 54

Do you have any views on how to accommodate the scenarios outlined in Box H above?

[8] See the ISDA response at http://www2.isda.org/functional-areas/public-policy/financial-law-reform/

We agree that it would be appropriate to set specific "cross-border conditions" which must be met before the local resolution regime may be used to support foreign resolution measures. However, the vaguely defined "cross-border conditions" need to be developed further with sufficient details in order to provide the necessary certainty and transparency to market participants. For example, regarding the no-local-creditors-disadvantaged condition set out in paragraph 239(ii), we query whether condition (ii) would apply simply because the foreign resolution regime's depositor protection scheme is less favourable than Hong Kong's regime. We would recommend that the "cross-border conditions" should be tied up to the safeguards featured in the Key Attributes. Key safeguards include the following: (a) the protection of netting arrangements; (b) the protection of rights of set-off; (c) the preservation of credit support arrangements (including title transfer arrangements); (d) there is no discrimination between creditors (e.g. the resolution measure does not discriminate on the basis of the nationality of the creditor or the jurisdiction of their claim); (e) the no creditor worse off principle (i.e. the creditor's position is no worse relative to the position the creditor would have been in had normal insolvency proceedings been commenced with respect to its counterparty (including with respect to priority)); (f) appropriate procedural protections are in place (e.g. due process is observed such that, for example, affected parties are given proper notice and the opportunity to be heard); and (g) only resolution measures which have been introduced and are publicly available are recognised (e.g. a press release containing a generic summary of a confidential measure which has been implemented would be insufficient).

Paragraph 240 of the Consultation Paper mentioned that the Hong Kong authorities are not in favour of an automatic recognition mechanism. Although we understand that the Hong Kong resolution authority may need some discretion in assessing whether the cross-border conditions are met, market participants also need the resolution law to be clear in terms of the resolution authority's powers and the extent by which the resolution measures will be recognised on a cross-border basis. This is important to market participants as they need to understand its potential impact at inception of contract. This is necessary for various reasons, including good credit risk mitigation. There also needs to be consistency in recognition between all jurisdictions. If there is discretion in terms of how each jurisdiction gives effect to the same measure, inconsistencies may be introduced which could undermine a cross-border resolution. In this respect, we note that recognition of FI resolution regime is different to previous attempts at cross-border recognition of insolvency proceedings (where the relevant insolvency proceedings looked very different). Broadly speaking, resolution powers do look very similar (as do the nature of the safeguards), including because of an attempt by jurisdictions to be consistent with the Key Attributes. ISDA members would prefer an automatic and immediate recognition (unless clearly articulated safeguards are not satisfied) without the need for additional domestic steps to implement resolution measures. A general public policy exception to such automatic and immediate recognition should be limited in scope.

Last but not the least, we would like to stress that home and host authorities collaboration is absolutely key to resolving a cross-border FI. As noted in the Consultation Paper, a coordinated and cooperative approach to the resolution of cross-border FIs has the potential to better protect financial stability across home and host jurisdictions. In this respect, we strongly support Key Attributes 8 which requires home and key host authorities of all G-SIFIs to maintain Crisis Management Groups to facilitate the planning and management of the resolution of a cross-border financial crisis.

Contractual approaches to support cross-border resolution

We agree that any use of a contractual solution is very much an interim measure, although it is a useful interim solution and backstop. A contractual approach has certain limitations and so a statutory approach is preferred. We have set out some of these limitations below.

(a) It requires an agreement between the parties concerned. Various market participants have expressed the view that they have no commercial incentive to agree to the resolution measures (and may have fiduciary duties meaning they cannot).

(b) We agree with the additional concern raised by the FSB that not every entity is regulated meaning the approach of compelling entities by regulation does not seem to be an optimal solution. Inconsistencies in

terms of the extent by which each local regulation demands a contractual opt-in may mean the ISDA 2014 Resolution Stay Protocol published on 12 November 2014 (the **ISDA Protocol**) and other similar protocols may not be consistently adopted (e.g. if one regulator demands recognition of stays of termination rights only, buy-side market participants in that jurisdiction would not agree to sign up to the ISDA Protocol as it goes further than this type of measure).

(c) Concerns around the lack of motivation of parties are exacerbated in derivatives and other markets (e.g. repo market) as opt-in involves changing existing master agreements so as to have a retrospective effect on existing transactions.

(d) Contractual agreements can be overridden by other considerations relevant to the recognising jurisdiction. This observation is made in the FSB cross-border CP with respect to public policy. Other examples include on grounds of capacity, authority, recognition of a foreign composition of local law debt and insolvency clawbacks. As a contract, it is open to challenges, whereas a legislative approach could ensure certainty of outcome.

(e) Contractual solutions may not work so as to transfer rights in rem (or, if they do, there may be perfection requirements, clawback periods may be reset, the secured party's priority may be changed, third party consent or action may be needed etc.). Consider, for example, an English law charge on securities held in a non-English clearing system as credit support for an English law ISDA Master Agreement with a US bank. If the US bank resolution action involves a transfer to a bridge bank, a contractual opt-in as a matter of English law under the ISDA Master Agreement may not be sufficient of itself to effect a transfer of the property rights as a matter of the law applicable to such cleared securities. This issue will be exacerbated by the move away from title transfer in respect of mandatory requirements for initial margin.

(f) Any contractual solution potentially requires thousands of new contracts which will take time (and may be subject to their own negotiations). The mere existence of an ISDA Protocol does not guarantee adherence, particularly when an attempt is made to expand potential adherents more widely, so as to cover all market participants.

(g) Whilst it is prudent for market participants to take steps to ascertain the enforceability of any contractual approach, such steps will not represent an assurance that the contractual approach will be enforceable. Legal opinions may have a role in this respect, but their use will be limited and they will invariably contain reasoning based on qualifications and assumptions, and risks will remain. A legislative approach would be better able to mitigate such risks.

In addition to the above comments, our members would like to have clear recognition by the regulators that any requirement on FIs to adopt contractual solutions in financial contracts or debt instruments should not affect FIs' current capital requirements or obligations. In relation to contractual provisions relating to bail-in for capital or debt instruments, our members would like to have more clarity that any such requirement to include contractual provision would only be imposed on a going forward basis and would not require amendment to be made to existing or issued and outstanding capital or debt instruments.

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

Yours faithfully,

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

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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, ISDA has over 800 member institutions from 67 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.