ISDA Safe, Efficient Markets

BY E-MAIL

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European Commission
Directorate-General Internal Market and Services
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Ladies and Gentlemen

Discussion paper on the debt write-down tool – bail-in

The International Swaps and Derivatives Association, Inc. (ISDA)[1] is grateful for the opportunity to respond to the Commission's informal consultation, by reference to its in its discussion paper on "the debt write-down tool – bail-in" (the **Discussion Paper**), on economic and legal aspects of the proposed debt write-down or bail-in tool as part of its development of a European resolution regime for financial institutions.

We note that the Discussion Paper is not a formal consultation, however it does raise a series of questions and we understand that you are open to specific responses. We offer responses and supporting comments in relation to the derivatives aspects with a view to assisting the Commission in the development of its formal legislative proposal. We previously corresponded with the Commission in March 2011 and with the Financial Stability Board in September 2011 about the potential impact of bail-in on the derivatives markets.[2]

We continue to support the development of a consistent European regime for the resolution of financial firms, and we acknowledge that the bail-in resolution power, if properly designed and calibrated, could potentially play an important role as part of the regulatory toolbox. We remain, however, conscious of some difficult conceptual and practical hurdles that must be overcome before bail-in will be credible as a tool in resolution.

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

2 Our letter to the Commission dated 3 March 2011 responding to the Working Document of DG Internal Market and Services on "Technical Details of a Possible EU Framework for Bank Recovery and Resolution" issued on 6 January 2011 (pages 18-20 addressing bail-in); and our letter to the Financial Stability Board dated 1 September 2011 responding to the FSB Consultative Document "Effective resolution of systemically important financial institutions" issued on 19 July 2011 (pages 6-8 addressing bail-in). Each of these is available on our website at: http://www2.isda.org/functional-areas/public-policy/financial-law-reform.

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

Support for core principles proposed by Commission:

We agree with the following principles, which appear to be supported by the Commission:

(a) Bail-in should reflect as far as possible the normal priority order on insolvency.

(b) Bail-in should respect and protect the enforceability of netting arrangements.

(c) Resolution, including the exercise of bail-in, should leave no creditor worse off than would have been the case if the failed firm went into "normal" insolvency proceedings.

(d) An effective resolution regime, including bail-in, must ensure ex ante legal certainty, transparency and predictability as to the treatment that shareholders and creditors will receive so as to enable each properly to assess the risk of dealing with the firm.

(e) The broader impact of bail-in on the market, in particular on the cost of funding for banks, should be minimised.

(f) The impact of bail-in on the internal market and divergent national implementations should be minimised.

Brief summary of our prior responses on bail-in:

We have previously argued (in our March 2011 response to the Commission) that derivatives exposures, whether or not under a master agreement, are not an appropriate form of debt to make subject to the write-down power. Such exposures normally form part of a bank's trading book and are akin to trade debt. Those exposures should be excluded for the same reason that trade debt generally should be excluded from bail-in. Similar arguments would apply to exclude repo and securities lending exposures.

Our response (in September 2011) to the FSB is more detailed and makes the following points:

- There are severe, if not insuperable, valuation and operational difficulties of applying bail-in to "live" derivatives transactions.

- It would, on the other hand, be relatively simple to apply bail-in to a net liability owed by a failing firm after all transactions under a master agreement have been terminated and a net close-out amount has been determined.[3]

- However, the latter would require all transactions to be terminated and valued, and this is a process that would normally take some time depending on the nature, number and complexity of the transactions then outstanding.

- It is highly likely that this timing would not be sufficiently quick to accommodate the speed with which the authorities would normally want to recapitalise the failing firm in order to minimise disruption and allow the failing firm to continue trading.

- After close-out netting, the benefit of bailing in the resulting net liability may well not outweigh the cost, disruption and possible complexity of the close-out.

- Closing out the transactions is also at odds with another stated resolution goal of maintaining continuity of derivatives positions by preventing close-out due to the application of resolution tools.

- There are cogent reasons of principle why derivatives should be excluded from the bail-in power:

  - Bail-in is concerned with recapitalisation, but derivatives transactions are not capital transactions in the sense that they are not funding transactions. They are risk allocation transactions.

  - Derivatives transactions are functionally trade debt of a financial firm and should be exempted for the same reason that trade debt is excluded.

  - Potential application of bail-in to liabilities under derivatives transactions could have a disruptive effect on the availability and cost of derivatives trades to a financial firm.

Application of bail-in to derivatives liabilities

We believe that a number of the points we made to the FSB remain issues to be addressed by the Commission under the proposals set out in the Discussion Paper, but the Discussion Paper offers a number of new observations and raises a number of new questions, which we also attempt to address.

The bulk of our observations concern the scope of bail-in, not only in relation to derivatives liabilities generally, but also specifically in relation to collateralised versus non-collateralised derivatives and cleared versus non-cleared derivatives. We are also concerned about the potential impact of bail-in on the integrity of netting agreements, and this requires us to

[3] However, on this point, note our concerns below regarding how quickly this may be done and the high importance of leaving it to the non-defaulting party to conduct the close-out in accordance with the terms of the relevant master agreement.

address the proposed sequential model, which is, at least as currently formulated, at odds with the principle of respecting netting agreements, as are, indeed, some other aspects of proposals in the Discussion Paper.

Therefore, in setting out our comments below, while we have indicated broadly to which Question Boxes are answers relate, we do not adhere strictly to the sequence of questions as they are set out in the Discussion Paper. We believe that most, if not all, of the conclusions below follow from a proper application of the core principles proposed by the Commission.

1. *Scope of bail-in generally*

Question Box 3

We remain of the view that there are grounds of principle for excluding derivatives liabilities, namely, the close analogy to trade debt. We understand that some feel that derivatives liabilities should be brought within the scope of the bail-in power as a matter of fairness, but we think that this is based on a misunderstanding of the nature of derivatives liabilities. A derivative liability is not a form of capital.

In any event, we must emphasise that the strongest grounds for excluding derivatives liabilities are practical. It will not normally be feasible from a valuation or operational point of view to apply bail-in to derivatives liabilities without terminating the transactions and applying normal close-out methodology.

The difficulty of applying bail-in to outstanding derivative transactions increases with the number and diversity of underlying assets and reference values in the derivatives portfolio (including rates, prices and indices relating to interest rates, foreign exchange rates, equities, debt securities, credit risk, energy products and other commodities, bullion, emissions allowances, inflation and other economic statistics, weather data, freight forward rates, bandwidth, longevity and so on).

It is difficult, if not impossible, to see how core principles (a) to (e) above could be protected and, importantly from the point of view of market confidence in the resolution, could be shown to be protected in relation to the write-down of liabilities under on-going derivative transactions. It is difficult, therefore, to see how bail-in could be applied to live derivative transactions in a manner that respects the core principles set out by the Commission itself, in particular those highlighted above in our response.

On the other hand, it would be relatively straightforward to apply bail-in to a net liability owed by a failing firm after early termination and close-out of transactions. However, we must emphasise strongly that any such early termination and close-out of transactions should be carried out by the market counterparty and not by the authorities, and should be carried out in accordance with the terms of the master agreement by which such transactions are governed. Only on this basis can the core principles, in particular principles (b) and (d), be respected.

The authorities will simply not have enough information about how each market counterparty hedged its positions with the failing firm to close out those positions in a manner that reflects the actual risk position of the market counterparty. Statutory valuation provisions pursuant to "delegated acts", as suggested in part 6(e) of the Discussion Paper, are likely to be too crude and too approximate (or worse), accurately to value a diverse portfolio of different trades (which may run to hundreds, if not thousands, of trades between the failing firm and a single large market counterparty). The significant mismatch between a statutorily determined close-out and the actual market position of the counterparty on the failing firm's entry into resolution would actually increase systemic risk, and specifically contagion risk. This runs, of course, exactly counter to what effective resolution is supposed to achieve.

Accordingly, we remain sceptical that it would be possible for the authorities to achieve an effective write-down power in relation to derivatives liabilities on the basis outlined in part 6(e) of the Discussion Paper.

Quite apart from the complexities of valuation, there is the important question as to whether the early termination and close-out netting could be achieved sufficiently quickly to meet the policy objective of a rapid resolution of a failing firm (which will typically be expected to take place over a weekend).

If bail-in proceeds on the basis of actual close-out by the market counterparty, then it could be considered whether it is necessary for this process to be completed at the same time as other resolution actions are completed or whether the process could be allowed to proceed at a normal (if expeditious) pace, with settlement of the bailed-in net liability to the derivatives counterparty in due course by the bridge bank or bailed-in financial firm (depending on whether it is a closed bank or open bank resolution).

Of course, the failing firm would lose the benefit of hedges closed out for this purpose, but it could presumably replace those in the market, although market movements and the fact that the failing firm is in distress may well mean that those hedges are more expensive.

And the authorities could decide not to exercise the bail-in power in relation to derivatives transactions that they wished to preserve as hedges (noting that the protection of netting means that none of the derivatives transactions under a particular master agreement could be bailed in unless all of the transactions were).

<u>Question Box 4</u>

With long term and short term derivatives liabilities included under the same master agreement, it is difficult to see how the Commission's proposed sequential model of bail-in could be applied without breaching core principle (b). So, it would seem that all derivative liabilities under a single master agreement would need to be treated in the same way and either included or excluded as a single set of liabilities, regardless of maturity.

Question Boxes 3, 4 and 6

Finally, we believe that it follows from core principle (a) that senior unsecured liabilities should not be bailed in until all equity and subordinated liabilities have been fully wiped out. It will also be difficult to establish that core principle (c) has been respected unless all equity and subordinated liabilities have been wiped out before senior unsecured liabilities are touched.

2. *Collateralised derivatives liabilities*

Question Box 3

We believe that it also follows from core principle (a) that collateralised derivatives liabilities, whether collateralised by a security collateral arrangement or by a title transfer collateral arrangement, should be exempt from bail-in to the extent of the collateral. In relation to excess liability of the failing firm after application of the collateral, this should be treated in the same way as unsecured derivatives liability.

In relation to derivative transactions subject to a collateralised master agreement, the only way in which bail-in could feasibly be applied, respecting the core principles, would be for there to be an early termination and close-out under the master agreement, the application of collateral to any net liability of the failing firm and then the write-down of any net liability of the failing firm after exhaustion of the collateral. We believe, however, that it is not realistic to expect that this could occur within the rapid timeframe normally envisaged for implementing the resolution of a failing (the "resolution weekend").

3. *Cleared versus uncleared derivatives liabilities*

Question Boxes 3 and 4

We see no reason why a failing firm's derivatives liabilities to a customer should be treated differently depending on whether the transactions giving rise to those liabilities are cleared or not. Encouraging or mandating clearing is a policy objective that has nothing to do with resolution. It will be governed by EMIR and incentives to encourage clearing will be included in the European implementation of Basel III. Giving a more favourable treatment to cleared derivatives liabilities over uncleared derivatives liabilities in the bail-in regime where there is no direct policy reason for doing so risks unintended consequences.

In relation to the derivatives liabilities of a failing firm to a central clearing counterparty (CCP), that is, where the failing firm is a clearing member of the CCP, we think that there are grounds for excluding such liabilities from the scope of bail-in. The CCP will normally be fully protected in relation to those liabilities and therefore the exclusion for collateralised liabilities will, in any event, take most, if not all, of the exposure of the CCP to the failing firm out of scope of the bail-in tool. The remaining uncollateralised liability, if any, is not likely to be significant in the vast majority of cases (and will normally be absorbed by the solvent clearing members under the loss sharing rules of the CCP). For the sake of simplicity, therefore, it is better simply to exclude such liabilities.

4. *Contractual provisions and foreign law*

Question Box 8

To the extent that bail-in could apply to uncollateralised derivatives liabilities, as already noted above, it will be necessary to close out the derivative transactions and this should take place in accordance with the terms of the master agreement rather than in accordance with a statutory regime, even if the trigger for the close-out is "pulled" by the relevant resolution authorities. The non defaulting party will be in the best position to minimise the impact of the close-out and to determine the values of the terminated transactions in accordance with the provisions of the master agreement.

Also, the closing out of the master agreement in accordance with its terms will give rise to less difficulty than a close-out operated by the authorities according to statutory rules if the master agreement is governed by a foreign law, as there is always a question as to whether a local court in the jurisdiction of the governing law of the contract will recognise the effect of a foreign law statutory amendment, including a write-down, of a local law governed contract or liability under that contract.

While this problem may be ameliorated within the EU by virtue of a mutual recognition principle in the relevant European legislation, this will not solve the difficulty where in relation to a master agreement governed by a non EU law. One possibility would be for the relevant master agreement to include a provision under which the parties would recognise, as a matter of contract, the implementation of a statutory write-down. This could, however, be quite challenging to draft, and the parties would need to have much more information than we currently have about the precise statutory mechanism of the write-down before drafting could begin.

There would be an additional challenge (which should not be underestimated) in amending the many existing master agreements of European financial firms to incorporate the wording, particularly where a financial firm has contracted with an end-user that would have no incentive to agree the amendment. But this is something that, in principle, we would be happy to discuss further with you.

We hope that you find the comments above useful in your continuing deliberations on the proposed debt write-down resolution tool. We look forward to a continuing dialogue with you on these issues. 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 work of the Commission in relation to the effective resolution of financial institutions.

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, the Association has more than 815 members from 58 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers.

ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – show the strong commitment of the Association toward its primary goals; to build robust, stable financial markets and a strong financial regulatory framework.

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

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