ISDA® Safe, Efficient Markets

BY EMAIL

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Exposure draft of Deposit Takers Bill

The International Swaps and Derivatives Association, Inc. (**ISDA**)[1] is grateful for the opportunity to make a submission on the exposure draft of the Deposit Takers Bill (the **Bill**).

Background

ISDA's interest in the Bill stems from its commission of legal opinions, on behalf of its members, addressing among other things the enforceability of close-out netting and security enforcement rights in the insolvency of New Zealand counterparties. Given that New Zealand registered banks are significant and active participants in the derivatives markets, ISDA and its members are keenly interested in any proposed legislation that will affect the enforceability of those rights. Changes to the perceived legal risk attaching to counterparty types, such as registered banks, are key factors in the decision of whether to trade with such counterparties and, if so, on what terms.

As such, ISDA has focused on Part 7 (crisis management and resolution) of the Bill — in particular, Subpart 5 of Part 7 (moratorium and restriction on resolution trigger) (**Subpart 5**); as well as a general comment in relation to statutory bail-in and derivatives. The submissions ISDA makes below all relate to Subpart 5 and statutory bail-in.

In making its submissions, ISDA appreciates that a number of policy decisions have already been made by Cabinet in respect of the resolution regime. That being the case, ISDA has not sought to submit on the Bill to the extent it might otherwise if this was 'clean slate' legislation. Rather, ISDA has confined its submissions to four specific, and discrete, matters.

Submissions

There are four parts of Subpart 5 on which ISDA wishes to make a submission.

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1 Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 970 member institutions from 77 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

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(1) *Clause 278(2)*

Clause 278(2) states that clause 278(1)(b) — which provides an exception to the general moratorium for certain rights under a "netting agreement" — is subject to clause 279. As both clause 278(1)(b) and clause 279 are permissive (as opposed to restrictive) provisions, we submit that to have one permissive provision "subject to" another creates uncertainty as to what is actually intended.

Is the intended effect of clause 278(2) that the rights referred to in clause 278(1)(b) can only be exercised after the default time (or an earlier/later time) as prescribed in clause 279? If so, ISDA submits this should be expressed more clearly. That would involve some technical redrafting given that the prevailing view is that clause 270 (or, at least, its equivalent under section 122 of the Reserve Bank of New Zealand Act 1989 (the **RBNZ Act**)) does *not* actually prohibit the rights referred to in clause 278(1)(b). Further, if that is the intention, then it would also mean the exercise of those rights following a *non-resolution* trigger would be temporarily stayed. That is at odds with the general approach in the Bill, which is to *not* temporarily stay the exercise of such rights.

ISDA submits the simpler, and more internally consistent, approach would be to delete clause 278(2).

(2) *Clause 279 – definition of "derivative"*

From the perspective of the derivatives industry, clause 279 is a very significant provision. It provides for an exception to the moratoria in clauses 270(1) and 273(2) in the case of a "derivative" or a "relevant security interest". In the absence of this exception, a derivatives counterparty may face a statutory stay on its ability to exercise its close-out netting and security enforcement rights in the resolution of a licensed deposit taker.

A key to obtaining the benefit of this exception is ensuring each transaction entered into between the parties (e.g., under an ISDA master agreement) is a "derivative". For most transactions customarily documented under an ISDA master agreement that would not be problematic; they clearly *are* "derivatives". However, that is not universally the case. Specifically, it is unclear whether repurchase transactions (or 'repos') and securities lending transactions are "derivatives".

ISDA does not propose to discuss the legal analysis for and against this proposition, other than to note two things:

(a) First, in Australia, there are differing views within the legal profession as to whether repos and securities lending transactions are "derivatives" within the meaning of section 761D of the Corporations Act 2001.[2] This is significant because the New Zealand definition (in section 8(4) of the Financial Markets Conduct Act 2013 (the **FMCA**)) is substantially based on that Australian definition. Therefore, it is reasonable to expect the uncertainty in Australia to exist in New Zealand also.

(b) Secondly, one (entirely plausible) interpretation of the "derivatives" definition produces a meaning that goes well beyond what was no doubt intended. For example, given the breadth of section 8(4)(a)(iii) of the FMCA, guarantees and indemnities

[2] The view of ISDA's Australian counsel is that they *are*.

could be "derivatives". That such an interpretation is plausible then raises the question of how the definition should be sensibly read down to give it its intended effect. That is not a question that should be left for lawyers to debate, at least in the context of high-value financial instruments such as repos and securities lending transactions that are a key part of the global financial markets.

The significance of this issue is set to be exacerbated with the impending publication by ISDA of its Securities Financing Transactions Definitions. These Definitions will allow repos and securities lending transactions to be documented under an ISDA master agreement, along with 'true' derivatives. The publication of these Definitions will likely result in the increasing use of a single ISDA master agreement to document all such transactions.

It is critical to the effective operation of the ISDA master agreement that the same set of rights for all transactions be available to a non-defaulting party in the insolvency of its counterparty. That would be jeopardised if different transaction types attracted different rights. If that were the case, there would likely need to be parallel but separate enforcement procedures, which would deprive the industry of the benefits of broad cross-transaction netting and securities enforcement. That would clearly be an undesirable outcome and, accordingly, ISDA submits clause 279 should apply to repos and securities lending transactions.

There are a number of ways this clarification could be made.

(a) Ideally, section 8(4)(b) of the FMCA would be amended to expressly include repos and securities lending transactions in the list of transactions that are "recurrently entered into in the financial markets in New Zealand or overseas". That approach would then have the ancillary effect of addressing the same issue that arises in the context of section 125 of the Financial Market Infrastructures Act 2021 (the **FMI Act**).

(b) If, for whatever reason, that approach was unpalatable, an alternative would be to make the same clarification (but in a more targeted way) in the definition of "derivative" in clause 279(4) of the Bill.

(3) *Clause 279(3) – the "transferred or otherwise dealt with" requirement*

Clause 279(3) is a carry-over of section 122(9A)(b) of the RBNZ Act. It creates a prerequisite to the availability of an exception to the stay on enforcing collateral rights where, among other things, "the collateral is transferred or otherwise dealt with so as to be in the possession or under the control" of the enforcing counterparty or someone on its behalf.

The requirement for collateral to be "transferred or otherwise dealt with" so as to confer possession or control is borrowed from section 14A(1)(b) of the Payment Systems and Netting Act 1998 (Cth) (the **PSNA**). The requirement is problematic under some collateral management scenarios commonly found in derivatives markets. For example, where a collateral taker has "possession" of collateral by virtue of a record entry being made by its intermediary (which is also acting as intermediary for the collateral provider), it is a stretch

to say the collateral has been "transferred or otherwise dealt with" so as to confer that possession.

ISDA submits it would be preferable for the Bill to adopt (instead of the PSNA wording) the broader formulation used in Article 2(2) of the EU Financial Collateral Directive 2002/47/EU. This refers to collateral being "delivered, transferred, held, registered or otherwise designated" so as to be in the possession or under the control of the secured creditor.

(4) *Clause 280 – extension of the stay*

The exception in clause 279 applies to rights exercised after the "default time" (the close of the day after the date on which the licensed deposit taker enters resolution) or an earlier or later time specified by the Reserve Bank. It is the prospect of *a later* time (in particular, a later time with no specified maximum duration) that concerns ISDA members.

ISDA submits this prospect is inconsistent with both the Financial Stability Board's 2014 *Key Attributes of Effective Resolution Regimes for Financial Institutions* (the **Key Attributes**)[3] and the prevailing approach in major overseas jurisdictions. For example, the Key Attribute 4.3 states as follows in relation to so-called *ipso facto* clauses (i.e., clauses that trigger the exercise of early termination rights following a counterparty's entry into resolution):

> The stay should:
>
> (i) be *strictly limited in time* (for example, for a period not exceeding 2 business days);
>
> (ii) be subject to adequate safeguards that protect the integrity of financial contracts and provide certainty to counterparties (see I-Annex 5 on Conditions for a temporary stay); and
>
> (iii) not affect the exercise of early termination rights of a counterparty against the firm being resolved in the case of any event of default not related to entry into resolution or the exercise of the relevant resolution power occurring before, during or after the period of the stay (for example, failure to make a payment, deliver or return collateral on a due date).
>
> The stay may be discretionary (imposed by the resolution authority) or automatic in its operation. In either case, jurisdictions should ensure that there is *clarity as to the beginning and the end of the stay*.
>
> (emphasis added)

By contrast, the stay in clause 273 is not "strictly limited in time" and does not ensure "clarity as to the beginning and the end of the stay". This is of great concern to ISDA. Where the provisions of the stay depart from the Key Attributes, this will have a significant negative impact on the opinion in relation to netting enforceability under the ISDA Master Agreement in New Zealand.

[3] Available at https://www.fsb.org/wp-content/uploads/r_141015.pdf.

ISDA submits there is no justifiable policy reason for the Bill's departure from the Key Attributes in this respect. The fact that there is precedent under existing New Zealand legislation for such an approach[4] is not such a justification. Also, the effect of that precedent legislation is not nearly as significant as this part of the Bill.

Accordingly, ISDA submits there should be no power for the Reserve Bank to extend the stays in clauses 270(1) and 273, as they apply to derivatives and relevant security interests, beyond the "default time".

(5) *Statutory bail-in and derivatives*

We note that the implementation of a statutory bail-in regime (a power that could write down or convert certain liabilities without relying on contractual provisions in those liabilities) has been left to a later stage. Any implementation of such regime should involve industry consultation and would need to address numerous legal issues in some detail, including (but not necessarily limited to) company, securities, property, insolvency, commercial and private international law issues.

While we reserve any in-depth comments in respect of statutory bail-in power until future consultation with the industry, we wanted to draw the Reserve Bank's attention to the following.

As a general rule, liabilities of a party to a derivative transaction are largely or wholly contingent while the transaction is outstanding. Derivative transactions contemplate both payment obligations and, where physical settlement is permitted or required, delivery obligations, that is, obligations to deliver an agreed form of asset. For present purposes it is sufficient to focus on payment obligations.

While an amount may, after satisfaction of relevant conditions precedent, become due and payable on a particular payment date, for example, under a swap transaction, liabilities will remain contingent in relation to subsequent payment dates. The amount of any future payment obligation under the swap transaction will also potentially be subject to payment netting against any amount due on the same day by the same party and potentially also to netting against amounts due on the same day by the same party under other transactions under the same master agreement.

Given the foregoing and given also the wide variety of possible derivative product types (swap, forward, option, cap, collar, floor and many variations and sub-variants of these product types) as well as the wide range of possible underlying assets and other measures of value that can be used to determine the value of a derivatives transaction (including rates, prices and indices relating to interest rates, foreign exchange rates, equities, debt securities, credit risk, commodities, bullion, emissions allowances, inflation and other economic and monetary statistics, meteorological data, freight forward rates, bandwidth and so on), it is likely that there would be severe practical difficulties in applying a statutory bail-in power to a "live" derivative transaction, that is, a derivative transaction still in effect, with obligations remaining to be performed, at the time the power is exercised.

The difficulties would include valuation and operational difficulties, without considering the disruptive impact on related positions (which are either hedges for or hedged by the

[4] See section 122(9A)(c) of the RBNZ Act and section 125(2) of the FMI Act.

transactions subject to the bail-in power). These difficulties would be magnified where there are numerous trades between a licensed deposit taker and a major counterparty. The possibility of the application of bail-in to derivative transactions still in effect would also probably have negative implications for regulatory capital that would need to be worked through very carefully.

Accordingly, it is important that any statutory bail-in power is only applied to a *net amount* due under the close-out netting provisions of a master agreement, such as the ISDA Master Agreement. Such an amount, once determined, is normally simply an unconditional debt owed by the party that is "out of the money" on a net basis under the relevant master agreement, whether the party is the defaulting party or the non-defaulting party. That debt is capable, therefore, of being written down or converted to equity without the difficulties and complexities referred to above in relation to applying bail-in to "live" transactions.

Further discussion

We hope you find ISDA's comments and responses informative and useful. Should you have any questions or desire further clarification on any of the matters discussed in this letter, please do not hesitate to contact the undersigned.

Yours faithfully,

For the **International Swaps and Derivatives Association, Inc.**