ISDA Safe, Efficient Markets

20 December 2018

ISDA response to the PRA's Consultation Paper CP25/18 – The Bank of England's approach to amending financial services legislation under the European Union (Withdrawal) Act 2018

The International Swaps and Derivatives Association ("**ISDA**") welcomes the opportunity to respond to the PRA's Consultation Paper CP25/18 – The Bank of England's approach to amending financial services legislation under the European Union (Withdrawal) Act 2018.

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 900 member institutions from 68 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 website: www.isda.org.

We welcome the Bank and PRA's intent to use the temporary transitional power conferred upon them by HM Treasury in relation to capital requirements and contractual recognition of bail-in and recommend extending this to the rules on contractual recognition of stays in resolution. We comment on these areas in particular in our response.

1. General approach

The scope of the provisions which may be subject to transitional relief remains unclear, with examples being provided but not an exhaustive list. In order to remove uncertainty in the industry it would be helpful if the PRA could specify which amendments contained in the consultation package fall within the transitional provisions. This would be preferable to current list of non-exhaustive provisions and help firms adopt the correct measures for exit day. We would welcome confirmation that the PRA intends to exercise its temporary transitional power to give relief from all changes to firms' obligations that arise from Brexit (except where transitional provision is already made in the relevant onshoring SI or in the cases where the PRA has already stated that it does not intend to exercise its temporary transitional power), not just those which arise from specific changes made by the PRA to its rules or BTS.

We would also ask that the transitional provisions are kept under review and are extended as necessary once further SIs are published e.g. those relating to the securitisation frameworks.

Additional transitional relief should also be provided where reliance is placed on credit risk assessments provided by EEA ECAIs until the FCA has published a list of which ECAIs have been recognised.

2. Contractual recognition of bail-in and contractual recognition of stays

ISDA welcomes the proposal for the PRA to use its temporary transitional power to delay the obligation to include a contractual recognition of bail-in term in EEA law governed phase two liabilities that are created or materially amended after exit day.

However, in contrast to the approach under the contractual recognition of bail-in rules, we note that there is no intention for the PRA to use the temporary transitional power to delay the obligation to include a contractual recognition of stay term in EEA law governed financial arrangements created or materially amended after exit day.

We are concerned that this may create a discrepancy for liabilities arising under derivative contracts (which are most likely to be phase two liabilities benefiting from transitional relief from the contractual recognition of bail-in rules). This could have the effect of undermining the application of the temporary transitional relief to the contractual recognition of bail-in term requirement, as firms are likely to include that contractual term to the extent Stay in Resolution wording is being added to the agreement governing the liability. It would be helpful if the treatment of the two requirements could be aligned, with the temporary transitional power being extended to the Stay in Resolution rules.

3. Use of the temporary transitional power in relation to exposures to EEA central governments and EEA central banks

ISDA supports the intention of the PRA to provide a period of relief during which firms would be able to continue to treat EU27 exposures and assets preferentially, as this will ensure firms are not disproportionately disadvantaged by the sudden increase in capital requirements envisaged by the removal of the preferential risk-weighting treatment currently afforded to exposures to EEA central governments and EEA central banks. This will also give regulators leeway to consider potentially amending this requirement in the longer term. Likewise, the transitional power could also be used similarly for firms currently relying on assessments made by EEA ECAIs which would (on the basis of the baseline approach) no longer be eligible.

We strongly welcome the PRA's confirmation that it will use the temporary transitional power in relation to these requirements and that for the duration of the transitional relief firms would be able to continue to treat EU27 exposures and assets preferentially. In addition, we also welcome confirmation from the PRA that such transitional relief will

also allow firms to continue to report and disclose regulatory data on the same basis as before exit day.

We note that the FCA does not give any similar indication regarding use of its temporary transitional powers, and we would welcome confirmation that the PRA and FCA are working together to ensure that the FCA's approach is aligned with that of the PRA.

Why continuation of the preferential treatment is important

Failure to continue with the current regime of preferential risk-weighting treatment would have a detrimental impact on capital, liquidity and large exposure metrics through increases to risk weights, loss of CVA exemptions, loss of collateral eligibility and changes in liquidity flow rates. The step change in prudential metrics which the loss of preferential treatment would cause is not justified by any changes in risk profile and is contrary to the aims of the EU Withdrawal Act of not making policy changes.

While the granting of equivalence decisions may mitigate most of these increases, there is no certainty that these will be granted in the event of a no-deal Brexit, and there are also areas of the rules which do not provide for equivalence decisions. For example, the ability to opt sovereign exposures from the internal ratings based ('IRB') approach onto the standardised approach under Article 150 (1) (d) has been removed without an equivalence decision.

This will have a negative impact upon the ability of UK banks' returns and may constrict appetite to lend and the ability to compete on the same terms in certain sectors. In particular, firms will be restricted from applying beneficial treatments to EEA sovereigns and ECAs, thereby incurring non-zero capital charges, which will not only have a negative impact upon the competitiveness of the UK's banks, but will also have a negative impact upon global trade.

ISDA concerns if the transitional powers are not exercised

While we would prefer a commitment to capital neutrality, we welcome the PRA's confirmation that it will use the temporary transitional power in relation to these requirements and that for the duration of the transitional relief firms would be able to continue to treat EU27 exposures and assets preferentially.

While a period of stability would be welcome, it is clear that the PRA's use of its temporary transitional powers is time-limited. As a result, without longer term measures being put in place there is a risk that the UK's approach to these requirements will become disjointed from changes to the regulatory framework that are currently in progress at an international level. We therefore believe that measures should be taken to allow transitional provisions to be extended in line with any international developments.

In particular, the timing of transitional provisions should be linked to the implementation of the reforms to the Basel framework. If the UK were to leave the EU on 29 March 2019 without a deal, the changes to the capital regime would come into force on 30 March 2021, some 9 months ahead of the proposed implementation date of the Basel III reforms. To do otherwise would be operationally burdensome both for firms and the PRA in that changes to firm's models may require several iterations during the transitional period. It would also introduce unnecessary volatility in capital ratios.

For sovereign exposures, although the timing of the changes is less certain than the other Basel III reforms, the transitional provisions should nevertheless be linked to the implementation of the changes to the sovereign framework that are under discussion by the Basel Committee.

For more information please contact Fiona Taylor, ftaylor@isda.org