ISDA® Safe, Efficient Markets

BY E-MAIL

1 September 2011

Financial Stability Board
Centralbahnplatz
CH-4002 Basel
Switzerland

E-mail: fsb@bis.org

Ladies and Gentlemen

Effective Resolution of Systemically Important Financial Institutions

The International Swaps and Derivatives Association (**ISDA**)[1] is grateful for the opportunity to respond to the Consultative Document "Effective resolution of systemically important financial institutions" issued by the Financial Stability Board (**FSB**) on 19 July 2011 (the **Consultative Document**). We have previously had the opportunity to discuss these issues with members of your working groups on financial resolution issues, particularly in the two areas with the most direct impact on the derivatives activities of our members, namely, bail-in within resolution and the proposal for a temporary stay on contractual early termination rights in support of resolution.

The issues considered in the Consultative Document are of great importance to the safety, efficiency and stability of the financial markets, including the over-the-counter (OTC) derivatives markets. We agree that there is an urgent need to improve the capacity of national authorities to resolve a systemically important financial institution (**SIFI**) without systemic disruption and without exposing the taxpayer to the risk of loss.

Scope of this response

In this response, we primarily address the issues of bail-in and the proposed temporary stay, although we also take the opportunity to make some observations about issues raised in other parts of the Consultative Document. While we agree that the issues dealt with throughout the Consultative Document 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 Consultative Document, namely, on the key attributes of effective resolution regimes, cross-border co-operation between authorities, resolvability assessments, recovery and resolution plans, measures to improve resolvability and creditor hierarchy, depositor preference and depositor protection in resolution.

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.

International Swaps and Derivatives Association, Inc.
One Bishops Square
London E1 6AD, United Kingdom
P 44 (0) 20 3088 3550 **F** 44 (0) 20 3088 3555
www.isda.org

NEW YORK WASHINGTON
LONDON BRUSSELS
HONG KONG SINGAPORE
TOKYO

We have had the opportunity to review a near-final draft of the high-level response to the Consultative Document prepared jointly by the Global Financial Markets Association, The Clearing House Association, the American Bankers Association, The Financial Services Roundtable, the Institute of International Bankers and the Institute of International Finance (IIF). We have also had the opportunity to review a near-final draft of the separate and more detailed response of the IIF. We support the comments made in each of those responses. The Consultative Document, the joint Association response and the IIF response all acknowledge the interdependence of the issues discussed throughout the Consultative Document, and of course we agree. Our comments need to be read against the broader background.

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 SIFI 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 and effect.

Key attributes of effective resolution regimes

We agree that, as a general rule, corporate liquidation procedures are not well suited to deal with the failure of SIFIs, for the reasons set out in the Consultative Document. We also agree that an effective resolution regime requires a designated administrative authority with a statutory mandate to promote financial stability and with a range of resolution objectives, tools and powers broadly along the lines set out in Annex 1 to the Consultative Document.

Scope of regime

We note that paragraph 1.1 of Annex 1 says that the resolution regime should be clear and transparent as to the institutions within its scope. We would have welcomed greater guidance on this point in the Consultative Document and look forward to seeing a more detailed consideration in due course.

We are sceptical as to whether it will be possible to define the scope of future resolution regimes solely by reference to systemic significance, as the systemic significance of a financial institution will depend not only on intrinsic characteristics of the institution but also on extrinsic factors in the financial markets and in the broader economy.

In order, to analyse the risks associated with dealing with a financial firm, including the credit and legal risks, a market counterparty needs to know in advance and with sufficient certainty whether the firm will, if it gets into difficulties to the point of non-viability, potentially be subject to a resolution regime, even if, within that regime, there is a choice of tools and approaches that could be applied by the resolution authority.

We therefore think that it may make more sense to determine the scope of the regime on transparent and objective grounds. We agree that special rules are necessary for global SIFIs, as discussed in parts 9 – 12 of Annex 1.[2] Separate sectoral rules will be necessary for different types of financial institution, distinguishing, for example, deposit-taking banks, investment firms with custody of clients assets and insurance companies.

[2] We note that the assessment of the global systemic importance of banks (G-SIBs) is discussed in a separate consultative document issued by the Basel Committee on Banking Supervision entitled "Global systemically important banks: Assessment methodology and the additional loss absorbency requirement" (July 2011).

Netting, collateralisation and segregation

We welcome the statement in paragraph 5.1 that the legal framework governing netting and collateralisation should be clear, transparent and enforceable during the resolution of a SIFI. We would welcome greater detail as to how safeguards to ensure this would be framed. Experience with existing resolution regimes has already shown that the detail of the safeguards is crucial.

Legal certainty must be ensured. As far as possible, private law contractual and property rights must be respected. The remedy for a breach of a netting or collateral safeguard must also be clear, and it must not be a purely administrative remedy, for example, one requiring an application to an authority, a period for determination by the authority and, if the application is granted, the payment of compensation or award of other relief only at the end of that period. The remedy must be immediate and self-executing. For example, a netting safeguard should ensure that netting is enforceable notwithstanding the transfer by the resolution authority of some but not all of the rights or obligations under a master netting agreement. Similarly, in relation to security, the safeguard should provide that a transfer of secured obligations is legally ineffective unless the related security arrangement together with the security assets are also transferred to the transferee (the new obligee).

We agree that segregation of client positions (by which we understand you to mean client assets) should be clear, transparent and enforceable. The regime should provide for rapid identification and return to each client and/or a solvent custodian for the client of its assets. A major source of disruption and uncertainty in relation to the administration of Lehman Brothers International (Europe) in England was caused by the lack of clarity regarding the rules applicable to client assets held by LBIE at the time it went into administration.

Paragraph 5.1 also notes the importance of ensuring that the legal protection of netting, collateralisation and client asset segregation should not hamper the effective implementation of resolution measures. First, we note that ensuring the certainty and effectiveness of netting and collateral arrangements and the clarity and transparency of client asset segregation arrangements is, if anything, likely to reinforce the effectiveness of a resolution regime by inspiring confidence in market participants that they are being dealt with fairly and in a predictable manner consistent with their expectations.

Where it is considered necessary to suspend or otherwise affect any private law right, there is clearly a balancing that needs to be to occur. Any such suspension or other effect should be the absolute minimum necessary to achieve the policy goal of the relevant resolution tool or power. This principle is relevant to our discussion below of the proposed temporary stay on contractual early termination rights.

Cross-border issues

Given the global nature of the derivatives markets, the cross-border issues are crucial. These are dealt with in some detail in the joint Association response and in the IIF response. We simply underline the importance for the derivatives markets of ensuring, in particular, that there is:

(1) no ring-fencing of local assets of a foreign SIFI in the event of its local branch being made subject to resolution in the host country; and

(2) no discrimination against foreign creditors in the host country.

Each of these is objectionable on a number of grounds, including grounds of efficiency, equity and systemic stability in the financial market as a whole. The precise impact of each will depend on how it operates both *de jure* and *de facto* and on its scope of application. Specifically from a derivatives perspective, the existence of either in a host country will have a potential adverse impact on the enforceability of close-out netting and any related financial collateral arrangement entered into with a multibranch SIFI with a local branch in that country.

Need for mutual recognition

Also, although there are difficulties in achieving this in the short-term, the longer term goal must be to ensure that any action taken in a resolution is recognised as legally effective under the laws of all other jurisdictions relevant to the particular case. For example, a statutory transfer by the Singapore resolution authority, during the resolution of a Singapore bank, of an ISDA Master Agreement governed by New York law must be recognised as effective by the New York courts. Similarly, a temporary stay imposed by the Norwegian resolution authority, during the resolution of a Norwegian bank, on a counterparty's right to designate an Early Termination Date under an English law governed ISDA Master Agreement must be recognised as effective by the English courts.

In each case, we understand that there is currently doubt about whether that would be true under the current state of the law. It may take a binding international agreement to ensure that the necessary mutual recognition is achieved not only as between the various G20 countries but also as between the many other jurisdictions, including emerging market countries, where active participants in the global derivatives market are based.

Possible contractual measures

In the meantime, we agree that it may be helpful for market participants to consider whether some aspects of this problem could be addressed by contract. For example, parties to an ISDA Master Agreement could agree that the right to designate an Early Termination Date under Section 6(a) will be conditioned on there being no "qualifying stay" on contractual early termination under a resolution regime applicable to the other party. The definition of "qualifying stay" would need careful consideration, but it could be drafted to ensure that it is clearly limited to a stay under a relevant and recognised financial institution resolution regime that conforms to the necessary limitations discussed below in relation the proposed temporary stay on contractual early termination rights, discussed in the discussion note in Annex 8 to the Consultative Document.

Some of the cross-border issues will not be amenable, however, to contractual solutions. Also, before industry can properly debate possible contractual solutions to some of the cross border issues, it will be necessary to have substantially more detail as to the resolution regimes that will apply. We appreciate that the Consultative Document already provides more detail than prior international papers dealing with cross-border financial firm resolution, but more detailed proposals and consultation with industry will clearly be necessary before concrete legislative proposals can be brought forward and appropriate industry contractual responses can be developed.

Home country versus host country

We agree with the principle set out in the Consultative Document that the home country of the parent should have primary responsibility for the resolution of the parent and any subsidiary of the parent located in the home country. Each host country resolution authority (and other relevant host country authorities such as the host country central bank, financial regulator or Ministry of Finance) should cooperate and coordinate with the home country resolution authority effectively to ensure that all creditors of a particular class are, as far as possible, given equal treatment. We are aware that other industry responses comment on a number of difficult issues that will need to be worked through in sorting out the relative responsibilities of the home and host authorities. As there is no special derivatives aspect to these issues, we do not comment further here.

Bail-in within resolution

General comments

We support the principle of statutory bail-in within resolution (that is, statutory conversion, write-down or write-off of SIFI capital instruments), provided that it only applies as a last resort after all other feasible measures to rescue the failing firm (that is, to prevent it from reaching the point of non-viability) have, in the reasonable determination of the relevant authorities, been exhausted. Its scope of application must also be clear and its basis legally certain. Numerous legal issues will need to be addressed in some detail, including (but not necessarily limited to) company, securities, property, insolvency, commercial and private international law issues.

There will also, of course, be issues as to the interaction between the bail-in resolution tool and other resolution tools, the interaction between contractual bail-in provisions and the statutory power (discussed, but not sufficiently elaborated, in the Consultative Document), change of control provisions in contracts entered into by the SIFI and regulatory restrictions on investors. For example, a regulated fund that has previously invested in debt obligations of the SIFI could find itself in breach of its own investment restrictions following a statutory conversion of that debt to equity.

There will potentially be difficult tax issues for a SIFI subject to statutory bail-in and for its investors.

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 SIFI.

We agree with the principle set out in paragraph 6 of Annex 2 to the Consultative Document that bail-in must respect, as far as possible, *pari passu* treatment of creditors and the statutory order of priorities. In relation to the application of bail-in, recapitalization should be effected by starting at the bottom of the capital structure, that is, with the equity level and then moving up the structure in reverse order of priority. Senior debt should only be subject to statutory bail-in after exhaustion of subordinate levels of capital. And, of course, senior debt should only be bailed in to the extent necessary to recapitalize a SIFI or, as the case may be, the portions of its business transferred to a bridge institution, at a reasonable level.

We agree that a statutory bail-in regime should respect the principle of “no creditor worse off than in liquidation”, should provide an appropriate mechanism for compensation where this principle can be shown to be breached and should provide for expedited judicial review of bail-in decisions, where appropriate (but in a manner that does not interfere with the speed or flexibility of the use of the tool that the authorities will need when implementing an actual resolution).

Derivatives market impact

The foregoing are general comments, which we believe are in line with the comments of other industry bodies and market participants, and a number of these points are, of course, acknowledged by the Consultative Document. In relation to the specific impact of a statutory bail-in power on the derivatives markets, there are two aspects:

(1) First, there is the question of the impact of bail-in on a SIFI equity or debt instrument that is the subject of a derivative transaction. The principal concern of market participants in this regard is to ensure that there is sufficient clarity and certainty as to the rules that will apply and as to the full legal and tax effects, as mentioned above, so that market participants can analyse the market and other risks of the transaction, structure and document it properly, price it accurately and hedge it effectively and reliably.

(2) Secondly, there is the question of whether and, if so, how statutory bail-in could be applied to a derivative transaction itself as a form of debt of a SIFI. This is part of the more general question as to the scope of the application of the statutory bail-in power.

Should derivative transactions be within the scope of a statutory bail-in power?

In paragraph 5.1 of Annex 2 to the Consultative Document, you say that the scope of a statutory bail-in regime, in terms of liabilities covered, should be "as wide as possible". There are a variety of considerations, however, that will need to be taken into account before determining whether it is feasible and, where feasible, whether it is ultimately beneficial to bail in certain types of liability. Therefore, we cannot accede in an unqualified way to the principle that the statutory regime should be as wide as possible.

There are a number of cases of liabilities of a SIFI where the beneficial effect of the application of statutory bail-in may be outweighed by negative effects for the SIFI itself (particular in terms of its access to credit and liquidity), for counterparties to SIFIs and for systemic stability. Potential special cases include (but are not necessarily limited to) deposits (in particular, retail deposits), inter-bank borrowings, foreign exchange transactions, liabilities relating to unsettled securities trades (that is, securities trades initiated and still in the course of settlement), trade debt and liabilities under derivative transactions.

In relation to liabilities of a SIFI under derivative transactions as a form of senior debt, there are a number of issues. A preliminary point is that sometimes obligations under a derivative transaction are subordinated. Subject to what we have said above about the importance of observing the creditor hierarchy and proceeding strictly in reverse order through the capital structure, no particular issue is raised by this fact, and we can for present purposes focus on senior debt liabilities of a SIFI under a derivative transaction.

Another preliminary point is that it appears that secured senior liabilities would be exempt from the bail-in power. This would take a proportion of derivatives liabilities out of scope in any event, for example, in the US market where a significant proportion, perhaps the majority, of derivatives master agreements are secured by a security interest in collateral created under Article 9 of the New York Uniform Commercial Code.

In the European market, on the other hand, where it is considerably more common to collateralise on a title transfer basis, it is not clear that the collateralised derivatives liabilities would be out of scope, as they are not secured in a proprietary sense, the collateral arrangement relying instead on netting or set-off. We proceed in this letter on the basis, therefore, that derivatives liabilities collateralised by title transfer collateral arrangements would be considered unsecured liabilities, but this would need to be clarified and confirmed. Similar considerations would apply to securities repurchase (repo) and securities lending transactions and related master agreements, which are based on the same title transfer mechanism and substantially the same legal analysis.

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. Again, 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 transactions subject to the bail-in power). These difficulties would be magnified where there are dozens, hundreds or even thousands of trades between a SIFI, particularly, a G-SIFI, 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.

The foregoing points apply to derivative transactions of a SIFI that are traded "over-the-counter" or off an organized market or exchange and not cleared through a clearing house or other clearing system. Where derivative transactions are exchange-traded and cleared or traded OTC and cleared, as is increasingly required by legislative changes in effect or under way in the G20 economies and presumably in other countries as well, then additional operational and other difficulties are likely to arise in applying the bail-in power.

It would, of course, be considerably simpler to apply a statutory bail-in power 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.

Two points to note immediately, however, are: (1) all transactions under the master agreement would need to be terminated and valued and this is a process that can take some time depending on the nature, number and complexity of the transactions then outstanding and the state of the market at the time of close-out; and (2) the SIFI will not necessarily be debtor in such a case and therefore the resulting net amount following close-out might therefore not be available to be bailed in.

Regarding the first point, the timing of the process of close-out is unlikely to be sufficiently rapid to accommodate the speed with which the authorities will want to recapitalize a SIFI in order to minimize disruption to the market and to allow the SIFI to continue trading.

Regarding the second point, although in the circumstances described the net amount, being owed to the SIFI, would represent an asset of the SIFI and therefore strengthen (however, minimally) its balance sheet, 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. Early termination for this purpose is also directly at odds with the general aim, discussed in Annex 8 to the Consultative Document, to prevent early termination occurring in the event of the exercise of certain resolution tools.

Indeed, the desirability of avoiding early termination specifically in the context of the exercise of a statutory bail-in power is mentioned in paragraph 8 of Annex 2, although, of course, that reference concerns the possibility of suspending a contractual early termination right under a financial contract that might otherwise be triggered by bail-in of any capital instrument, and not specifically the application of bail-in to liabilities under derivatives transactions. But the basic point remains that bail-in of derivatives liabilities is only likely to prove feasible, if at all, in relation to close-out amounts and not to the (largely contingent) liabilities due under "live" derivative transactions.

One further point to note in relation to paragraph 8 of Annex 2 is the suggestion that a "brief stay" on the exercise of early termination and close-out rights should not only be contemplated in relation to bail-in but also in relation to "other resolution tools", giving transfers of contracts to a bridge bank as merely one example. This is far too broad. As far as we are concerned, no case is made in the Consultative Document, or in any of its precursors from the FSB or the Basel Committee on Banking Supervision, for a brief stay on contractual early termination rights other than in relation to (a) the possibility of a transfer of assets to a bridge bank or private sector purchaser or (b) the possibility of bail-in.

In addition to the foregoing considerations, there are cogent reasons of principle why derivative transactions should be excluded from the scope of the bail-in power. Bail-in is concerned with recapitalization. Liabilities under derivatives transactions do not form part of the capital of a SIFI, other than, perhaps, in the very limited case where a specific derivative transaction is closely related to a capital transaction of the SIFI. The vast majority of derivative transactions constituting the normal derivatives trading of the SIFI would not fall into this category.

This is similar to the position of trade debt, and indeed for a SIFI liabilities under derivative transactions are functionally trade debt. We think it unlikely that G20 ministers intended that bail-in could apply to day-to-day claims such as those of a landlord under a lease of a building to a SIFI or of a supplier in relation to the supply of goods or services to a SIFI. The potential application of a statutory bail-in power to trade debt could have a significant effect on a SIFI's ability to access goods and services on credit and on the cost to the SIFI of those goods and services. Similarly, the potential application of bail-in to liabilities under derivative transactions could have a disruptive effect on the availability and cost of derivatives trades to a SIFI.

Measures to improve resolvability

In paragraph 3.4 of Annex 6 to the Consultative Document, we note that the FSB proposes that the SIFIs should:

(1) consider eliminating cross-default clauses in master agreements and similar contractual rights that are triggered by the default of another group member; and

(2) explore "standardised valuation methodologies" under an ISDA Master Agreement for closing out derivative transactions.

Each of these proposals presents difficulties. In relation to the first proposal, it is a fact of commercial life that it is necessary when assessing the credit of a firm not only to assess it on a self-standing basis but also as part of a financial group. It is prudent and longstanding credit risk management practice to take into account events affecting affiliates as part of one's overall assessment of the credit of a specific counterparty. Cross-default and similar clauses give tangible support to this, allowing a party better to manage its risk at an earlier stage than would be the case if the party looked at its counterparty only in isolation. The Lehmans case illustrates plentifully the credit interdependence of group entities, and an important general trend in credit risk management is to take more thorough account of group effects. The Consultative Document in other parts reinforces, albeit for systemic risk management reasons, this trend and, indeed, underlines it as essential. Home and host authorities must cooperate and act in a coordinated manner in relation to financial groups. A host authority should take into account the potential impact on financial stability in other jurisdictions of its resolution actions in relation to a local entity or branch of a SIFI, the relevant other jurisdictions being principally where other members of the same group are located. These perspectives are not incompatible with the desire to address "intra-group contagion", but we believe that more work needs to be done before a convincing case can be made that the intra-group contagion effects of cross-default clauses that might be triggered against a SIFI outweigh the benefits to a healthy SIFI (and other market participants) of having this credit risk mitigation tool available when dealing with another SIFI.

Regarding the second point, valuation methodologies for closing out transactions and groups of transactions form part of the broader practice of valuation within an institution and are closely related to the methodologies used for valuing trades and related hedge positions for pricing, regulatory reporting, risk management, collateral management and other purposes.

These methodologies are proprietary, although there will, of course, be much in common from firm to firm in terms of principles, approaches, models and techniques. But competition in relation to expertise in valuation is fundamental to the market, as it ensures that those firms with the greatest skill in valuation have a comparative advantage over other less skilled firms. This competition ensures that the best principles, approaches, models and techniques are reinforced and the less effective ones are either improved or abandoned. It is fundamental to price discovery and price competition in the market.

It is probably an understatement to say that it would be harmful to the market to attempt to impose a standardized valuation methodology for pre-default purposes, and the Consultative Document does not suggest this. But if a standardized close-out valuation methodology were imposed, then firms would be forced largely to conform their pre-default valuation methodologies to the standardized close-out approach, as it would be the latter that would determine their ultimate credit risk. Not to do so would create a great deal of systemic risk.

A degree of standardization, development of best practices and so on is certainly possible and, indeed, does occur in relation to certain aspects of valuation methodology. Many of ISDA's product-specific working groups have produced standard documents that have contributed in a significant way to these efforts in different product sectors and in relation to collateral management. But within agreed market frameworks, individual firms must be allowed to employ their individual expertise, judgment and discretion in valuing trades for the various purposes mentioned above, in order to ensure safe, efficient and liquid markets.

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 (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,

[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.

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.

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 work of the FSB in relation to effective resolution of systemically important financial institutions.

Yours faithfully

Dr Peter M Werner
Senior Director
pwerner@isda.org

Edward Murray
Chairman
ISDA Financial Law Reform Committee
ed.murray@allenovery.com

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 825 members from 57 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.

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.