ISDA Safe, Efficient Markets

October 9, 2013

Banking Reform Bill Team
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BY EMAIL

Dear Sir,

ISDA Response to HM Treasury & BIS consultation on Banking reform: draft secondary legislation

This paper sets out the International Swaps and Derivatives Association, Inc. ("ISDA")[i] response to questions 18 – 23 of the consultation paper, in relation to the proposals for ring-fenced banks to be permitted to sell simple derivatives products to their customers, subject to safeguards, and the draft Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 201* (the **Order**).

18. Will allowing ring-fenced banks to sell derivatives hedging interest rate, foreign exchange and commodity risk enable small businesses to hedge the most common risks?

We are concerned that limiting the ability of ring-fenced banks (**RFBs**) to enter into derivatives with their customers other than derivatives relating to interest rates, foreign exchange and commodities will be overly restrictive.

The stated policy objective was to ensure that the only derivatives which an RFB may enter into with their customers would be "simple" derivatives, in order to ensure that the RFB's derivatives portfolio does not hinder ease of resolution. As discussed below in our response to this question and to question 20, we are concerned that this will not be achieved by creating artificial distinctions between product types and that this approach may make the provisions more complex to implement, apply and enforce, while preventing RFBs from entering into certain derivatives which are intrinsically no less simple than those which the RFB is permitted to enter into.

It will be necessary to strike a balance between enabling the RFB to continue to provide necessary services to its customers and simplifying the derivatives portfolio of the RFB to ensure that it does not hinder ease of resolution.

We have a number of concerns regarding Article 6.

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Definition of "derivatives":

The definition of "derivatives" under the Order cross-refers to Sections C (4) – C (10) of Annex I to the Markets in Financial Instruments Directive (**MiFID**). This risks creating a mis-match between the scope of the excluded activities and the scope of the prohibition.

The prohibition on RFBs under section 142D FSMA states that an RFB may not engage in the regulated activity of "dealing in investments as principal" unless the activity is carried on in the circumstances specified by the Treasury. The activity of "dealing in investments as principal" is described in the FSMA 2000 (Regulated Activities) Order 2001 (**RAO**), and covers dealing as principal in the investments identified as specified investments in Part III of the RAO.

The list of specified investments under the RAO includes the instruments referred to in sections C (4) – C (10) of Annex I to MiFID, but also includes additional instruments. For example, it is not clear whether certain forward foreign exchange instruments would be within scope of MiFID. The UK Financial Conduct Authority has given guidance on its interpretation of the scope in relation to the RAO (stating that physically settled forward foreign exchange will be within scope where it is for investment purposes), but the position of the European Commission remains unclear. If the European Commission confirms that physically settled forward foreign exchange are outside the scope of MiFID, RFBs may find that they are unable to enter into physically settled forward foreign exchange with their customers.

As a result, the definition of "derivatives" should cross-refer to the relevant definitions under the RAO.

Definition of "account holder":

It is not clear why the exclusion in Article 6 for entering into simple derivatives should only be available where the RFB deals with "account holders".

The Order defines "account holder" as any person who has a current account or a deposit account with a ring-fenced body, other than a relevant financial institution. This would mean that the RFB would not be able to enter into simple derivatives with any of its other customers, if those customers do not have a current or deposit account with the RFB (for example, if a customer has borrowed from the RFB, but does not have a current or deposit account).

Nature of permitted transactions:

Article 6(1) (a) would only permit the RFB to enter into transactions to **sell** relevant instruments. However, a person entering into an OTC derivative instrument will create that OTC derivative instrument by contract. With limited exceptions it is not meaningful to refer to "selling" an OTC derivative instrument.

We understand that the intention is to permit an RFB to create a derivative instrument for its customers as well as to sell existing derivative instruments. The term "selling" is defined in the FSMA 2000 (Regulated Activities) Order 2001 as:

> In relation to any investment, includes disposing of the investment for valuable consideration, and for these purposes "disposing" includes –
>
> (a) in the case of an investment consisting of rights under a contract –
>
> > (i) surrendering, assigning or converting those rights; or
> >
> > (ii) assuming the corresponding liabilities under the contract;
>
> (b) in the case of an investment consisting of rights under other arrangements, assuming the corresponding liabilities under the arrangements; and
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> (c) in the case of any other investment, issuing or creating the investment or granting the rights or interests of which it consists.

We would welcome confirmation that the same definition would apply to the use of the term "sale" under the Order.

Product scope and boundaries:

Article 6 states that an RFB is permitted to enter into a transaction to sell an investment which is a derivative instrument which relates to currencies, interest rates or commodities.

It is not clear why the scope of permitted derivatives should be restricted to derivatives relating to currencies, interest rates or commodities. Clients of an RFB may also need to enter into any of the other instruments specified under the RAO, and it is not clear why these instruments should be intrinsically any less "simple" or any more risky to the RFB than derivatives on currencies, interest rates or commodities. An RFB should be permitted to enter into any derivative contract, so long as it can be considered to be a "simple" derivative.

It is also unclear when a derivative might be considered to be a derivative which "relates to" currencies, interest rates or commodities. For example, bond futures are often categorised as interest rate derivatives. Would these be derivatives "relating to" interest rates, or would they be outside of scope because the underlying of the relevant derivative is a bond?

Recital 25 to the MiFID Implementing Regulation (Regulation 1287/2006) states that:

> A derivative contract should be understood as relating to a commodity or to another factor where there is a direct link between that contract and the relevant underlying commodity or factor. A derivative contract on the price of a commodity should therefore be regarded as a derivative contract relating to the commodity, while a derivative contract on the transportation costs for the commodity should not be regarded as a derivative contract relating to the commodity. A derivative that relates to a commodity derivative, such as an option on a commodity future (a derivative relating to a derivative) would constitute an indirect investment in commodities and should therefore still be regarded as a commodity derivative.

If the current wording of Article 6 is retained, it will be necessary to clarify these issues (and other relevant issues).

19. Do you agree that limiting derivatives to those classed as falling into levels 1 and 2 of the fair value hierarchy of IFRS 13 limits the sale to products that can be valued relatively easily?

We do agree that, where the policy objective is to limit the ability of an RFB to deal as principal to dealing in products that can be valued relatively easily, referring to levels 1 and 2 of the fair value hierarchy of IFRS 13 would be an appropriate way to do this.

It will be important to ensure that it is clear that this test should only be applied at the point of entering into the relevant transaction, and not throughout the life of the transaction. While it will be possible to assess the value of a derivative financial instrument on the basis of level 1 or level 2 inputs at the point of entering into the relevant transaction, this may not be possible at other points during the life of the transaction, as there may no longer be any active market values or observable inputs. For example, where a person enters into a 10 year interest rate swap it may be possible to value that swap using level 1 or 2 inputs. However, when valuing a 10 year interest rate swap with 3 years and 54 days left to run, it will be necessary to use level 3 inputs as there will be no relevant active market and may be no observable inputs.

As a result, subsequent changes in the availability of level 1 or 2 inputs should not affect the assessment of the instrument if level 1 or 2 inputs were available at the point that the RFB entered into the transaction.

As IFRS is outside the remit of the UK legislative process, it would be important to keep the definitions of level 1 and 2 of the fair value hierarchy of IFRS 13 under review, in case any changes are made to IFRS which would have an impact on the ability of RFBs to enter into derivatives.

20. What are your views on the restriction of contracts to forward, future and swap contracts only?

It is not clear which instruments would be captured by Article 6(2) (b).

If the requirement for the profit or loss to be "directly proportional" to a change in value or level of the reference instrument means that there should be a linear relationship between the value of the derivative and the value of the underlying, it is not clear that swaps would be within scope of the exclusion.

In addition, we do not consider that it would be appropriate to prevent an RFB from entering into other types of derivative instruments (e.g., options or forward rate agreements) with its customers.

While we understand that the purpose of this provision is to ensure that the RFB only enters into "simple" derivatives with its customers, it is not the case that all derivatives other than forward, future or swap contracts are necessarily "complex". It is equally possible to create a complex swap contract as it is to create a simple option. This provision should focus on whether or not the relevant contract is a "simple" derivative, rather than seeking to identify particular types of contract as intrinsically complex.

Similarly, seeking to restrict the types of contract which an RFB may enter into with its customers may have the effect of removing the ability of the RFB to provide the customers with adequate protection. There will be circumstances where it would be more appropriate for a customer to enter into an option, rather than a forward, future or swap and the RFB should not be prevented from providing the customer with that instrument. For example, businesses which import and export need to be able to use instruments such as foreign exchange options in order to manage their exposure to fluctuations in exchange rates.

The requirement in Article 6(2) (c) that any derivatives entered into by the RFB with its customers should be capable of being valued on the basis of a level 1 or level 2 input under IFRS 13 should provide sufficient protection to the RFB, ensuring that its derivative portfolio will not impede resolution. It should not be necessary to make distinctions between categories of derivatives in an attempt to determine which may be more intrinsically "simple": the key protection for the RFB should be that any derivatives it enters into should be simple to value.

21. How do you think the sale of derivatives on a brokerage basis could be organised?

Section 142D FSMA only prohibits an RFB from dealing in investments as principal. It should still be possible for an RFB to deal in investments as agent, or to arrange for its customers to enter into derivative contracts with another group entity or third party broker. As a result, the RFB would not be prohibited from acting as broker.

However, even if an RFB would not be prohibited from acting as broker, it may not be able to do so for other reasons. For example, where an RFB acts as broker it may incur an exposure to a non ring-fenced bank which would be prohibited under Article 8 (for example, if the non ring-fenced bank owes fees to the RFB).

In addition, an RFB which does not have a group entity which could act as broker would need to arrange for its clients to enter into derivative contracts with an unaffiliated entity. This arrangement is likely to lead to an increase in costs for the client, as the client will not be able to benefit from efficiencies which may arise where all the services can be provided within a single entity or intra-group. For example, it is likely that the RFB will hold assets which could be used as collateral for transactions. Where an unaffiliated entity acts as broker, the client may need to post additional collateral to cover the exposures of the unaffiliated entity.

This difference in costs may result in clients preferring to deal with RFBs which are part of a larger group, so that all services can be provided within the group, rather than with RFBs which stand alone or which are part of a smaller group and which cannot provide the full range of services that clients require.

22. Do you think that the methods chosen for the net and gross caps are an adequate means of limiting the riskiness and the size of a ring-fenced bank's client derivatives portfolio respectively? Do you agree with the proposed limits?

In order to provide useful feedback on the proposed limits it would be necessary for banks to be able to model the effects of the proposed limits. However, banks would require more clarity on the proposed scope of the permitted derivatives in order to be able to do this.

As a general point (irrespective of the level at which any caps may finally be set), it is not appropriate in Article 6(3)(a) to refer to the position risk requirement being "at all times" less than 0.5% of the RFB's own funds. The test needs to be capable of being applied at the point when the RFB is entering into relevant transactions, and should not have the effect of rendering a particular transaction retroactively unlawful because the position risk requirement associated with that transaction changes.

The condition under Article 6(3) (a) should require the RFB to consider whether entering into a particular transaction may have the effect of increasing its position risk requirement to 0.5% or more of its own funds. The same point also applies in relation to the requirement under Article 6(3) (b) for the sum of the position risk requirements to be at all times less than 20% of the credit risk capital requirement of the RFB.

While there is a risk that the RFB's position risk requirement may be within the prescribed caps at the time that it enters into a particular transaction, but may subsequently increase beyond those limits, this risk should be addressed elsewhere through conduct of business or other on going monitoring obligations for the bank. As mentioned above, the test in Article 6 should not have the effect of rendering a particular transaction retroactively unlawful.

23. Do you have any other views on the approach taken here?

We do not consider that the Order should refer expressly to provisions of the FS Handbook (e.g., the references in Article 6(4) to BIPRU 7). The relevant sections of the FS Handbook are likely to be amended or deleted altogether with effect from 1 January 2014 as part of the UK's implementation of the Capital Requirements Regulation. Since the Capital Requirements Regulation is already in force, it may be more appropriate to refer to the relevant sections and definitions in the Capital Requirements Regulation.

Clearing:

The types of contracts that the RFB is likely to enter into are also likely to be the types of contracts which will become subject to the mandatory clearing obligation under EMIR. As a result, an RFB will need to be able to access a CCP either directly or indirectly through a clearing member in order to fulfil the mandatory clearing obligation. However, the prohibition on financial institution exposures under Article 8 is likely to prevent an RFB from receiving indirect clearing services from a clearing member of a CCP. If an RFB is not able to access a CCP directly or receive indirect clearing services from a clearing member, this will clearly present significant obstacles to the RFB's ability to continue to provide services to its customers.

Drafting comments:

- Article 6(3) (a) (i) and (ii) should refer to "transactions entered into" by the RFB (in line with the wording in Article 4(1) and Article 6(1)), rather than introducing the idea of "investments traded" under Article 6 without any further description.

- The references in Article 6(3) (a) (ii) to "article 3(1)" should be a reference to Article 4(1).

- The reference in Article 6(3) (a) (ii) to "hedging" should be replaced with wording more closely tracking the wording used in Article 4(1), or "hedging" should be defined.

- The proviso in Article 6(3) (a) (ii) is unclear. It would be more straightforward to refer to "any transactions entered into by the ring-fenced body under article 4(1) exclusively for the purpose of [hedging risks to its business] arising in relation to the investments referred to in sub-paragraph (i)".

We welcome the opportunity to share these comments and would be pleased to have further discussions with the Banking Reform Bill Team. If you require further information, please do not hesitate to contact me.

Yours faithfully

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[i] Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.