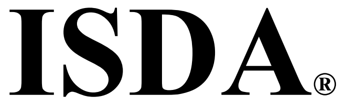

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23 April 2008

Dear Sirs

UK consultation document on financial stability and depositor protection

The International Swaps and Derivatives Association, Inc. (**ISDA**)[1] is grateful for the opportunity to comment on and to respond to some of the questions raised in the consultation document "Financial stability and depositor protection: strengthening the framework" (January 2008) issued by the Bank of England, HM Treasury and the Financial Services Authority (the **Consultation Document**).

ISDA defers, of course, to national experts in the United Kingdom on the appropriateness of the proposals in the Consultation Document to address issues and longer term concerns arising out of the recent market turmoil and, in particular, the difficulties faced by Northern Rock. But given the importance of London as an international financial centre and as the principal financial centre of Europe, ISDA would like to respond, from an international perspective, to certain aspects of the Consultation Document that have the potential to affect cross-border financial transactions, including OTC derivative transactions.

[1] ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry, a business that includes interest rate, currency, commodity, credit and equity swaps, options and forwards, as well as related products such as caps, collars, floors and swaptions. ISDA currently has more than 800 member institutions from 56 countries on six continents. More than half of the total membership is based in the European Union and neighbouring countries and a significant portion of the rest active participants in the European financial markets as dealers, service providers or end users of derivatives. Promoting legal certainty for cross-border financial transactions through law reform has been one of ISDA's core missions since it was chartered in 1985. ISDA has been an active participant in the Commission's public consultations over the years on a wide variety of legal and regulatory measures, and has followed the evolution of the European legal and regulatory framework for the single market in financial services with close attention.

Our comments focus principally on the aspects of the proposals that we believe will have the most important and direct effect on the wholesale financial markets, namely, the proposals in Chapter 4 of the Consultation Document.

We are aware of the responses of the City of London Law Society (CLLS) Financial Law Committee and of the CLLS Insolvency Law Committee. We are also aware of the responses prepared by certain other financial market trade associations, including the London Investment Banking Association, the British Bankers Association and the Building Societies Association. There are, of course, differences of approach and emphasis in those various responses, but there appears to be a broad consensus among financial market experts as to the key difficulties, areas of uncertainty and sources of potential legal and reputational risk for the UK financial market in the proposals set out in the Consultation Document.

We are also aware of the response of the Financial Markets Law Committee, which focuses on issues of potential legal uncertainty rather than policy, and we support the views expressed there as they relate to the legal uncertainty issues we highlight in this response.

Some common themes of all of these responses (some reviewed in near final draft and some in final form) include the following:

- There has been insufficient time to consider the proposals, particularly given their potential complexity and likely significant impact on financial market operations and the confidence of market counterparties dealing with UK banks and building societies.

- The Consultation Document is lacking in sufficient detail on a number of the proposals to make an adequate assessment of the feasibility and potential market impact of the proposals.

- The case for some of the radical changes proposed, particularly in relation to a special resolution regime (SRR) and special bank insolvency regime, has not been made effectively in the Consultation Document.

- The problems highlighted in the Consultation Document could be addressed by less radical adjustments to the current regime.

- It is critical to London's international reputation that the clarity and predictability of the current English legal framework for the financial markets not be undermined and, in particular, the current robust rules protecting close-out netting and financial collateral arrangements.

1. The importance of English law to the international financial markets

One of the principal strengths of London as an international financial centre has been the (to date, well-justified) perception that English law provides a sensible, stable and predictable legal environment for financial transactions, protects the legitimate expectations of creditors and provides robust tools for creditors to manage credit and legal risks relative to counterparties organised under English law.

Of particular interest to the OTC derivatives and related financial markets, English law is widely recognised internationally as providing one of the most robust and transparent legal frameworks for close-out netting and financial collateral arrangements. Close-out netting is enforceable under English law on the basis of general principles.

Unlike a number of other leading jurisdictions, England does not rely on detailed netting legislation to carve out special protection for netting in defined circumstances from an otherwise unfavourable legal environment. While detailed netting legislation is a good thing where it is needed, and we have promoted such legislation in many jurisdictions, nonetheless, the fact that it is not needed in England has historically been an advantage for the London financial market.

Furthermore, the fact that a single insolvency regime, subject to minor qualifications, applies to English bank and corporate counterparties has also historically been an advantage for the London financial market.

One important evidence of the foregoing advantages of the current English system is the fact that an English law firm is able to give a simpler and more straightforward legal opinion as to the enforceability of close-out netting and related financial collateral arrangements than is the case for many other leading jurisdictions with more complicated systems, elaborate special legislative provisions for close-out netting and financial collateral and separate insolvency regimes for banks, corporates and other types of counterparties.

Under current bank regulatory capital rules,[2] supervised institutions are required to have a legal opinion from each "relevant jurisdiction" which would typically include the jurisdiction where the counterparty against the supervised institution wishes to net and, generally, the home jurisdiction of the supervised institution itself concluding that close-out netting would be enforceable to a high degree of legal certainty in the event of insolvency proceedings in respect of either party.

In light of the importance of the international financial market centred on London and the high respect in which English law is held as an appropriate governing law for cross-border financial transactions, from the first version of the ISDA Master Agreement published in 1987 to the versions published in 1992 and 2002, market participants using

[2] Such as those in the Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU) in the Financial Services Authority Handbook of Rules and Guidance.

the standard form have English law as one of their two standard choices, the other being New York law.

Not surprisingly, virtually all ISDA Master Agreements entered into in the London financial market are governed by English law. But more generally in Europe, the vast majority of cross-border ISDA Master Agreements are also governed by English law. In other parts of the world, particularly Asia, English law is also commonly chosen to govern ISDA Master Agreements entered into on a cross-border basis.

There is a serious risk that certain aspects of the current proposals could, unless more thoroughly though through and implemented in a careful and proportionate way, could undermine the reputation of English law for providing a clear, stable, predictable and pro-creditor legal environment. If such a risk were realised, it would be to the detriment not only of London (and therefore the UK) but also to the detriment of the European and international financial markets that rely on London.

2. Insufficient time given the scope and complexity of the proposals

Given what is at stake and given the scope and complexity of the proposals, we believe that certain aspects of the proposals require considerably more time than has currently been allocated for study, consultation and discussion. This is particularly the case in relation to the proposals in Chapter 4 of the Consultation Document.

We understand that the Government wishes to introduce draft legislation based on the proposals fairly rapidly after the end of the consultation period, and we have heard it suggested that the Government is aiming for the legislation to be passed by the Autumn of this year. This suggests that draft legislation is already being prepared, ahead of, and pre-empting the results of, the public consultation ending today. This does not inspire confidence that the serious concerns being raised by financial market commentators will be adequately addressed.

We would strongly urge the Government to consider moving ahead with the parts of the proposals that are less controversial and more easily implemented, such as the proposals in Chapters 3, 6 and 7 of the Consultation Document.

3. The proposed SRR

We defer to national experts in the UK on the need for a SRR for UK banks and building societies, but we do not see the introduction of a limited set of SRR tools as necessarily problematic. The key, however, is understanding clearly the scope and operation of the SRR tools, the conditions under which they may be invoked (the so-called “triggers”), the breadth of the powers and whether appropriate safeguards have been included to protect creditors.

Uncertainty on these points could lead to doubt as to whether such tools could be used to defeat the legitimate commercial expectations of financial market counterparties to

troubled UK banks and building societies, to interfere with the terms of financial contracts and/or to interfere with close-out netting, set-off or financial collateral arrangements.

The Consultation Paper, unfortunately, does not provide sufficient detail on the SRR tools, which therefore makes it difficult to risk-assess the proposals properly.

The fact that the SRR proposals are inspired by apparently successful SRR tools available to the Federal Deposit Insurance Corporation (FDIC) in the US does not necessarily mean that the market will perceive favourably the introduction of such tools in the UK. The detail is important. The FDIC regime has operated reasonably well to date, but its use has largely been confined to smaller regional or local US banks with comparatively small amounts of non-depositor liabilities, relatively straightforward business models and little or no international exposure.

In any event, we note the FDIC regime has specific protections for close-out netting and financial collateral arrangements that are lacking from the SRR proposals in the Consultation Document. This is discussed further below.

4. Special bank insolvency procedure

Leaving aside the SRR (which, of course, has both pre-insolvency and insolvency aspects), the Consultation Document suggests that a special bank insolvency procedure might be necessary as part of the overall package of legislative reform.

It is not clear to us that the case for a special bank insolvency procedure is made in the Consultation Document, which is, in any event, short of specific details as to how the special bank insolvency procedure would differ from current insolvency procedures.

It seems to us that the current situation, where the principles applicable to corporate and bank insolvency are, for the most part, the same is a considerable advantage of the English legal position over the position, for example, in the US and in other countries with separate bank insolvency regimes. It is simpler and more straightforward for foreign counterparties to assess and understand and, to date, has been considered one of the advantages of dealing with a bank subject to English insolvency law. We mentioned above, for example, the advantage that close-out netting opinions under English law are generally simpler and more straightforward due to the fact that the same insolvency regime applies to corporate and bank counterparties, and the market has generally viewed this as an attractive aspect of the English legal regime for OTC derivatives and other financial transactions subject to close-out netting arrangements.

ISDA as a trade association does not, of course, have a view on whether, in principle, banks should be subject to a separate insolvency regime from the insolvency regime applicable to non-bank corporates. Whether or not separate regimes are necessary or advisable will depend on a variety of factors that will vary from jurisdiction to jurisdiction. We merely wish to point out that the current situation in England appears to

have the advantage of relative simplicity and clarity and that we do not believe the Consultation Document has discharged the burden of proving that change in this regard is necessary.

5. Close-out netting

The enforceability of close-out netting is a cornerstone of financial stability, given the powerful credit risk reduction achieved by the widespread use of master agreements for the close-out netting of OTC derivatives, securities lending and repurchase (repo) and other types of financial transaction. According to figures published by the Bank for International Settlements in November 2007, total mark-to-market credit exposure of all outstanding OTC derivatives as of June 2007 was reduced by 76% after applying close-out netting. In its third quarterly report for 2007, the US Office of the Comptroller of the Currency, which regulates US federally chartered banks, noted that total mark-to-market credit exposure for such banks as of 31 March 2007 was reduced by 83.9% after applying close-out netting.

The importance of close-out netting for financial markets is reflected in the fact that nearly forty jurisdictions around the world have adopted some form of netting legislation over the past 20 years.[3] A number of emerging market jurisdictions are currently considering adopting such legislation. Various pieces of European legislation have recognised the importance of close-out netting, including, in particular, the Financial Collateral Arrangements Directive (the FCAD)[4] and the Winding Up Directive for Credit Institutions (WUDCI).[5]

It is essential, therefore, that if an SRR is introduced it should contain specific safeguards for close-out netting arrangements. The lack of an explicit safeguard for close out netting in the Banking (Special Provisions) Act 2008 (the BSPA) has caused some concern in the market, given the apparently broad and open-ended power of the Treasury to transfer some but not necessarily all of the property, rights and liabilities of a bank to another body corporate, which appears, on an unsophisticated analysis, to open the door to "cherry-picking" of rights and obligations under a financial market master agreement. To date, this concern has been mitigated by a number of factors, including (a) the understanding that the BSPA was introduced in exceptional circumstances to deal specifically with the Northern Rock situation, (b) the fact that the BSPA is of limited duration (expiring, we understand, on 21 February 2009) and (c) the existence of a variety of strong arguments from general principle against the ability of the Treasury to exercise the powers conferred in the BSPA to interfere with otherwise valid contractual close-out netting arrangements. Nonetheless, in a permanent SRR, it is essential for legal certainty and therefore market confidence that close-out netting be specifically and expressly protected.

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[3] A list of the jurisdictions where ISDA is aware that netting legislation has been adopted may be consulted on the ISDA website at http://www.isda.org.

[4] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.

[5] Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions.

More generally, financial market contracts should continue to be enforceable as written with no greater risk of modification or invalidation by administrative action or court order than exists under current English law. If a master agreement is disclaimed by the liquidator of an insolvent bank, it should be disclaimed as a whole. If a master agreement is to be "transferred",[6] it should be "transferred" as a whole. As we note above, this is an express requirement of the FDIC regime. The terms governing individual transactions should not be modified or invalidated if those terms would otherwise be valid and enforceable under existing law. If the right to terminate, value and/or net transactions in the event that the SRR is invoked is to be suspended for a period of time, that period should be as short as possible.

6. Set-off generally

The availability of set-off post-insolvency under English law is a fundamental and long-standing principle and a pillar of its reputation as a governing law for professional financial and commercial dealings. Close-out netting is sometimes based on contractual set-off,[7] although close-out netting under an ISDA Master Agreement is effected on another legal basis, which is sometimes characterised as the "flawed asset" approach.[8] But the importance of set-off goes far beyond those close-out netting arrangements that rely on it.

The availability of contractual set-off and set-off under the Insolvency Rules 1986 is a fundamental expectation in financial transactions based on English law involving counterparties subject to the English insolvency jurisdiction. The fact that set-off is not stayed under English insolvency law, even in the event of an administration, is considered by financial market participants to be one of the great advantages of dealing with English-incorporated entities.

In principle, ISDA does not favour any derogation from set-off, but, of course, defers to national experts on the advisability of a limited derogation in relation to the Financial Services Compensation Scheme (FSCS) and the payment of insured deposits. Set-off of mutual claims must, however, remain one of the core rules governing an administration (where there is a distribution) or winding up of an English bank.

7. Building society set-off

Although we have not, up to this point in our response to the Consultation Document, commented specifically on building societies, we are aware of the importance of English building societies as participants in the UK financial market, and the fact that the

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6 There are conceptual difficulties with the idea of a master agreement being "transferred". Instead, it would be terminated and replaced by a master agreement with another counterparty or, in other words, novated. This has a number of implications for the interpretation of the BSPA and the SRR proposals that are quite technical, but which we would be pleased to discuss in more detail on a future occasion.

7 For example, market standard master agreements for securities repurchase (repo) transactions are generally based on contractual set-off.

8 This is discussed in some detail in the memorandum of law dated 5 March 2004 (as subsequently updated) prepared for ISDA by Allen & Overy LLP on the validity and enforceability under English law of close-out netting under the 1992 and 2002 ISDA Master Agreements.

proposals in the Consultation Document also apply, with some adaptations, to building societies.
We note that the absence of a specific insolvency set-off provision for building societies has for some years caused some concern to market participants when considering their credit exposure to building societies.

Notwithstanding this, it has been possible, at least in relation to the ISDA Master Agreement (which, as noted above, does not rely on set-off to achieve close-out netting), to obtain a favourable legal opinion as to close-out netting against an English building society. But, for reasons outlined in a recent paper on this subject prepared by the Financial Markets Law Committee,[9] this situation is, nonetheless, not ideal. We strongly urge the Government to take the opportunity, in the legislation projected to follow the current consultation, to address this defect in the insolvency regime for building societies.

8. Financial collateral arrangements

Just as close-out netting and set-off must be protected for the health and reputation of the UK financial markets, financial collateral arrangements must similarly be protected, ideally by express safeguards in any proposed legislation to follow the current consultation. A considerable proportion of financial market dealings in London are done on a collateralised basis, and legal certainty as to the enforceability of those arrangements is crucial.

ISDA favours the introduction of a power enabling the Government to make secondary legislation in relation to financial collateral arrangements, provided, of course, that such power is used carefully, with due deliberation and subject to appropriate consultation and that it has the effect of strengthening, rather than restricting, the protections available to financial collateral arrangements.

You have asked for suggestions as to future revisions to the financial collateral regime. Our initial suggestions are as follows:

(i) clarify the definition of "control" for purposes of determining in what circumstances a collateral provider can be said to have provided financial collateral such that it is "in the possession or under the control" of the collateral-taker for purposes of the Financial Collateral Arrangements (No. 2) Regulations 2003,[10] which implement the FCAD in the UK; and

(ii) clarify the conditions under which those Regulations apply to floating charges.

These are merely preliminary comments, and we may have further and more detailed suggestions in response to a more detailed consultation on this subject. We note that the existence of this power may be convenient in light of the proposal by the European

[9] Available on the FMLC website at http://www.fmlc.org.
[10] SI 2003/3226.

Commission, published today, to amend the FCAD, as foreshadowed in its Evaluation Report on the FCAD published in December 2006.

9. Importance of consistency with current European obligations

The UK should, of course, continue to honour its European obligations and ensure that any legislation following this consultation is consistent with its obligations under, for example, the FCAD and the WUDCI. It is not entirely clear that this aspect has been thoroughly considered in framing the various proposals in the Consultation Document.

As a final comment, we note that Article 25 of the WUDCI provides that "netting agreements shall be governed solely by the law of the contract which governs such agreements". It has been widely assumed since the WUDCI first came into effect that English law was the most likely law to be chosen to govern a netting agreement between European parties in order to take advantage of this provision. English law was the leading candidate because of its reputation for clarity and robustness on the question of the enforceability of close-out netting.

It would be ironic, and unfortunate for the London market, if as a result of the introduction of legislation that failed clearly to protect close-out netting, a market counterparty dealing with an English bank or building society were in future more likely to insist that English law not be chosen in order to ensure that the netting agreement remained effective against the English bank or building society.

We would be pleased to discuss any of the above issues with representatives of any or all of the Treasury, the Bank and/or the FSA. As you know, we have been involved in many discussions in the past with representatives of each of these Authorities on related and other issues affecting financial markets, in relation to various UK, European and international initiatives.

If there is further more detailed consultation on any of the issues addressed in the Consultation Document, as we hope there will be, we would be pleased to participate in those discussions as well. In the meantime, please do not hesitate to contact either of the undersigned if we can be of further assistance in relation to these important issues for the UK and European financial markets.

Yours faithfully

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