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Consultation Paper: Resolution Regime for Financial Market Infrastructures

The International Swaps and Derivatives Association (**ISDA**)¹ is grateful for the opportunity to comment on the Resolution Regime for Financial Market Infrastructures Consultation Paper (**Consultation Paper**).

ISDA's submissions on the Consultation Paper are focussed on particular issues which are relevant to market participants which use clearing and settlement facilities (**CS facilities**) rather than all aspects of the Consultation Paper.

Question 3: Do you have any comment on the proposed power for the Minister to require a licensed overseas CS facility that is systemically important with a strong domestic connection to transition to a domestic licence?

ISDA submits that the circumstances in which a 'trigger event' would occur should be specific and clear to provide transparency to counterparties of an overseas CS facility. The proposal made in 2.1.3 of the Consultation Paper does not provide further detail as to the scope or terms on which trigger events might occur, or how they might be implemented. These aspects are key to providing certainty to CS facilities and market participants.

The Consultation Paper notes only that licence conditions could include events such as activity thresholds "linked to the systemic importance or degree of domestic connection of the CS facility". ISDA suggests that clarification as to how systemic importance and degrees of domestic connection would be calculated needs to be provided to market participants so that they

¹ 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 67 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

may consider the impact of a potential change of status of an overseas CS facility in their ongoing risk assessments of their dealings with the CS facility.

Question 14: Do you have any comments on the proposed objectives of the resolution regime? Are there other relevant objectives or considerations that should be included?

ISDA submits that the principle be considered that the liabilities of the participants in the CS facility be predictable and not unlimited. No entity can support nor would be authorized by its regulator or management to participate in an activity where exposures are uncontrollable and either unlimited or unquantifiable.

Question 17: Do you have any comments on the proposal conditions for entry into resolution and use of resolution powers, and, in particular, the distinction between general and specific conditions? Is there another option you prefer? If so, why?

ISDA submits that the conditions for entry into resolution and the use of resolution powers should be clear, and be able to be determined with a high level of certainty. The extent of intervention which these powers enable means that certainty as to when they are able to be used is critical. Further, ISDA considers that the conditions should be aligned with the recovery plans of the CS facilities. For example, if the recovery plan of a CS facility is in operation and the CS facility is returning to viability, then no exercise of resolution powers should be necessary. If the recovery plan is not in operation then the resolution powers should first be used to ensure that the recovery plan is followed. Only if severe systemic disruption would arise if the recovery plan were followed, financial stability is compromised, or if insolvency processes would commence despite the recovery plan, should the wider and more discretionary resolution powers be used. This would provide certainty to market participants that the recovery plan of a CS facility is the most likely process in the event of the CS facility's financial distress.

Question 18: Do you have any comments on the proposed powers of a statutory manager? Are there additional powers that should be included? If so, why?

ISDA submits that the empowering legislation should prescribe competency requirements to which the RBA must have regard when appointing a statutory manager to a CS facility. This is because the management of a CS facility will require particularly specialist knowledge, with the result that competency in this area will be a critical factor.

Question 22: Do you have any comments on the proposal to empower the resolution authorities to impose a limited moratorium on outgoing payments from an FMI? Do you have comments on the proposed limitations applied to the scope of the moratorium? Is there another option you prefer? If so, why?

ISDA submits that the moratorium should not apply to payments made by the CS facility under market netting contracts or close-out netting contracts (as defined in the Australian *Payment*

Systems and Netting Act). Imposing any suspension on these payments is unlikely to be appropriate or consistent with the greater level of protection given to these arrangements under Australian law. Further, as these are contracts which usually require payments both to, and by, the CS facility, imposing a moratorium would result in an imbalance of payment obligations which were always intended to be mutual.

Further, ISDA submits that the moratorium should be clearly limited such that it can only be applied when it is necessary to prevent the discontinuity or disruption of the critical functions of the CS facility.

Question 23/24: Do you have any comments on the proposed powers for business transfer and the proposed conditions for such transfer? Are there any changes you would propose, why? Do you have any comments on the proposed powers for establishment of a temporary bridge institution? Are there any changes you would propose? If so, why?

ISDA submits that the exercise of these powers with respect to a CS facility licensee is likely to be more problematic than with respect to an Authorised Deposit-Taking Institution. Assuming that transfer of part of a distressed clearing business is not contemplated (as the netting, collateral and default fund consequences would be extremely challenging) this would leave either the transfer of the distressed clearing business in whole (which would share some of the same issues) or the transfer of any separate non-distressed clearing businesses (which still could attract some netting and collateral issues). In addition there are likely to be issues associated with licensing and obtaining the benefit of the protection of the *Payment Systems and Netting Act* for the bridge entity. Accordingly, we submit that the exercise of these powers should be only a fall-back if the use of the CS facility's recovery plan, and then statutory management powers, fail.

Question 25: Do you have any comments on setting a timeframe for the duration of a temporary stay (for example, 48 hours)? Do you agree that there may be circumstances in which it would be necessary to extend the duration of the stay in order to support financial system stability?

ISDA submits that the default period should be as short as possible, and in any event, should not exceed 48 hours. Neither the resolution authority nor any other government entity should have power to extend the temporary stay period beyond the 48 hours proposed. Such an ability to extend would not be consistent with the approach taken in jurisdictions outside of Australia and would expose participants in an Australian CS facility to risks to which they are not subject when using clearing houses outside of Australia.

Counterparties of the Australian CS facility need to be able to re-hedge or manage their risks promptly and with certainty. This 48 hour period would particularly be an issue where the market is volatile (as it may be expected to be in the event a CS facility was subject to financial distress) or where the CS facility has a large or complex portfolio. Even if the resolution authority decides at the end of the 48 hour period (or sooner) that the FMI may be restored to financial viability,

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the CS facility's counterparties should be able to exercise their termination rights if permitted to do so under their contracts to insulate themselves from further market risk by closing-out existing positions.

ISDA also submits that it be clearly recognised and stated that any stay is imposed only for termination rights which are based on the appointment of the statutory manager to the CS facility and that such a stay is never applicable to termination rights which are based on other events, such as a failure of the CS facility to make the payments or deliveries which are payable by it under its market netting contracts or close-out netting contracts.

Further, ISDA submits that it is important that any stay would not prevent a participant in a CS facility from resigning if permitted to do so accordance with the rules of the CS facility.

Question 26: Do you have any comments on the proposed provisions, especially with respect to compensation arrangements?

ISDA submits compensation arrangements would be inadequate to deal with a particular circumstance which is articulated in paragraph 4.3 of the Consultation Paper. This is where there is to be a transfer of the business of the CS facility and either:

- some of the obligations under the same netting contract are separated as part of the transfer, or
- secured obligations and the collateral which secures them are separated as part of the transfer.

In this circumstance, the counterparty to the CS facility loses its ability to rely on the netting or collateral which were a fundamental part of its decision to originally contract with the CS facility. The removal of these rights as part of the FMI resolution process produces a different result to that which would have occurred in the winding up of the CS facility and, as a result, is not consistent with the 'no creditor worse off' principle.

The existence of this right has a real potential to jeopardise the accounting and capital treatment given to exposures on the CS facility by the prudential regulators of the participants in the CS facility. This presents a significant cost to other systemically important financial institutions. This cost arises before (and whether or not) any failure of the CS facility occurs and, as a result, no post-resolution compensation arrangements would be sufficient to address this issue.

Accordingly, ISDA submits that there should not be any discretionary right to cherry-pick obligations under netting contracts, or to separate security from the obligations which it secures.



In relation to other cases where compensation arrangements are contemplated, ISDA submits that a greater level of detail will be required in relation to how the compensation would be calculated (particularly if complex valuations are required) and by whom.

ISDA welcomes the opportunity to discuss these matters, and other issues in connection with the Consultation Paper, with you. Please contact Cindy Leiw (CLEiw@isda.org) or Keith Noyes (knoyes@isda.org) if we may be of further assistance.

Thank you for your consideration.

Yours faithfully

For the International Swaps and Derivatives Association, Inc.

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