ISDA® Safe, Efficient Markets

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Dear Sirs,

Consultation Paper on Criteria for Qualified Third Party

The International Swaps and Derivatives Association, Inc. ("**ISDA**") appreciates the opportunity to comment on the criteria for Qualified Third Party ("**QTP**").

1. General principles

1.1 Given that two fundamental principles, namely:

(a) respecting the sanctity of contractual rights freely entered into, and
(b) allowing creditors of a defaulting party to institute insolvency proceedings against the defaulter and treating creditors on a *pari passu* basis,

would have been violated in the short stay and transfer resolution process, it is of fundamental importance that the non-defaulting party have reasonable assurance that the transferee not only has the means to perform the qualified financial agreements ("**QFAs**") that it takes on, but also its obligations generally. It would not be fair to the non-defaulting party if (after having the transfer of the QFAs forced upon it) it should have to deal with a transferee that fails.

1.2 The July 19, 2011 Consultative Document on *Effective Resolution of Systemically Important Financial Institutions* by the Financial Stability Board ("**FSB**") recommends *inter alia* the following safeguards:

"*In the case of a transfer to a bridge financial institution or other specialized entity that is not required to be* ***capitalized under the applicable legal framework*** *or that does not have a* ***credit rating****, some form of assurance may be needed. The availability*

of temporary liquidity funding through the resolution regime (without imposing costs on taxpayers) would generally provide sufficient assurances for counterparties. If the acquiring entity is a ***healthy institution that is fully capitalized and in compliance with prudential requirements****, assurances of performance should not be necessary, especially since the* ***counterparties' rights to terminate based upon a breach of the contract by the acquirer would be enforceable***" (emphasis added).

1.3 Based on the FSB recommendations, the transferee in relation to a member institution should be a similarly situated institution (that is, bank for bank, insurance company for insurance company, etc.) in Malaysia that is fully compliant with Malaysian capital and prudential requirements. Alternatively, it should be an entity that has at least an investment grade credit rating.

1.4 In relation to an Affected Person, we repeat our past submissions that the extension of the short stay and transfer resolution process to QFAs of a non-financial institution is unprecedented elsewhere in the world. Indeed, the Basel Committee on Banking Supervision ("**BCBS**"), G20 and FSB initiatives and recommendations do not even extend to all financial institutions but only those financial institutions deemed to be systemically important. Without prejudice to our stand that it is not appropriate to impose the short stay and transfer resolution process to Affected Persons in the first place, the transferee in relation to an Affected Person should at the minimum be an entity that has at least an investment grade credit rating.

2. Assumptions

2.1 As a preliminary point, we would like to reiterate our understanding of the basis for any transfer of QFAs to a QTP, whether that be in regard to a transfer of QFAs from a member institution or an Affected Person, namely:

(a) Such transfer will be of **<u>all</u>** the QFAs that the member institution/Affected Person has with the non-defaulting party and the transfer of all such QFAs with that non-defaulting party will be made to **<u>one QTP</u>** only.

(b) If there is any agreement relating to financial collateral (whether that be security interest or title transfer collateral), such agreement together with the property held by the member institution/Affected Person as collateral will also be transferred to the transferee.

(c) The transfer to the transferee will be on the same terms and conditions as the existing agreements (that is, ISDA Master Agreement, confirmations and credit support documents) between the member institution/Affected Person and the non-defaulting party – the transferee will have no right to require re-negotiation of terms.

(d) The non-defaulting party will not be required to make any payment to (or receive any payment from) the transferee to reflect the then mark-to-market value of the QFAs as a condition of the transfer – any such payments will be for the separate account and settlement between the transferee and PIDM.

Similarly, the non-defaulting party will not be required to make any adjustment to the QFAs in this regard.

(e) Once the transfer has been effected, should the transferee commit an Event of Default or Termination Event under the agreement, the non-defaulting party would be entitled to exercise its rights of termination and close-out netting in accordance with the agreement. In other words, the PIDM Act should not be invoked again in respect of the transferee to stay the exercise of termination and close-out netting rights under the agreement. This is also in line with the recommendations in FSB's July 19, 2011 Consultative Document on *Effective Resolution of Systemically Important Financial Institutions* which states "*For contracts that are transferred, the exercise of early termination rights on the basis of the resolution of the troubled financial institution would continue to be precluded but any acceleration or termination rights based on a* ***subsequent*** *default by the acquiring entity should be preserved*". Please also refer to paragraph 1.2 above where the FSB has stated that this right to terminate for default by the transferee also affects the sufficiency of the assurance of performance by the transferee.

(f) Any taxes or duties in connection with the transfer (whether Malaysian or otherwise) will not be borne by or for the account of the non-defaulting party.

2.2 We would also like to confirm the position with regard to guarantees of the obligations of the member institution/Affected Person under the QFAs and the provision of financial collateral by a third party. Section 3(11)(d) of the Second Schedule to the PIDM Act states that "*A transfer of an asset or a liability under a transfer instrument shall not … release a surety from an obligation*". Thus, our members assume that any guarantee or third party financial collateral will also be carried over, that is, the guarantor or third party financial collateral will continue to guarantee/secure the obligations of the transferee under the transferred QFAs. In this regard, we would point out that there may be a need as part of the transfer process to disapply any statutory provisions that would otherwise prohibit the giving of such guarantee/third party collateral (e.g. Section 133A of the Companies Act 1965) in relation to the transferee.

3. QTP in relation to Member Institutions

3.1 An institution licensed under the Banking and Financial Institutions Act 1989 ("BAFIA"), the Islamic Banking Act 1983, the Insurance Act 1996, the Takaful Act 1984 or the Development Financial Institutions Act 2002

3.1.1 We assume that the transferee will be of the same class as the member institution, e.g. where the member institution is licensed under BAFIA that the transferee will also be licensed under BAFIA.

3.1.2 While our members agree in principle that this is a sensible starting point, in addition to the points made in paragraph 1 above, there are a number of risk management and operational concerns, including the following:

(a) As the transferee may be an institution that the non-defaulting party considers to be of a weaker credit standing, the non-defaulting party's internal policies would ordinarily have required it to impose additional credit risk mitigation or other measures as a pre-condition to dealing with that transferee. The forced transfer to the transferee would thus require the non-defaulting party to breach its internal policies which simply reflects the fact that the non-defaulting party is now taking on additional risk without the protection it considers necessary for dealing with a counterparty such as the transferee.

(b) The transfer to a transferee with a weaker credit standing may also mean that the non-defaulting party will have to incur higher regulatory capital charges since the risk weighting of its exposures to such transferee may increase. This would mean that the QFAs are now priced too cheaply but the non-defaulting party would have no right to re-price the QFAs.

(c) The non-defaulting party may not have sufficient 'head-room' to accommodate the transfer of the QFAs to the transferee, resulting in a breach by the non-defaulting party of regulatory limits such as single counterparty exposure limits. Our members assume that such breach will be excused as part of the transfer process.

(d) Where the transferee does not have the level of sophistication or operational capability to manage the QFAs (including collateral arrangements), this would put the non-defaulting party in a difficult position.

(e) Where the transferee has an existing trading relationship (that is, ISDA Master Agreement and credit support documents) with the non-defaulting party, the agreements would have to be reconciled as the QFAs that have been transferred to the transferee and any existing transactions between the transferee and the non-defaulting party should be documented under one set of agreements. The current proposal suggests that two sets of trading documentation may be on foot simultaneously.

(f) There may be statutory or regulatory restrictions on the ability of the transferee to enter into derivative transactions, e.g. pursuant to the Revised Guidelines on Derivatives for Insurers, there are certain restrictions on the entry into derivatives by insurers. Any such restrictions would need to be disapplied as part of the transfer process.

(g) Some at least of the QFAs may have been entered into by the defaulting member institution for hedging or asset liability management (ALM) purposes. As these QFAs could be transferred without the associated underlying positions, they could be viewed as 'speculative' transactions in the hands of the transferee. It should be made clear that this cannot be an excuse for the transferee to later renege on these transactions.

3.2 A foreign financial institution

3.2.1 We would ask that you re-consider permitting a foreign financial institution ("**FFI**") to be the QTP. In Singapore, a compulsory transfer of the business of a bank can only be made to a transferee that is licensed to carry on banking business in Singapore (see Section 55E of the Banking Act). However, the Monetary Authority of Singapore may make a determination that the transfer be made to a transferee who is not licensed to carry on banking business in Singapore on terms that the transfer shall take effect only in the event of the transferee becoming so licensed. Given that each country is free to choose whether to adopt, and even if it does so, to modify the BCBS recommendations on capital and prudential requirements as it sees fit, the mere fact that the FFI is licensed by a foreign regulator does not provide any assurance that it meets the requirements set out in the BCBS recommendations, let alone any tougher requirements mandated by Bank Negara Malaysia.

3.2.2 Thus, we submit that licensing of the FFI by a foreign regulator is not sufficient and there needs to be some form of assurance that the FFI is viable and will be able to continue to perform the QFAs. In addition, protection along the lines provided for in Section 201(c)(9)(B) of the Dodd-Frank Wall Street Reform and Consumer Protection Act should be afforded to the non-defaulting party. Section 201(c)(9)(B) provides as follows:

"*TRANSFER TO FOREIGN BANK, FINANCIAL INSTITUTION, OR BRANCH OR AGENCY THEREOF.--In transferring any qualified financial contracts and related claims and property under subparagraph (A)(i), the Corporation as receiver for the covered financial company shall not make such transfer to a foreign bank, financial institution organized under the laws of a foreign country, or a branch or agency of a foreign bank or financial institution unless, under the law applicable to such bank, financial institution, branch or agency, to the qualified financial contracts, and to any netting contract, any security agreement or arrangement or other credit enhancement related to one or more qualified financial contracts, the contractual rights of the parties to such qualified financial contracts, netting contracts, security agreements or arrangements, or other credit enhancements are enforceable substantially to the same extent as permitted under this section.*"

3.2.3 In addition to the above comments and the comments in paragraphs 1 and 3.1 above, the additional concerns with a QTP that is an FFI include the following:

(a) As an FFI could include a non-bank institution, it is important that the FFI should be of the same class as the member institution, e.g. where the member institution is a bank that the FFI be restricted to a banking FFI. Similarly, where the member institution is an Islamic bank, the FFI should be restricted to an FFI that is Syariah-compliant.

(b) The FFI should not be from a country or of a type that the non-defaulting party's home jurisdiction or internal policies prevent it from dealing with, e.g.

the FFI should not be from a country that is included in the non-defaulting party's home jurisdiction 'ban' list.

(c) The transfer to an FFI should not result in any adverse tax consequences for the non-defaulting party. To the extent that there would be such an adverse tax impact, the FFI would have to bear that cost and indemnify the non-defaulting party against the same.

(d) To the extent that the QFAs include transactions for which any approval or filing would be required when entered into with a foreign party, e.g., Ringgit transactions for which any approval or filing would be required under extant exchange control regulations, such approvals or filings should be deemed to have been obtained/made as part of the transfer process.

3.3 A public entity or an entity which the Government of Malaysia or PIDM has provided guarantees for the performance of the QFAs

3.3.1 Our members seek clarification of the meaning of a "*public entity*" as we understand that this is not a term that has a legal definition in any existing Malaysian statute. Our members would agree with this assuming that a "*public entity*" refers to an entity which satisfies all of the following conditions:

(a) All of the obligations (that is, not only the QFAs) of the entity are expressly backed by the full faith and credit of Malaysia.
(b) The entity does not enjoy any sovereign immunity.

3.3.2 On the second limb of the proposal, we assume that the guarantee to be provided will be a legally enforceable all-moneys guarantee that would not be subject to any sovereign immunity. Our members are concerned that the guarantee to be provided is limited to the performance of the QFAs. As pointed out in paragraph 1.1., the non-defaulting party would be rightly concerned with the ability of the transferee to perform its obligations generally as well as it ability to perform the QFAs as the last thing that it would want is to have to deal with the consequences of a failed transferee. Though it has recourse to the guarantee from the Government of Malaysia/PIDM, having to enforce the guarantee would likely take some time. Thus, the guarantee should either extend to all obligations of the transferee or some additional form of assurance of the continued viability of the transferee would need to be provided.

3.3.3 Our comments in paragraph 3.1 would also apply. In particular, our members are concerned that such entity should have the level of sophistication and operational capability to manage the QFAs (including collateral arrangements) and should not be able to renege on the transactions on the grounds that they are 'speculative'.

4. QTP in relation to Affected Persons

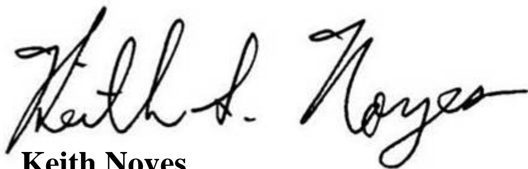
For the reasons given in paragraph 1, our members submit that it would not be appropriate that the transferee be any party who is willing to assume the QFAs of the

Affected Person. There has to be some form of assurance that the transferee is viable and will be able to continue to perform the QFAs.

In addition, the comments in paragraphs 3.1 and 3.2 (except to the extent that they relate to licensed institutions) would also apply.

Please feel free to contact Jacqueline Low (jlow@isda.org, +65 6538 3879) or Keith Noyes (knoyes@isda.org, +852 2200 5909) at your convenience.

Yours faithfully,
For the International Swaps and Derivatives Association, Inc.



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