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HM Treasury
London SW1

24th April, 2003

To: FSM Team, HM Treasury

Re: The Financial System and Major Operational Disruption

Please find attached the response of the International Swaps and Derivatives Association, Inc. on the above, as requested. In summary, ISDA:

- applauds the emphasis on a definitive position as to the status of financial markets in times of disruption;
- believes, however, that the private sector requires flexibility in order to be able to carry out its responsibilities in response to contingencies;
- considers that the authorities can greatly enhance markets' resilience by co-ordinating pre-emptive gap analysis and, in an emergency proper, co-ordinating communications among market representatives

ISDA would, naturally, be delighted to discuss further with HM Treasury any of the points raised in this response.

Yours faithfully,

Richard Metcalfe
Co-Head, European Office

The Financial System and Major Operational Disruption

ISDA appreciates the opportunity to comment on HM Treasury's consultation on how best to deal with possible operational emergencies affecting the financial markets ('The financial system and major operational disruption', February 2003). ISDA shares the view expressed in the paper that the private sector bears significant responsibility for responding to such contingencies. In fact, it considers that private-sector response, albeit aided by regulatory co-ordination, is the most appropriate mechanism for dealing with such eventualities and believes that this core issue merits further study and action. Consistent with this, it also believes that the role of the authorities in such circumstances should be limited and subject to an overarching principle, namely, to intervene only where and insofar as this is likely to be necessary and helpful.

As regards the usefulness and desirability of providing HM Treasury with additional powers, ISDA's view is influenced by a combination of factors, including its experience of dealing with the effects on over-the-counter (OTC) derivatives and related markets of the terrorist action in New York of September 2001; and specifically the way market participants interpreted and made use of the standard-form documentation that ISDA maintains¹. Since September 2001, various components of ISDA's documentation have evolved, in part reflecting the markets' experiences from that time. (The consultation paper makes reference to one such development, namely the treatment of force majeure in the newly published 2002 ISDA Master Agreement.)

Business days

It is clear that the notion of business day is crucial to transactions such as OTC derivatives, as various actions or processes may depend upon the occurrence of a 'good' business day. These include the ability to value a transaction, or to effect physical delivery or otherwise settle it. In addition to the Master Agreement, ISDA documentation includes 'definitions' booklets relating to specific classes of product (eg, credit derivatives or equity derivatives) and these set out, among other things, i) criteria that firms may adopt for determining whether or not a day is a 'good' business day and ii) a procedure that firms may agree to follow in the event that it is not. In the case of the 2002 ISDA Equity Derivatives Definitions, the standards for business day and market disruption were updated specifically bearing in mind the experience of the temporary closure of the New York Stock Exchange on and after September 11, 2001.

The HM Treasury paper envisages two possible new powers, relating to:

- 1) Suspension of Obligations;
- 2) Direction of Infrastructure.

While the second of these proposed powers is potentially of non-specific relevance for OTC derivatives markets, it is the first that is primarily and more directly of interest. In relation to the second proposed power, we would just make the following point: to the extent that firms make use of a centralised clearing function for over-the-counter transactions, powers to direct infrastructure should be framed so as to be sensitive to the fact that firms may be using both that central clearing and existing means of settling transactions.

Concerning suspension of obligations, as may be apparent from the very brief description above of some facets of its standard-form documentation, ISDA members prize certainty as to a) the triggers of extraordinary actions and b) the consequences once those triggers are activated. ISDA therefore applauds the emphasis that HM Treasury places on a definitive means of establishing the status of financial markets and transactions in a time of disruption. Thus, the ability to declare an extraordinary bank holiday is something that could be of considerable value in some circumstances, though it is ISDA's understanding that this power has not in fact been exercised in any disruptions affecting London in at least the past 15 years. This is perhaps not surprising. At the time of an operational crisis, it can be hard to determine how beneficial it might be actually to cause markets to be closed. (In advance, it is of course even harder.)

¹ ISDA is the trade association representing the global, bilaterally negotiated ("over-the-counter") derivatives markets, of which a significant portion is conducted via London. ISDA carries out a range of activities in relation to these markets, including the provision of standard-form documentation designed to support legal certainty in relation to OTC derivatives transactions. It counts nearly 600 members headquartered in over 40 countries round the world, including major dealers in derivatives and many end-users and providers of support services.

In a crisis, it is ISDA's view that consensus-based guidance as to how to parties should proceed on a bilateral basis, while not providing an instantaneous solution, will be the most practical step. Importantly, this allows the flexibility to take the specific circumstances and the current interests of the marketplace into account. The aftermath of September 11th showed that market participants have and respond to strong incentives to act in the interests of the marketplace as a whole, with considerable forbearance shown in dealing with the issue of delayed payments in particular. ISDA members were also able to reach a consensus on how to deal with issues of valuation in equity and commodity markets and to issue non-binding guidance to reflect that consensus.

Role of authorities

This is not to say that the authorities have no role to play. ISDA would argue that the authorities can greatly enhance markets' resilience by co-ordinating: first, contingency planning and "gap" analysis; and, second, in the event that an emergency in fact materialises, communications among market representatives. As alluded to above, the process of forming consensus as to how to proceed can take time and any mechanism to make it more efficient (and more widely known) can only be helpful. As regards contingency planning, we note that this appears to be the focus in the United States. (See in particular "Interagency Paper on Sound Practices to Strengthen the Resilience of the US Financial System", at www.federalreserve.gov/boarddocs/press/bcreg/2003/20030408/default.htm, which concentrates on encouraging private sector actions.)

Trigger definition

Assuming that a power to suspend obligations was to be binding, ISDA's concern is that a trigger for action would be inherently difficult to define and that, absent a clear definition, uncertainty as to the prospective status of transactions could be increased, not decreased. The quantity and range of serious definitional questions that the paper raises, concerning the scope, duration and after-effects of any suspension, illustrate the scale of this challenge and the somewhat uncertain ground that this proposal in our view occupies.

If, on the other hand, the suspension was not binding, then the proportion of the market on which it would have impact would be uncertain.

One further consideration that prompts caution in regards to the proposed new powers and that we believe merits further investigation is the international nature of the markets (which is a significant characteristic of OTC derivatives, as well as some other financial instruments). The suspension of obligations in the UK could cause operational issues when other centres remained open. Determining the appropriate reaction to a crisis affecting an overseas centre could, meanwhile, be even more problematic than reacting to a crisis affecting the UK.

The power to suspend appears to go beyond powers available in other jurisdictions and we would question whether the existence of such an extraordinary power in the UK could diminish the perceived sense of certainty relating to transactions for which actions must be carried out in the UK. Also, as the paper acknowledges, some actions to be performed in the UK could be governed by foreign law and such a combination of circumstances does, in ISDA's view, need to be studied more carefully before drawing conclusions.

As regards the focus on the performance of actions in the UK, as distinct from obligations governed by UK law, this is preferable in ISDA's view. (It is possible for parties to elect that English law govern their ISDA Master Agreement, even if those parties are not located in the UK, and we would have concerns about any attempt to impose suspensions in relation to such contracts.)

ISDA agrees that any powers that are added should focus exclusively on non-financial crises.

Conclusion

In conclusion, ISDA believes that, though the objective is one that we share, it would not be appropriate to proceed with the proposals without further analysis of the benefits and disadvantages; and that alternative, practical measures relating to contingency planning may be more helpful and provide greater levels of certainty and confidence in the market. Should extra powers in fact be sought, these should be framed such that their exercise and effect would be as predictable as possible.