



Resolution Planning

Identifying “non-standard terms” in Derivative Documentation

Introduction

Feedback Statement 12/1 (“FS 12/1”), published by the FSA in May 2012, provides detailed guidance to firms which are subject to the UK’s recovery and resolution planning rules. In general, FS 12/1 is a superb roadmap document, assisting firms through the detailed data requirements which form the core of recovery and resolution planning. Unfortunately, there remain a number of areas of FS 12/1 in which clarity is lacking. One such area appears in the context of Module 3.7 (“Derivatives / Securities Financing”), which forms part of the ‘Group structure & key legal entity information’ section.

Module 3.7

Module 3.7 requires firms to provide information with respect to their derivatives exposures. Exposures are to be split into three broad categories, being:

- Exchange traded derivatives;
- OTC but centrally cleared derivatives; and
- OTC bilateral derivatives.

Within each category, detailed reporting is required in four main areas:

- Counterparty details;
- Exposure data;
- Collateral data; and
- Documentation.

Within the “Documentation” section, firms must provide, inter alia, information regarding “non-standard terms”. Rather unhelpfully, the summary provided by the FSA to explain the background to the data requirement states simply that its purpose is to “determine requirements regarding trade termination etc”. However, on the plus side, two examples of a “non-standard term” are provided, being:

- Events of default, and
- Cross-default clauses.

No other information is provided to assist firms with their submissions. Additional FSA guidance is expected on 13 August 2012, but this seems unlikely to address this particular issue. Consequently, many firms, particularly those with large portfolios of derivative documentation, have been left struggling to understand where to draw the line.

Unfortunately, there is no single correct answer to this question. Nonetheless, it would seem possible to identify two general principles which will assist with the identification of “non-standard terms” in derivative documentation. We would suggest that these principles are that:

- an objective, rather than a subjective, measure of what is “non-standard” is appropriate; and
- clauses should only be regarded as “non-standard” to the extent that they could:
 - have an adverse effect on the application of a resolution tool; or
 - constitute a barrier to resolution.

An objective measure of what is “non-standard”

ISDA negotiation practices have converged significantly over recent years on a number of issues with the result that it is possible to discern a number of ‘industry standard’ positions. As such, the ISDA negotiation policy of a firm will often represent a good starting place to assist in understanding what can be regarded as ‘standard’. Clauses in executed documentation which lie outside of an agreed negotiation policy should raise internal flags and merit further investigation. Inevitably, however, this exercise is of limited assistance as it represents a firm’s subjective view of its own risk tolerance. Despite the fact that recovery and resolution planning remains a very firm-specific exercise, if assessments of resolvability and the contents of resolution plans are to be meaningful and consistent across EU Member States, a truly objective benchmark is required. An assessment of the effect of a contractual clause on the ultimate resolvability of a firm creates this objective standard.

“Non-standard” clauses must affect resolvability

The power to transfer, modify or cancel contractual arrangements entered into by a firm under resolution form the essence of the Resolution Powers conferred on resolution authorities pursuant to the draft RRP Directive. Accordingly, in assessing whether a contractual provision could have an adverse effect on the resolvability of a firm or the application of a resolution tool, one should be primarily concerned with the ability of a resolution authority to transfer or terminate a derivatives transaction so as to help facilitate an orderly wind-down of the firm in question.

Towards defining a set of “non-standard” terms

With this in mind, it is possible to group contractual provisions into three main categories:

- Probable Non-Standard Terms;
- Possible Non-Standard Terms; and
- Unlikely to be Non-Standard Terms.

The Schedule below applies the principals set out above to a number of clauses of the type typically found in derivatives documentation in order to generate the groupings referred to above. However, it is important to recognise that, whilst an assessment of the effect of a contractual provision on the resolvability of a firm helps to create an objective benchmark regarding what is “standard”, the exact positioning of this benchmark will inevitably change over time. What could be regarded as a “standard” provision, say, 5 years ago may well not be standard today. Similarly, what is standard today may not be standard in another 5 years

time. As such, this aspect of recovery and resolution planning must be kept under periodic review.

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SCHEDULE

Group 1: Probable Non-Standard Terms

Clause	Explanation
Events of Default	Specifically referred to in FS 12/1
Cross-default / Cross-acceleration	Specifically referred to in FS 12/1
Termination Rights Generally	Termination rights should be regarded in the same light as Events of Default
Ratings Downgrade Clause	Often takes the form of an Event of Default / Additional Termination Event
Material Adverse Change Clause	Often takes the form of an Event of Default / Additional Termination Event
Credit Event Upon Merger linked to specific ratings or other factors	CEUM is a Termination Event under a standard ISDA Master Agreement
Unusual Governing Law	Effective application of resolution tools may be more difficult/impossible in certain jurisdictions which do not recognise the powers of resolution authorities

Group 2: Possible Non-Standard Terms

Clause	Explanation
Undisclosed Agency Arrangements	May make application of the resolution tools more difficult as the identity of the counterparty may be difficult to ascertain
Indemnities	Should not of itself prevent exercise of a resolution tool but may still constitute a barrier to resolution if indemnities are enforced
Illiquid CSA Collateral	Should not of itself prevent exercise of a resolution tool but may still constitute a barrier to resolution in terms of transferring or terminating transactions
ISDA First Method	Should not of itself prevent exercise of a resolution tool but may still constitute a barrier to resolution if a counterparty has a right to 'walk away' without making payment
Ratings Dependent CSA Credit Support Amounts	Should not of itself prevent exercise of a resolution tool but may still constitute a barrier to resolution if additional collateral must be posted

Unusually wide definition of “Specified Entities”	Widens the application of ISDA Events of Default and/or Termination Events

Group 3: Unlikely to be Non-Standard Terms

Clause	Explanation
Automatic Early Termination	AET is primarily designed to protect against ‘cherry picking’. However, in certain circumstances the automatic termination of trades could constitute a barrier to resolution. Nonetheless, it is placed in Group 3 due to the fact that, under normal circumstances, resolution tools would have been implemented before insolvency (and therefore AET) occurs
Non-daily CSA calls	Should not be effective to prevent the exercise of the resolution tools
Non-zero/large CSA Thresholds/MTAs	Should not be effective to prevent the exercise of the resolution tools
Unusually large/small collateral haircuts	Should not be effective to prevent the exercise of the resolution tools
Non-assignment Provisions	Should not be effective to prevent the exercise of the resolution tools