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State Bank of Pakistan  
Dr Ishrat Husain, Governor  
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Dear Dr Husain,

**Proposed netting legislation in Pakistan – ISDA technical comments**

The International Swaps and Derivatives Association, Inc. (“**ISDA**”) respectfully presents this letter to the State Bank of Pakistan in relation to the proposed Netting of Financial Contracts Act, 2005 (the “**Draft Netting Act**”). We refer to our letter of 13 July 2005 (sent to Mr Syad Ghazanfar Agha from United Bank Ltd) in which we provided some general comments on the Draft Netting Act, we indicated our strong support for the Draft Netting Act, and we offered to provide further more detailed technical comments on the text of the Draft Netting Act for your consideration.

ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry. ISDA was chartered in 1985, and today has more than 650 member institutions from 47 countries, including Pakistan. These members include most of the world’s major financial institutions that deal in privately negotiated derivatives, as well as many corporations, governmental entities and other end-users that use over-the-counter derivatives to manage efficiently the financial market risks inherent in our business activities. ISDA documentation is, inter alia, referred to in paragraph 16 of Annexure P-I to the Financial Derivatives Business Rules drafted by the State Bank of Pakistan. A current list of ISDA’s members, as well as other information about ISDA and its activities, is available on our website at [www.isda.org](http://www.isda.org).

We are now pleased to offer our technical comments for your consideration. As mentioned in our letter of 13 July 2005, we defer completely to national legal experts in Pakistan on the appropriateness of the proposed legislation in the general scheme of Pakistan law and its

interaction with other substantive areas of Pakistani law. Our comments are exclusively from an international financial market perspective, and we hope that you will find them helpful as respectful suggestions for your consideration.

The majority of our comments are intended merely to help clarify the text without effecting any substantive change. As we mentioned in our prior letter, we believe that the Draft Netting Act is an important piece of proposed legislation that will bring significant benefits to Pakistan, its financial market and Pakistan's banks, corporations and other financial market participants.

We believe that it is particularly helpful that the Draft Netting Act deals not only with netting but also with financial collateral arrangements. Would it be appropriate to indicate that in some way in the name of the statute?

We thought that it would be easier and more useful for you if we presented the bulk of our technical comments in the form of a marked copy of the proposed legislation. As noted above, these are merely suggestions in order to highlight areas where we are concerned that the text may not be as clear, from an international financial market participant's point of view, as would be desirable. Clearly the greater the clarity of the text, the greater the degree of legal certainty conferred by the proposed legislation, further strengthening Pakistan's financial law regime.

Most of our technical comments are, we hope, self-explanatory, but we offer some additional comments below, which we hope will be useful. We do have some more substantive suggestions regarding the scope of the Draft Netting Act in relation to financial collateral arrangement. These are discussed below.

1. **Executive Summary.** Broadly speaking, our comments fall into the following categories:
  - (a) suggesting clarification of some apparently overlapping definitions used in the Draft Netting Act (for example, as discussed in more detail below, (i) "netting agreement" and "close-out netting provisions" and (ii) "collateral arrangement" and "financial collateral arrangement");
  - (b) clarifying that close-out netting is not necessarily based on contractual set-off (although contractual set-off is a legal technique used in some netting agreements used in the financial market);
  - (c) clarifying the enforceability of title transfer financial collateral arrangements under the proposed law; and
  - (d) raising for your consideration the possibility of expanding the scope of the protections for financial collateral arrangements to make as explicit as possible that no special formalities are necessary for the creation or perfection of a financial collateral arrangement.

2. **General comments.** As you know, and as mentioned in our letter of 13 July 2005, we are the sponsors and publishers of the 2002 Model Netting Act (the **2002 MNA**), and we are pleased to note that the legislative draftsmen of the Drafting Netting Act appear to have taken the 2002 MNA into account when framing the proposed legislation, as have a number of other countries when framing their local netting legislation.

In fact, the 2002 MNA is, to a large extent, the distillation of the knowledge gained by ISDA during nearly twenty years of collaboration between ISDA, national legislators and regulators, and local financial market participants in countries around the world on legislative reform in this area.

In our letter of 13 July 2005, we also noted that the legislative draftsmen of the Draft Netting Act appear to have taken into account Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (the **FCAD**) when framing the provisions of the Draft Netting Act dealing with financial collateral arrangements.

The bulk of our technical comments emanate from the interaction of the provisions in the Draft Netting Act drawn from the 2002 MNA with the provisions drawn from the FCAD. The 2002 MNA is principally focussed on strengthening **netting**, but includes provisions designed to reinforce related **collateral** arrangements. The FCAD is principally focussed on strengthening the legal regime for **financial collateral arrangements**, but requires (in Article 7) Member States of the European Community to strengthen **close-out netting**.

Because the 2002 MNA and the FCAD were developed at different times for different purposes (quite apart from the fact that one is a model law and the other a European legislative instrument), inevitably each instrument deals with netting and with collateral in a somewhat different way from the other.

Note that the FCAD included provisions relating to close-out netting principally for two reasons: first, a significant proportion of financial collateral arrangements are intended to secure or support master netting agreements providing for close-out netting and, secondly, title transfer financial collateral arrangements often rely for their effectiveness on close-out netting. This is the case, for example, under the 1995 ISDA Credit Support Annex (Bilateral Form – Transfer) under English law (the **English CSA**), which creates a title transfer financial collateral arrangement for use with an ISDA Master Agreement.

Thus the bulk of our technical comments come from seeming inconsistencies between (a) the netting provisions of the 2002 MNA and the somewhat different close-out netting related provisions of the FCAD and (b) the collateral provisions of the 2002 MNA and the somewhat different financial collateral provisions of the FCAD, in each case as reflected in the Draft Netting Act.

To give a brief example, the Draft Netting Act includes the defined terms “close out netting”, “close-out netting provisions”, which are drawn from the FCAD, and the terms “netting”, and “netting agreement”, which appear to be drawn from the 2002 MNA. It

also uses the terms “master agreement”, which appears in both the FCAD and the 2002 MNA, but with slightly different definitions in each source.

Similarly, the Draft Netting Act includes the defined terms “collateral”, “collateral arrangement” and “title transfer collateral arrangement”, all apparently drawn from the 2002 MNA, as well as the terms “equivalent financial collateral”, “financial collateral”, “financial collateral arrangement” and “financial instrument” (which is used to defined “financial collateral”), all apparently drawn from the FCAD, along with the following terms that are used in provisions inspired by the FCAD but not separately defined in section 2 of the Draft Netting Act, namely, “security financial collateral arrangement”, “title transfer financial collateral arrangement”, “collateral-provider”, “collateral-taker”, and “relevant financial obligations”.

Many of our suggested amendments marked on the attached copy of the Draft Netting Act are intended to rationalise the defined terms into a single set that works for both the netting and the financial collateral provisions of the Draft Netting Act. We have looked to the 2002 MNA and the FCAD for some guidance, but we have also adapted our suggestions to the context of the Draft Netting Act. As noted above, these changes are not intended to change the substantive effect of the text, and we, of course, defer to your legislative draftsmen as to whether they achieve the intended effect for purposes of Pakistan law.

3. **Qualified financial contracts – definition and designation.** One of the most important aspects of the Draft Netting Act is, of course, its scope. It should be as clear as possible what constitutes a qualified financial contract for purposes of the Draft Netting Act. As currently drafted, the Draft Netting Act includes a generic definition of “qualified financial contract”, without reference to the non-exhaustive list of specific product types in the 2002 MNA.

It is not in our view strictly necessary to list the specific product types provided that the basic definition is sufficiently clear and broad enough to accommodate the development of new product types in the financial markets over time. Many market participants, however, draw comfort from seeing the list and feel that this enhances certainty, at least in relation the basic principal categories which constitute the bulk of the daily traded volume in the privately negotiated derivatives market.

We believe that it is the intention of the Draft Netting Act that any designation by the State Bank of Pakistan of a type of contract as a qualified financial contract is in addition to those products that already clearly fall within the generic definition. That would be consistent with the approach in the 2002 MNA. We note that the definition of “qualified financial contract” concludes with the words “or any agreement or contract designated as such by the State Bank by any rules, circulars or directions” (emphasis added), the word “or” implying that designation by the State Bank is an alternative to falling within the scope of the definition. We note, however, that section 5(1) of the Draft Netting Act appears to provide that only qualified financial contracts that have been designated

benefit from the protections of the Draft Netting Act. We have suggested an amendment to section 5(1) to clarify that the former and broader approach is the intention.

4. **Set-off and close-out netting.** The definition of “netting” in the 2002 MNA uses the word “offset” in sub-clause (iv). The equivalent provision of the Draft Netting Act has substituted the word “set-off”. The choice of the word “offset” in the 2002 MNA was deliberately made (although perhaps a better word could have been chosen) to avoid use of the more precise word “set-off”, which denotes a specific legal concept with a lengthy and complex jurisprudence.

The choice of the word “offset” in the 2002 MNA reflects the fact that close-out netting is not always based on contractual set-off. There are, in fact, a number of legal bases for close-out netting. While some bilateral agreements used in the financial markets that provide for close-out netting are based on contractual set-off, many, if not most, do not. A prominent example is the 2002 ISDA Master Agreement itself (the earlier versions of the ISDA Master Agreement are also based on the same principles).

Under the 2002 ISDA Master Agreement, upon the designation or deemed occurrence of an early termination date following an event of default or termination event, the obligations of the parties under the individual transactions governed by the Master Agreement are discharged by Section 6(c)(ii). At the same time a new obligation crystallizes under Section 6(e). The new obligation is the net close-out amount. It is determined by reference to the mark-to-market close-out values of the Transactions that were terminated under Section 6(c)(ii), with the non-defaulting parties gains as a result of the termination subtracted from its losses to reach a net balance. This is merely a calculation, however. The individual transactions have been discharged, so there is no setting off of one claim against another claim.

This conceptual basis of the ISDA Master Agreement (sometimes called the “single agreement concept” or, sometimes, the “flawed asset approach”, although the latter term has a somewhat different meaning) has proved to be very important over the years in ensuring the effectiveness of close-out netting in jurisdictions that were otherwise hostile to insolvency set-off. You will note that the definition of “close-out netting provision” in the FCAD carefully avoids the use of the word “set-off” precisely for this reason.

In our technical comments, we have suggested amending “set-off” to “set-off or netting out”, although another possibility would be the generic phrase “determination of a net balance”. This recognizes the possibility that different financial market master agreements are based on different legal approaches to the determination of a net balance. We note that section 8(3) of the Draft Netting Act uses the phrase “to set off or net out obligations”.

5. **Title transfer collateral arrangements.** Although the Draft Netting Act includes the defined term “title transfer collateral arrangement”, apparently drawn from the 2002 MNA, it does not appear to give title transfer collateral arrangements the same protection

it extends to security financial collateral arrangements in the provisions that are drawn from the FCAD.

While title transfer collateral arrangements are a new approach in the financial markets compared to more traditional security arrangements such as mortgages, charges, pledges and similar security interests, it has, in fact, become a very common alternative to security arrangements. For example, in the European market, it is probably more commonly used than security, because of the traditional difficulties with using security interests in the context of modern financial instruments (such as cumbersome creation and perfection formalities and enforcement procedures).

ISDA publishes standard form documents for both the security approach and the title transfer approach to creation of a collateral arrangement, the English CSA being an example of the latter. The FCAD gives each approach equal prominence, as one can see from the definition of “financial collateral arrangement” in the FCAD. We note that the Draft Netting Act uses a similar definition of “financial collateral arrangement” but does not otherwise appear to extend full protection to such arrangements. We have suggested additional language in our technical comments intended to achieve the necessary additional protection.

6. **Creation and perfection of a financial collateral arrangement.** Although most of our technical comments are intended primarily to clarify the scope and effect of the Draft Netting Act, as noted above, we have proposed an additional substantive provision in section 6 of the Draft Netting, adding a new sub-section (3) and re-numbering current sub-section (3) as sub-section (4). As noted in our mark-up of the Draft Netting Act, we believe that this is in the spirit of the other provisions of the Draft Netting Act. The suggestion provision is comparable to Article 3 of the FCAD.

We note that you have included in the re-numbered sub-section (4) a provision comparable to Article 4 of the FCAD intended to eliminate formalities such as notice periods, court approval, formal auction procedures and the like. Such enforcement formalities are unnecessary, from a policy point of view, in the context of financial collateral arrangements. Financial collateral can easily be valued by reference to the market to determine whether the collateral-taker has allocated a fair value to the collateral for purposes of enforcement, whereas old-fashioned enforcement formalities occasion unnecessary delay, expense and uncertainty for financial market counterparties at the time of a default.

Should you require any further information or wish to discuss this matter ahead of our submission of technical comments on the Draft Netting Act, please do not hesitate to contact Peter Werner in London on +44 20 7330 3550 or Angela Papesch in Singapore on +65 6538 3879.

Yours faithfully,

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