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Pakistan Banking Association  
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PAKISTAN

For the attention of: Mr Syed Ghazanfar Agha, Head Interbank Trading Division, Corporate Treasury & Capital Markets, United Bank Ltd

Dear Sirs

**Draft Banking Act, 2006 – Set-off, Netting and Financial Collateral**

We refer to your letter of 29 June 2006 and your kind invitation to provide you with technical comments on the draft Banking Act, 2006 (the “**Draft Banking Act**”). The International Swaps and Derivatives Association, Inc. (“**ISDA**”) is grateful for this opportunity to assist you in your preparation of comments for the Banking Law Review Commission. We note that the Banking Law Review Commission has set a deadline of 31 July 2006 for filing of comments. Please accept our apologies for not having been able to provide our own comments to you sooner.

As you know, through your kind intervention, we were invited to comment on the draft Netting of Financial Contracts Act, 2005 (the “**Draft Netting Act**”), which we did in our letters to the State Bank of Pakistan of 13 July 2005 and 1 August 2005, the former letter setting out general comments on the Draft Netting Act and the latter providing more technical comments on the detail of the Draft Netting Act, including a detailed mark-up of the draft legislation. You may find it useful to refer to those letters for additional background on the points we raise in this letter. You may also find it helpful to refer to the most recent version of our Model Netting Act, published in March 2006 (the “**MNA2006**”), along with a Memorandum on Implementation of Netting Legislation of March 2006 (the “**Memorandum for Legislators**”), which is intended as a guide for legislators and other policy-makers. Both of these are available from our website at: <http://www.isda.org>.

We share your concern with strengthening the financial markets through the promotion of law reform to enhance legal certainty. As you know, this has been a core part of ISDA's mission for over 20 years, and we are delighted to provide support, from the perspective of international financial market participants, for your efforts in this regard in Pakistan.

We, of course, defer completely to national legal experts in Pakistan as to the appropriateness of the Draft Banking Act in the general scheme of Pakistan law and its interaction with other substantive areas of Pakistani law. You refer to the Commission's solicitation of comments "*identifying the major weaknesses in the current laws and procedures as well as key concerns and issues that should be considered in the framing of the new law*". We must defer to you and Pakistani national legal experts as to major weaknesses, if any, in your current laws and procedures in relation to netting or financial collateral, but we are certainly able to assist you in identifying key concerns and issues that should be considered in the framing of the Draft Banking Act.

We also note that international financial market participants do draw comfort from well drafted and comprehensive statutory regimes that directly address the issues that you raise in relation to the effectiveness of close-out netting and financial collateral arrangements. Accordingly, even if general principles of Pakistani law are supportive of these arrangements, we agree with you that the framing of the Banking Act, 2006 seems a very good opportunity to provide additional assurance to the financial markets on these issues.

Our comments on the Draft Banking Act (references below to "section" and "sections" being to sections of the Draft Banking Act) are as follows:

1. As you indicate in your letter, the Draft Banking Act appears to address both set-off and netting in section 119. It does not, however, deal as thoroughly with those issues as did the Draft Netting Act. We comment in more detail on this below.
2. We also note, as you also indicated in your letter, that the Draft Banking Act does not appear to deal with financial collateral arrangements as such, other than in narrowly in relation to secured claims in section 120. But neither section 120 nor any other provision or provisions of the Draft Banking Act set out a regime for financial collateral arrangements. Again, this is an area that was addressed in some detail in the Draft Netting Act. We also discuss below how in principle this could be addressed in a revised version of the Draft Banking Act.
3. We note that the Draft Banking Act only applies to "banks", which is defined to include foreign banks, but does not cover other types of financial market participants in Pakistan. Accordingly, it would still be desirable for the enforceability of close-out netting and financial collateral arrangements to be addressed in broader legislation of the type set out in the Draft Netting Act. If any such broader legislation is eventually brought forward in Pakistan, it would be highly desirable if the approach taken in relation to entities other than banks were substantially the same as for banks. Hence, we agree that it is important, if at all possible, to broaden the scope of the protections given to close-out netting and financial collateral in the Draft Banking Act so that it provides protections comparable to

the protections in the Draft Netting Act (subject to our comments on the Draft Netting Act on issues of scope in our letters referred to above).

4. We have limited our comments in this letter to the issues of set-off, close-out netting and financial collateral arrangements. We are aware that the Draft Banking Act deals with many other important issues affecting banks operating in Pakistan, and that it may be difficult to draw the attention of the Banking Law Review Commission to these few issues in that context. However, as we know you agree, it is vitally important to the future integrity, efficiency and liquidity of the financial markets in Pakistan that these issues be properly and thoroughly addressed in appropriate legislation of the type exemplified by the Draft Banking Act.
5. ***Preliminary point.*** It is important that the Draft Banking Act should deal clearly with the concepts of set-off and netting, which have somewhat different meanings, as we noted in our comments on the Draft Netting Act and also as discussed in the Memorandum for Legislators. The ISDA Master Agreement<sup>1</sup> does not rely on set-off to achieve close-out netting. Instead, it relies on conditionality and novation (sometimes this is referred to as the “flawed asset” approach) to determine a net close-out amount under Section 6.

An ISDA Master Agreement typically, however, also includes a contractual set-off provision,<sup>2</sup> but this is to ensure that the non-defaulting party may set off any net close-out amount due against other debts owing between the parties (such as bonds, loans or deposits or amounts due under other financial market master agreements).

We note, however, that some master agreements used in some sectors of the financial market (for example, master agreements used for securities repo and securities lending transactions) do rely on contractual set-off to effect the close-out netting.

So it is important that close-out netting is sufficiently broadly defined in the Draft Banking Act so as to encompass the different methods by which close-out netting may be achieved, including the flawed asset approach and contractual set-off (there are other approaches as well, although these are the two most commonly used contractual methods used in the financial markets).

6. ***Section 119.*** We have a number of comments on section 119, which we would be happy to discuss with you in more detail should you find it helpful to do so. Our comments in brief are:
  - (a) Section 119(1) deals with set-off “by operation of law”. We are not familiar with how or when this applies under Pakistani law, but we would normally understand this to refer to statutory set-off. As noted above, close-out netting does not necessarily rely on set-off, but even where it does, it relies on contractual rather

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<sup>1</sup> There are, of course, various versions of the ISDA Master Agreement, the most commonly used being the 1992 ISDA Master Agreement (Multicurrency – Cross Border) and the 2002 ISDA Master Agreement. Unless otherwise specified, any comment in this letter on the ISDA Master Agreement applies to any of these versions.

<sup>2</sup> It is almost always added, as a matter of market practice, to a Schedule to a 1992 ISDA Master Agreement and forms part of the printed text of the 2002 ISDA Master Agreement.

than statutory set-off. This provision may be useful for other purposes, but is not directly relevant to close-out netting or contractual set-off and therefore we make no further remark on section 119(1).

- (b) Section 119(2) appears to be the core rule. It would be helpful if it could be made explicit that this rule applies notwithstanding any other provision of the Draft Banking Act or any other provision of Pakistani law, including any liquidation, reorganization or other insolvency law to which an insolvent bank may be subject. The inclusion of such language would significantly the comfort that this provision would provide to international financial market participants.

Ideally, it should be made explicit (although it flows by implication from the general principle) that the operation of a close-out netting arrangement would not be subject to (i) any stay or freeze under any insolvency law or (ii) any rules relating to the avoidance of fraudulent preferences or transactions at an undervalue (or similar insolvency avoidance rules) merely due to the operation of the close-out netting.

In relation to stays and freezes, it is a separate question whether enforcement of a net amount due from the insolvent bank should, once determined, be stayed. But certainly the operation of the close-out netting itself should not be stayed.

In relation to avoidance rules relating to fraudulent preferences and so on, it is a separate issue whether the overall arrangement in the specific circumstances involves fraudulent conduct of some type, in which case the normal avoidance rules would still apply. But such rules should not apply merely because the operation of a close-out netting arrangement improves the credit position of a the solvent counterparty, as that is, of course, the intended effect of the arrangement.

In relation to the foregoing, you may find it helpful to look at Part I, section 4 of the MNA2006. In particular, you may find it useful to consider the wording of section 4(a) (the general rule), the rest of section 4 strengthening the general rule by reference to specific issues such as stays and freezes and avoidance rules relating to fraudulent preferences and the like.

- (c) Regarding section 119(3), we have no specific comment.
- (d) Regarding section 119(4), the definition of “eligible financial contract” is, of course, crucial and defines the scope of the protection provided by section 119. It seems fairly clear that those drafting the legislation had regard to the MNA2006 as the first part of this definition follows the definition of “qualified financial contract” in the MNA2006 fairly closely.

The definition is good as far as it goes, and it is helpful that it makes reference to master netting agreements and indeed master-master (or umbrella) netting agreements. However, there are a number of omissions, and it would be helpful if

these omissions could be rectified to ensure that the risk reduction benefit of close-out netting is available for all of the activity that may be conducted by banks in Pakistan's financial market, both presently and in the future.

The mere fact that certain activity may not yet be well-developed currently or may be subject to closer regulation than other sectors (such as equity derivatives and credit derivatives) does not mean that such transaction types should be excluded from this definition, which is concerned with credit risk and not regulation. Activity in those sectors may be heavily regulated or even restricted at present, but there is no good policy reason why the benefit of close-out netting should not extend as broadly as possible to whatever activities a Pakistani bank is able to carry out assuming it complies with all relevant regulatory requirements. Accordingly, we see no harm in drafting as wide a definition of "eligible financial contract" as possible.

The types of products that do not appear to be fully covered by the definition of "eligible financial contract" include currency and interest rate forwards, futures and options (swaps, caps, collars and floors are covered, but interest rate forwards, futures and options are also traded and should ideally be covered), equity derivatives, credit derivatives, various types of energy and other commodity derivatives and other more recent types of derivatives such as those relating to inflation, freight, emissions allowances and to bandwidth. More precisely, the products omitted from the definition of "eligible financial contract" are those referred to in paragraphs (i), (j), (k), (l), (m), (n), (o), (p), (q), (t), (u) and (w) of the definition of "qualified financial contract in the MNA2006. Paragraph (w), we note, is a generic definition which is arguably broad enough to cover virtually all types, and could, if need be, be used on its own.

We note that the State Bank of Pakistan will have power to prescribe additional contracts by order, but past experience shows that legislation which is too narrowly drawn quickly leads to difficulties of interpretation (especially in relation to newer products that are hybrids or combinations of simpler product types), and the process of expanding the list of included transactions by secondary legislation is often not fast enough or flexible enough to keep pace with the development of the market.

There is also the potential issue of the effect of including under a single master agreement both eligible transactions and ineligible transactions. Does the inclusion of ineligible transactions (such as inflation derivatives under the current approach in the Draft Banking Act) cause the benefit of section 119 to be lost for the remaining transactions under a master agreement. Ideally, of course, the answer should be no. The broader the list of eligible transactions, the less likely it is that this issue will arise. This has been an issue in a few countries in the past, and has caused problems in the market as a result. It might be wise, in this regard, to include in section 119 a provision comparable to Part I, section 4(i)(i) of the MNA2006.

For the reason mentioned in part 5 of this letter above, the definition of “net termination value” in section 119(4) should be amended to add after the words “or setting off” the words “or otherwise netting”. You might find it fruitful to compare this definition to the definition of “netting” in the MNA2006 and, in particular, paragraph (iv) of that definition.

- (e) Regarding section 119(5), we are not sufficiently familiar with the relevant principles of Pakistani law to comment on this provision, but we trust that the powers of the High Court to declare transactions void and/or the relevant provisions of the Companies Ordinance, 1984 are not so broad as to undermine the effect of section 119(2).
  - (f) Regarding section 119(6), we are not able to comment, but we understand the high importance in Pakistani law of Shariah principles. It is not clear to us, however, why this provision is necessary here or what its practical implications would be. We presume that it does not mean that Shariah-compliant transactions fall outside the scope of the protection given by section 119. Guidance from you on this point would be most welcome.
  - (g) Section 119 does not provide any explicit protection for eligible financial contracts from the effect of gaming, wagering and similar laws. In this regard, we refer you to Part I, section 3 of the MNA2006. A similar provision added to section 119 would provide considerable comfort to international financial market participants on this point.
6. ***Multibranch netting.*** We have not had time fully to analyze the impact of section 128 or other provisions of the Draft Banking Act on multibranch netting, that is, netting against a Pakistan branch of a foreign bank. But it would appear that there is some potential for this provision to interfere with the intended global effect of a close-out netting arrangement if local insolvency proceedings are commenced in Pakistan against the local branch of the foreign bank. In other words, there appears to be a degree of “ring-fencing” risk in those circumstances, although we acknowledge that we are not fully informed on this point and this may not be an accurate reading of section 128.

If there is a ring-fencing risk, you may wish to consider the provisions of Part II of the MNA2006 in relation to multibranch netting with a view to protecting close-out netting in those circumstances. We would be happy to discuss this further with you.

7. ***Financial collateral arrangements.*** We will deal briefly with financial collateral arrangements, although we would be happy to discuss this issue with you in more detail, if you would find it helpful. The MNA2006 includes financial collateral arrangements within the scope of the definition of “qualified financial contract” and also includes other provisions specifically dealing with collateral. It might be helpful to take a similar approach in suggesting amendments to section 119.

In this regard, we note that the MNA2006 expressly acknowledges the distinction between security financial collateral arrangements and title transfer financial collateral arrangements, and it would be helpful therefore if section 119 did so as well.

This does not, however, necessarily deal with all of the issues that might arise in relation to financial collateral arrangements, including eliminating the recharacterisation risk that might otherwise be associated with title transfer financial collateral arrangements or addressing the conflict of laws rule that should apply to security created over intermediated securities (given that virtually all securities collateral given in the financial markets is held in intermediated or book-entry form). Additional provisions could be added to section 119 dealing with these points, although you may have a view as to whether or not this is likely to be acceptable to the Banking Law Review Commission or Pakistan legislators in this area.

Finally, we note that the Draft Netting Act (as amended by our suggestions) effectively covered the bulk of the issues that we believe should be covered in relation to financial collateral in order to ensure that there is a modern, efficient and robust regime for financial collateral. You might find it helpful, therefore, to have regard to our comments on the financial collateral aspects of the Draft Netting Act as set out in our letters referred to above.

Should you require any further information or wish to discuss any of the issues above with us, please do not hesitate to contact Peter Werner in London on +44 20 7330 3553 or Angela Papesch in Singapore on +65 6538 3879.

Yours faithfully,

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