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30 October 2009

Per fax and mail

H.E. Mr. Aleš Zalar
Minister of Justice
Slovenian Ministry of Justice
Zupanciceva 3
1000 Ljubljana

Re: Achieving Legal Certainty for Close-out Netting in Slovenia

Dear Mr Zalar,

Our attention has been drawn by members of the International Swaps and Derivatives Association (ISDA), inside and outside of Slovenia, to current efforts by the Banking Association of Slovenia (ZBS) seeking to improve the legal and regulatory framework for the Slovenian capital markets. In particular, proposals are being discussed to enhance the legal and regulatory framework for transactions in derivatives generally and for close-out netting in particular.

ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry, a business that includes interest rate, currency, commodity, credit and equity swaps, options and forwards, as well as related products such as caps, collars, floors and swaptions. The most commonly entered into transactions under ISDA documentation are described in Appendix A to this letter. ISDA currently has more than 830 member institutions from 58 countries on five continents. More than half of the total membership is based in the European Union and neighbouring countries and a significant portion of the rest comprises participants active in the European financial markets as dealers, service providers or end users of derivatives. Promoting legal certainty for cross-border financial transactions through law reform has been one of ISDA's core missions since it was chartered in 1985.

ISDA is committed to promoting the development of sound risk management practices. Its work includes efforts to ensure adequate legal and regulatory treatment of over-the-counter (OTC) derivatives transactions. Market participants and key regulators view ISDA as a responsible contributor in the debate on how best to manage the risk associated with OTC derivatives transactions. In particular, ISDA has worked with regulators in jurisdictions around the world to promote the legal enforceability of the close-out netting mechanism in the ISDA Master Agreement, which is the leading standard form documentation for international OTC derivatives transactions worldwide¹.

¹ ISDA has published five forms of the ISDA Master Agreement: (i) the 1987 ISDA Interest Rate Swap Agreement; (ii) the 1987 ISDA Interest Rate and Currency Exchange Agreement; (iii) the 1992 ISDA Master Agreement (Local Currency – Single Jurisdiction); (iv) the 1992 ISDA Master Agreement (Multicurrency – Cross Border); and (v) the 2002 ISDA Master Agreement.

For reasons set forth below, members of ISDA are particularly eager to provide all possible assistance to Slovenian market participants with regard to improving the current legal framework for derivatives in Slovenia in order to facilitate statutory support for OTC derivatives, the legal enforceability of standard market documentation such as the ISDA Master Agreement and, in particular, close-out netting in Slovenia and thereby foster greater harmonization of international and European standards

What is close-out netting?

Most documents that are widely used in international financial derivative markets are drafted as a type of master or framework agreement. Each of these master agreements is designed as a master netting agreement under which the parties can enter into a number of different trades and, on close-out, calculate the net exposure between the parties under all of these trades.

Close-out netting in relation to OTC derivative transactions is the ability of a party under a master agreement for such OTC derivative transactions (such as an ISDA Master Agreement) to net the mark-to-market values of all existing transactions under the master agreement upon their early termination following the default of its counterparty or other specified events.

The benefits of close-out netting

The benefits of close-out netting are risk reduction and cost reduction. The risk reduction is twofold: reduction of credit risk and the consequent reduction of systemic risk. Credit risk reduction benefits an individual party by reducing its overall exposure to its counterparty by more than 85 percent². By reducing credit risk at each node in the network of relationships between market participants, close-out netting also has an important beneficial effect on systemic risk.

Recognizing the value of close-out netting, the G10 central banks and central banks of other jurisdictions have permitted, subject to prudential conditions, the recognition of netting for capital adequacy and large exposure purposes. Other benefits for market participants include more efficient use of credit lines and the ability to maintain lower reserves to cover exposures.

The need for legal certainty and netting legislation in Slovenia

Cross-border transactions with Slovenian counterparties have significantly grown in volume over recent years, especially since Slovenia entered the euro zone. We recognize the fact that Slovenia has undertaken major efforts in implementing all relevant EU directives in the capital markets area, especially the Financial Collateral Arrangements Directive (2002/47/EC), the Settlement Finality Directive (98/26/EC) as well as the Winding-up Directive for Credit Institutions (2001/24/EC). All these EU legal instruments make reference to close-out netting in one way or another. The European Commission, in its report on the evaluation of the implementation of the Financial Collateral Directive acknowledged the crucial significance of the legal concepts of close-out netting and set-off and stated that the *acquis communautaire* as to the definition of close-out netting and set-off needs to be further harmonized going forward (COM (2006) 833 final). We understand that our colleagues from ZBS have recently discussed with you the EFMLG/ISDA proposal for an EU netting directive (http://www.isda.org/speeches/pdf/ISDA_EFMLG_Netting_Directive.pdf). As outlined above, the Basel Capital Accords expressly require the enforceability of netting for banks in order to obtain capital relief for regulatory capital purposes.

As far as the current legal recognition of close-out netting in Slovenia is concerned, ISDA has observed a significant degree of uncertainty and has therefore refrained from commissioning the global industry opinion on the enforceability of close-out netting in Slovenia (http://www.isda.org/docproj/stat_of_net_opin.html). ISDA is interested in including Slovenia in the list of netting-friendly jurisdictions.

² Bank for International Settlements, May 2009

Although there are no laws or regulations in Slovenia explicitly stating that close-out netting would not be enforceable, many market participants and legal experts believe that Slovenian law does not set out a clear position on this issue despite the implementation of the afore-mentioned EU directives. Without specific guidance under Slovenian law, a local court might prevent the application of close-out netting in an insolvency proceeding, for the lack of express recognition in local law. Recognizing the substantial credit and systemic benefits of close-out netting, many jurisdictions, where previously there was some doubt about the enforceability of netting, have introduced legislation to enable it or, more often, to strengthen it where it was already available. Examples in Europe include Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, Malta, Norway, Poland, Portugal, Romania, Slovakia, Spain, Sweden, Switzerland and Turkey. Examples elsewhere include Australia, Brazil, Canada, Israel, Japan, Mauritius, Mexico, New Zealand, South Africa, South Korea and the United States. A current status report on the enforceability of close-out netting worldwide can be obtained from http://www.isda.org/docproj/stat_of_net_leg.html.

Important Factors To Consider in Close-Out Netting Legislation

What should the minimum standards of close-out netting legislation include? In accordance with the points discussed above, two central themes that ISDA has emphasised when advocating the adoption of close-out netting legislation are: (1) legal enforceability by ensuring that any statutorily supported netting occurs in accordance with the parties' agreed terms, especially where these reflect a global industry standard, and (2) technical distinctions that need to be considered when distinguishing netting from set-off.

The Current Legal Analysis under Slovenian Law

We have discussed the current legal analysis with legal experts and market participants in Slovenia as well as with our colleagues from ZBS. At the outset it has to be reiterated that the mere implementation of the Financial Collateral Directive does not automatically include the implementation of substantive provisions on close-out netting. The Collateral Directive requires as a pre-condition to have close-out netting provisions in place already under national law. This is a requirement for close-out netting and collateral arrangements to be enforceable under the Financial Collateral Directive.

To our knowledge there are no substantive provisions on netting in place under Slovenian law currently. We are informed that Article 483 of the Slovenian Insolvency Act (ZFPPIPP) is aimed at implementing the provisions in Articles 25 and 26 of the Winding-up Directive for Credit Institutions. However, the reference to the governing law of the contract of the netting or repurchase agreement does not replace the need for a substantive provision on netting under local law. Moreover, it is not entirely clear from EU law if the reference to the contract law governing the netting agreement refers to substantive law or merely conflict of law rules under the law governing the contract. Close-out netting provisions are usually part of the national insolvency law. Therefore legal certainty is improved by having a substantive netting provision under local law which can be applied directly by the local courts.

Article 483 ZFPPIPP does not seem to refer to close-out netting in any way. Please accept our apologies for having to rely on the English translation, but the Slovenian term *vecstranski poboti* to our understanding is translated as "multilateral set-off". There does not seem to be a definition of this term anywhere in Slovenian law. The type of netting in question, though, is close-out netting which is (i) bilateral and (ii) different from set-off. Thus, relying on the concept of "multilateral set-off" in order to cover close-out netting is not sufficient in terms of creating legal certainty. Furthermore, with respect to corporates (as opposed to credit institutions or insurance undertakings) under the EU Insolvency Regulation (Council Regulation No 1346/2000) it is unclear if the term "set-off" is intended to encompass close-out netting. This analysis goes back to the aforementioned point that prompted the European Commission to seek further clarification in the *acquis communautaire* with regard to netting and set-off. Therefore, any assumption on the enforceability of close-out netting that is based on this very provision faces the same uncertainties.

Closely related to the issue of netting agreements are financial collateral arrangements under the Financial Collateral Directive. Market participants inside and outside of Slovenia are keen to see the enforceability of ancillary collateral or margin arrangements recognised, without risk of re-characterisation. This is an additional means by which market participants minimise their credit risks on derivative transactions, and thus systemic risk. **[Are there any**

problems in Slovenia in recognizing foreign law governed title transfer (eg English law CSA) or security interest (eg English law deed or New York law credit support docs) that we should mention here since we are talking about revisions to the initial implementation of the Collateral Directive?]

What to do next?

As a result of these uncertainties of the derivatives market in Slovenia, financial institutions and institutional investors inside and outside Slovenia that deal with Slovenian counterparties in financial transactions are at a competitive disadvantage, because they cannot confidently net their derivatives exposures against their Slovenian counterparties or rely on the terms set forth in their contracts. ISDA is in contact with ZBS and would like to convey its express support for the recent approach by ZBS towards the Slovenian authorities on this matter. ISDA, in cooperation with ZBS, would like to offer its assistance to the Slovenian authorities in discussing these issues further. The economic benefits to Slovenia of such reform would be significant. We understand that the Slovenian authorities are actively looking into the implementation of the new Directive Amending the Settlement Finality and Financial Collateral Directives (2009/44/EC). This directive needs to be implemented by the end of 2010 and provides an excellent opportunity to look into the initial implementation of the Financial Collateral Directive and any shortcomings in ancillary legislation. ISDA would like to suggest that the Slovenian authorities consider the aforementioned observations when preparing the first draft bill to implement the Amending Directive.

We hope that our comments are helpful to you during your considerations. We will be very glad for the opportunity, as the legislative process progresses, to work closely with the Slovenian authorities and ZBS to address those issues we have identified. If ISDA can be of any help in this process, we hope that you will not hesitate to contact me at the ISDA European Office, One Bishops Square, London E1 6AD, +44 20 3088 3550, pwerner@isda.org.

We understand from our colleagues at ZBS that several Slovenian authorities co-operate on this matter. Hence, we thought it appropriate to send this letter to the Ministry of Finance as well as the Ministry of Justice and the Bank of Slovenia.

Sincerely,

Dr Peter M Werner
Director of Policy
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