# ISDA

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Dear Mrs. Lachman-Messer and Mr. Lehman:

The International Swaps and Derivatives Association, Inc. ("ISDA") is an international financial trade association whose membership includes more than 600 of the world's largest commercial, merchant and investment banks, corporations, government entities and other institutions. ISDA was chartered in 1985 and today represents institutions from 47 countries on six continents. Its members are the leading participants in the privately negotiated, or over-the-counter ("OTC"), derivatives industry. The OTC derivatives industry includes interest rate, currency, commodity, credit and equity swaps, options and forwards, and related products such as caps, collars, floors, and swaptions. The most commonly entered into OTC derivatives transactions under ISDA documentation are described in Appendix A to this letter.

ISDA is committed to promoting the development of sound risk management practices. Its work includes efforts to ensure adequate legal and regulatory treatment of 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 worldwide.[1] For reasons set forth below, leading ISDA members outside of Israel are now particularly keen to develop such cooperation with the appropriate Israeli authorities in order to facilitate further statutory support for close-out netting in Israel and thereby foster greater harmonization of international 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. Appendix B provides a concrete example of how risks and costs may be reduced via close-out netting.

*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 reduction of systemic risk. Credit risk reduction benefits an individual party by reducing its overall exposure to its counterparty by anywhere from 40 to 60 percent. 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 netting legislation in Israel*

Although there are no laws or regulations in Israel explicitly stating that close-out netting would not be enforceable, many market participants and legal experts believe that Israeli law does not set out a clear position on this issue. Without specific guidance under Israeli law, an Israeli court might prevent the application of close-out netting in an insolvency proceeding, for example where local policy interests might be seen as overriding the parties' choice of law for their contract.

[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.

Indeed, the purpose of this letter is to initiate a dialogue on the enforceability in Israel of critical provisions of the ISDA Master Agreement that relate to close-out netting. 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, Channel Islands, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, Malta, Norway, Poland, Portugal, Spain, Sweden, Switzerland and Turkey. Examples elsewhere include Australia, Brazil, Canada, Japan, Mexico, New Zealand, South Africa and the United States. A current status report on the enforceability of close-out netting worldwide is attached as Appendix C.

As indicated, leading ISDA members from outside the country would like to see Israel on this list of jurisdictions where relevant statutory reforms have been enacted in support of international standards—especially in the face of conflicting legal opinions currently circulating about the status of close-out netting in Israel. We understand the interest of these members mirrors current initiatives in Israel for improving legal certainty, the standing of Israel's financial markets in the world and, if appropriate, statutory support for the enforceability of close-out netting for derivatives.

That said, there are a number of technical issues which have been considered in other jurisdictions and which may require clarification before proceeding. We have been specifically informed by the Association of Banks in Israel that you have been considering two such issues that you thought to be relevant: (i) creditor preferences and (ii) whether the benefits of netting should be restricted to banks or any other particular class of eligible counterparties.

(i) *Netting does not create prohibited creditor preferences.* It is generally recognized that insolvency laws in developed legal systems almost uniformly provide for the recapture of assets transferred by the debtor in the twilight period prior to the commencement of formal insolvency proceedings. A transaction is preferential where it prejudices other creditors of the debtor *and* occurs either while the debtor is actually insolvent (or renders him insolvent) or occurs in a suspect period prior to the formal opening of insolvency proceedings.

Although netting legislation ensures the benefit of legal certainty for those parties eligible for the calculation of a net settlement amount with the insolvent party, it is important to understand that the kind of close-out netting that ISDA members would seek to protect would not favor the claims of one creditor over another but would rather establish, and, in so doing, quantify and give an equitable account of, the net amount owed by *or to* the insolvent party to *or from* its counterparty. Where a net amount is owed by the insolvent party, this particular creditor's claim is given equal treatment as against claims asserted by other parties outside the coverage of the netting legislation.

In this regard, it may be helpful to distinguish the close-out netting methodology of the ISDA Master Agreement from the operations involved in more conventional set-off. This is because, unlike set-off, close-out netting under an ISDA Master Agreement does not extinguish any matured obligations due to the insolvent party's estate and thereby deprive the estate of an asset. By virtue of the conditionality to which payment and delivery obligations under the ISDA Master Agreement are subject, the parties never have more than a conditional

entitlement to receive payments and deliveries. In other words, the "assets" represented by the entitlement are flawed by the existence of certain conditions (and, in particular, the condition that there not be any default or potential default at the time that a payment or delivery obligation would otherwise arise). The disappearance of the expectation of future payments or deliveries upon a counterparty's insolvency does not therefore deprive the insolvent estate of any real asset with real value to which it was previously entitled.

Accordingly, netting legislation should provide that payments under eligible transactions are not to be treated as preferences where such payments were not made with an intent to hinder, delay or defraud other creditors.

(ii) *Eligible counterparties.* ISDA members believe that netting legislation should be broad and flexible. If the benefits of netting are restricted to an "eligible counterparty", then that term should be broadly defined to include all potential beneficiaries of close-out netting legislation, including those outside the financial sector. Netting legislation should not exclude corporations, insurance companies, special purpose vehicles, wealthy individuals or others that could potentially benefit from close-out netting of OTC derivatives transactions entered into on a bilateral basis.

While in the past some netting legislation (for example, in France and in Belgium) has drawn distinctions among the types of parties (for example, financial institutions) eligible for the benefits of close-out netting, it is not clear as a matter of logic that such distinctions ought to exist. Such distinctions, by limiting the benefit, limit the legal certainty and the efficiencies that netting aims to achieve. Legislating for netting in this way often leads to a need for amendment (as currently contemplated in Belgium) to ensure the intended protections for a dynamic market. Invariably, such distinctions lead to difficult issues of characterization. ISDA has attempted to communicate its experiences with netting legislation to regulators and legislators in order to ensure that these types of limitations are not imported into new netting laws.

*Economic benefits and competitiveness*

As a result of the uncertainty of the derivatives market in Israel, financial institutions and institutional investors inside and outside Israel that deal with Israeli counterparties in financial transactions are at a competitive disadvantage because they cannot confidently net their derivatives exposures against their Israeli counterparties. Further, many counterparties may require that Israeli branches of a multi-branch counterparty be excluded from framework agreements such as the ISDA Master Agreement. This may prevent dealings with the Israeli branches altogether, or it may require banks to use separate agreements and more expensive credit lines when dealing with Israeli branches. The overall result is that Israeli entities may be less able to employ OTC derivatives effectively. And, to the extent Israeli entities do enter into OTC derivatives transactions, they will bear additional costs associated with legal uncertainty over netting.

ISDA would like to offer its assistance to the Israeli government as it works to mitigate the risk of any such disadvantages and to promote legal certainty among international market players with respect to the enforceability of close-out netting in Israel. The economic benefits to Israel of such reform would be significant. Close-out netting legislation would allow financial institutions to calculate their exposure with Israeli counterparties on a net

rather than on a gross basis. If a party is able to net its liabilities against its assets, its overall credit risk is considerably reduced. When credit risk in Israel is reduced, leading international financial institutions will be encouraged to increase their credit lines to Israeli counterparties. Ensuring the legal enforceability of close-out netting also may reduce capital costs for your local banks and encourage the growth and competitiveness of Israeli financial markets.

We are confident that close-out netting reform will further solidify and improve both the domestic Israeli economy and the standing of Israel in the world financial markets. Please refer to the enclosed summary memorandum and appendices for additional information and details regarding the nature and benefits of OTC derivatives and close-out netting.

ISDA would welcome the opportunity to assist you in achieving a better understanding of issues that might affect the enforceability of close-out netting and of OTC derivatives trading in Israel. In addition, where helpful, ISDA would be available to provide technical assistance in relation to our broader documentation library and market practice in other jurisdictions. If ISDA can be of any help in this process, I hope that you will not hesitate to contact the undersigned at the ISDA New York office, 360 Madison Avenue, 16th Floor, New York, NY, (212) 901-6000 or Peter Werner at the ISDA European Office, One New Change, London EC4M 9QQ, +44 (0) 20 7330 3550, pwerner@isda.org.

Sincerely,

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# SUMMARY MEMORANDUM

## The Benefits of OTC Derivatives

OTC derivatives transactions play a large and ever-expanding role in the international financial system. ISDA's latest market survey statistics show a derivatives and risk management market size of between $130 and $170 trillion.[1] It is estimated that the ISDA Master Agreement is used as the basis for documenting over 90% of the trades in this sizeable market. In 2003, ISDA surveyed corporate usage for the first time and found that 92% of the top 500 companies globally use derivative instruments to manage and hedge their risks more effectively.

According to Alan Greenspan, the Chairman of the U.S. Federal Reserve, the importance of OTC derivatives is rooted in the fact that they are an "integral part of … risk capital allocation and profit maximization" because they "allow users to unbundle risks and allocate them to investors most willing and able to assume them."

The privately negotiated nature of OTC derivatives is a significant factor in their success. The process of private negotiation under the ISDA Master Agreement allows market participants to develop transactions that are specifically tailored to provide the desired economic outcomes of all parties involved. Therefore, parties may employ OTC derivatives to reduce risk, to reduce financing costs or to generate capital with acceptable levels of risk depending on their unique financial requirements.

## 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 reduction of systemic risk. Credit risk reduction benefits an individual party by reducing its overall exposure to its counterparty. A simple example to illustrate this process is as follows: if Party A owes Party B $10, and Party B owes Party A $10, on a net basis, each party's exposure to each other is $0, not $10. Estimates suggest that calculating credit exposure on a net basis can reduce overall credit risk by as much as 40 to 60 per cent. By reducing credit risk at each node in the network of relationships between market participants, close-out netting also lessens the potential adverse impact resulting from the termination of the transactions of a market participant on the other participants in the market, and would therefore have an important beneficial effect on systemic risk.

Close-out netting may also result in cost reduction. When credit risk is reduced, financial institutions are able to use their capital more effectively. Credit lines can be freed up and reserves may be reduced so as to allow a more productive use of capital that would otherwise be allocated inefficiently.

[1] In June 2004, the Bank for International Settlements measured the total amounts outstanding of OTC derivatives at $197 trillion worldwide.

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. Please refer to Appendix C for a list of jurisdictions that have adopted netting legislation.

**Improvement Relatively Easy to Achieve**

In light of the above considerations, ISDA strongly urges Israel to adopt appropriate legislation within the shortest practical timeframe to ensure that the current uncertainty regarding OTC derivatives and netting in Israel is resolved. Recent experience in other jurisdictions, such as Austria, Czech Republic, Hungary and Italy, has shown that such reforms usually require only a narrow, technical amendment to existing law and can therefore be achieved quickly and with broad support. The swift passage of netting legislation will allow Israel to move further into the mainstream of the international community and will ensure that Israeli institutions no longer face a competitive disadvantage in their risk management activities.

# APPENDIX A

## CERTAIN TRANSACTIONS UNDER THE ISDA MASTER AGREEMENT

Basis Swap. A transaction in which one party pays periodic amounts of a given currency based on a floating rate and the other party pays periodic amounts of the same currency based on another floating rate, with both rates reset periodically; all calculations are based on a notional amount of the given currency.

Bond Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a bond of an issuer, such as Kingdom of Sweden or Unilever N.V., at a specified strike price. The bond option can be settled by physical delivery of the bonds in exchange for the strike price or may be cash settled based on the difference between the market price of the bonds on the exercise date and the strike price.

Bullion Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified number of Ounces of Bullion at a specified strike price. The option may be settled by physical delivery of Bullion in exchange for the strike price or may be cash settled based on the difference between the market price of Bullion on the exercise date and the strike price.

Bullion Swap. A transaction in which one party pays periodic amounts of a given currency based on a fixed price or a fixed rate and the other party pays periodic amounts of the same currency or a different currency calculated by reference to a Bullion reference price (for example, Gold-COMEX on the New York Commodity Exchange) or another method specified by the parties. Bullion swaps include cap, collar or floor transactions in respect of Bullion.

Bullion Trade. A transaction in which one party agrees to buy from or sell to the other party a specified number of Ounces of Bullion at a specified price for settlement either on a "spot" or two-day basis or on a specified future date. A Bullion Trade may be settled by physical delivery of Bullion in exchange for a specified price or may be cash settled based on the difference between the market price of Bullion on the settlement date and the specified price.

For purposes of Bullion Trades, Bullion Options and Bullion Swaps, "Bullion" means gold, silver, platinum or palladium and "Ounce" means, in the case of gold, a fine troy ounce, and in the case of silver, platinum and palladium, a troy ounce.

Buy/Sell-Back Transaction. A transaction in which one party purchases a security (in consideration for a cash payment) and agrees to sell back that security to the other party (in consideration for the original cash payment plus a premium).

Cap Transaction. A transaction in which one party pays a single or periodic fixed amount and the other party pays periodic amounts of the same currency based on the excess, if any, of a specified floating rate (in the case of an interest rate cap) or commodity price (in the case of a commodity cap) in each case that is reset periodically over a specified per annum rate (in the case of an interest rate cap) or commodity price (in the case of a commodity cap).

Collar Transaction. A collar is a combination of a cap and a floor where one party is the floating rate or floating commodity price payer on the cap and the other party is the floating rate or floating commodity price payer on the floor.

Commodity Forward. A transaction in which one party agrees to purchase a specified quantity of a commodity at a future date at an agreed price and the other party agrees to pay a price for the same quantity to be set on a specified date in the future. The payment calculation is based on the quantity of the commodity and is settled based, among other things, on the difference between the agreed forward price and the prevailing market price at the time of settlement.

Commodity Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified quantity of a commodity at a specified strike price. The option can be settled either by physically delivering the quantity of the commodity in exchange for the strike price or by cash settling the option, in which case the seller of the option would pay to the buyer the difference between the market price of that quantity of the commodity on the exercise date and the strike price.

Commodity Swap. A transaction in which one party pays periodic amounts of a given currency based on a fixed price and the other party pays periodic amounts of the same currency based on the price of a commodity, such as natural gas or gold, or a futures contract on a commodity (e.g., Light Sweet Crude Oil on the New York Mercantile Exchange); all calculations are based on a notional quantity of the commodity.

Credit Protection Transaction.[2] A transaction in which one party pays either a single fixed amount or periodic fixed amounts or floating amounts determined by reference to a specified notional amount, and the other party (the credit protection seller) pays either a fixed amount or an amount determined by reference to the value of one or more loans, debt securities or other financial instruments (each a "Reference Obligation") issued, guaranteed or otherwise entered into by a third party (the "Reference Entity") upon the occurrence of one or more specified credit events with respect to the Reference Entity (for example, bankruptcy or payment default). The amount payable by the credit protection seller is typically determined based upon the market value of one or more debt securities or other debt instruments issued, guaranteed or otherwise entered into by the Reference Entity. Credit protection transactions may also be physically settled by payment of a specified fixed amount by one party against delivery of specified Reference Obligations by the other party. A credit protection transaction may also refer to a "basket" of two or more Reference Entities.

[2] Some market participants may refer to credit protection transactions as credit swaps, credit default swaps or credit default options.

Credit Spread Transaction. A transaction involving either a forward or an option where the value of the transaction is calculated based on the credit spread implicit in the price of the underlying instrument

Cross Currency Rate Swap. A transaction in which one party pays periodic amounts in one currency based on a specified fixed rate (or a floating rate that is reset periodically) and the other party pays periodic amounts in another currency based on a floating rate that is reset periodically. All calculations are determined on predetermined notional amounts of the two currencies; often such swaps will involve initial and or final exchanges of amounts corresponding to the notional amounts.

Currency Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified amount of a given currency at a specified strike price.

Currency Swap. A transaction in which one party pays fixed periodic amounts of one currency and the other party pays fixed periodic amounts of another currency. Payments are calculated on a notional amount. Such swaps may involve initial and or final payments that correspond to the notional amount.

Equity Forward. A transaction in which one party agrees to pay an agreed price for a specified quantity of shares of an issuer, a basket of shares of several issuers or an equity index at a future date and the other party agrees to pay a price for the same quantity of shares of an issuer to be set on a specified date in the future. The payment calculation is based on the number of shares and can be physically-settled (where delivery occurs in exchange for payment) or cash-settled (where settlement occurs based on the difference between the agreed forward price and the prevailing market price at the time of settlement).

Equity Index Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right to receive a payment equal to the amount by which an equity index either exceeds (in the case of a call) or is less than (in the case of a put) a specified strike price.

Equity Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) shares of an issuer or a basket of shares of several issuers at a specified strike price. The option may be settled by physical delivery of the shares in exchange for the strike price or may be cash settled based on the difference between the market price of the shares on the exercise date and the strike price.

Equity or Equity Index Swap. A transaction in which one party pays periodic amounts of a given currency based on a fixed price or a fixed rate and the other party pays periodic amounts of the same currency or a different currency based on the performance of a share of an issuer, a basket of shares of several issuers or an equity index, such as the Standard and Poor's 500 Index.

EU Emissions Allowance Transaction. A transaction in which one party agrees to purchase a specified quantity of emissions allowances at a future date at an agreed price and the other party agrees to deliver that quantity of emissions allowances for that agreed price.

Floor Transaction. A transaction in which one party pays a single or periodic amount and the other party pays periodic amounts of the same currency based on the excess, if any, of a specified per annum rate (in the case of an interest rate floor) or commodity price (in the case of a commodity floor) over a specified floating rate (in the case of an interest rate floor) or commodity price (in the case of a commodity floor).

Foreign Exchange Transaction. A transaction providing for the purchase of one currency with another currency providing for settlement either on a "spot" or two-day basis or a specified future date.

Forward Rate Transaction. A transaction in which one party agrees to pay a fixed rate for a defined period and the other party agrees to pay a rate to be set on a specified date in the future. The payment calculation is based on a notional amount and is settled based, among other things, on the difference between the agreed forward rate and the prevailing market rate at the time of settlement.

Interest Rate Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to receive a payment equal to the amount by which an interest rate either exceeds (in the case of a call option) or is less than (in the case of a put option) a specified strike rate.

Interest Rate Swap. A transaction in which one party pays periodic amounts of a given currency based on a specified fixed rate and the other party pays periodic amounts of the same currency based on a specified floating rate that is reset periodically, such as the London inter-bank offered rate; all calculations are based on a notional amount of the given currency.

Physical Commodity Transaction. A transaction which provides for the purchase of an amount of a commodity, such as coal, electricity or gas, at a fixed or floating price for actual delivery on one or more dates.

Repurchase Transaction. A transaction in which one party agrees to sell securities to the other party and such party has the right to repurchase those securities from such other party at a future date.

Securities Lending Transaction. A transaction in which one party transfers securities to a party acting as the borrower in exchange for a payment or a series of payments from the borrower and the borrower's obligation to replace the securities at a defined date with identical securities.

Swap Option. A transaction in which one party grants to the other party the right (in consideration for a premium payment), but not the obligation, to enter into a swap with certain specified terms. In some cases the swap option may be settled with a cash payment equal to the market value of the underlying swap at the time of the exercise.

Total Return Swap. A transaction in which one party pays either a single amount or periodic amounts based on the total return on one or more loans, debt securities or other financial instruments (each a "Reference Obligation") issued, guaranteed or otherwise entered into by a third party (the "Reference Entity"), calculated by reference to interest, dividend and fee payments and any appreciation in the market value of each Reference Obligation, and the other party pays either a single amount or periodic amounts determined by reference to a specified notional amount and any depreciation in the market value of each Reference Obligation.

A total return swap may (but need not) provide for acceleration of its termination date upon the occurrence of one or more specified events with respect to a Reference Entity or a Reference Obligation with a termination payment made by one party to the other calculated by reference to the value of the Reference Obligation.

Weather Index Transaction. A transaction, structured in the form of a swap, cap, collar, floor, option or some combination thereof, between two parties in which the underlying value of the transaction is based on a rate or index pertaining to weather conditions, which may include measurements of heating, cooling, precipitation and wind.

# APPENDIX B

## EXAMPLE OF RISK REDUCTION VIA CLOSE-OUT NETTING

Swaps and other derivative transactions can be said to have a value to one or other of the parties. This value derives from the underlying rate, asset or risk to which the derivative relates. For example, the value of a straightforward fixed-for-floating interest rate swap derives from anticipated market interest rates for the currency concerned. To the fixed rate payer, the swap will have a value if, to replace the swap now, it would have to pay a higher fixed rate (in return for LIBOR) than it is required to pay under the existing swap. The swap would be, in that sense, an asset for the fixed rate payer in these circumstances, and a liability for the floating rate payer. In other words, the fixed rate payer is "in-the-money" and the floating rate payer is "out-of-the-money".

Over the course of time, a bank may enter into a number of different interest rate swaps with a counterparty. At any point in time, under some of those swaps the bank may be in-the-money, while under others it may be out-of-the-money. If the counterparty were to become insolvent, the bank would attempt to terminate all outstanding swaps with the counterparty. If all those outstanding swap transactions had been documented under an ISDA Master Agreement, then they would have been entered into on the basis that they constituted a single agreement with the Master Agreement. The purpose of this "single agreement" approach is to facilitate close-out netting by avoiding "cherry picking".

The term "cherry picking" refers to a power that some insolvency officials have under the insolvency laws of certain jurisdictions to reject certain contracts burdensome to the insolvent company while affirming contracts beneficial to the insolvent company.

Generally, where an insolvency official has the power to reject or affirm contracts, a counterparty to a rejected contract must file a claim for moneys owed (or for damages) against the estate of the insolvent company in respect of the rejected contract, for which it can expect to receive no more than a fraction of the value, while continuing to perform its obligations to the insolvent company under any affirmed contracts.

If a bank has a number of swaps with an insolvent company, "cherry picking" results in those swaps which are out-of-the-money to the insolvent company being rejected and those swaps which are in-the-money being affirmed. Assuming the swaps are unsecured, the counterparty is in the disastrous position of being forced to pay full value in respect of the swaps which are out-of-the-money to itself while likely to receive only part value (if any) in respect of the swaps which are in-the-money to itself.

The ISDA Master Agreement attempts to overcome this problem by making it clear that the Master Agreement and all transactions entered into under it constitute a single agreement between the parties which must therefore be affirmed or rejected by the insolvency official as a whole. Normally, upon declaration of an early termination date for a Master Agreement by reason of an insolvency default, all transactions are terminated and their value is determined. As noted above, some of these swaps, depending on rates prevailing at the time of

termination, may be in-the-money and some may be out-of-the-money to the non-defaulting party. The values for the swap transactions are converted to a single currency and netted against each other to produce a single "settlement amount".

The benefits of netting the values of individual transactions upon termination are clear. Suppose a bank had entered into four interest rate swaps with a counterparty which subsequently became insolvent and that on the date the insolvency petition was presented the values of those swaps to the bank were as follows:

Swap 1 ……U.S.$7 million
Swap 2 ……U.S.$5 million
Swap 3 ……U.S.$-6 million
Swap 4 ……U.S.$-3 million

Positive figures indicate that the bank is in-the-money and that the swap is, in that sense, an asset for the bank. Negative figures indicate that the bank is out-of-the-money and that the swap is, in that sense, a liability for the bank.

Assume that the transactions were terminated and valued on the day the petition was presented. If the insolvency official appointed to deal with the counterparty's estate were able to cherry pick, the bank would be obliged to pay U.S.$9 million, representing the value of the transactions which were, in effect, liabilities of the bank and assets of the counterparty. The bank would also have a claim against the insolvent's estate for U.S.$12 million, representing the value of the transactions which were, in effect, assets of the bank and liabilities of the insolvent. Assuming the bank was only paid 10% of its claim against the estate, it would have paid U.S.$9 million and received U.S.$1.2 million.

If close-out netting, on the terms of the ISDA Master Agreement, were enforceable as against the insolvency official, the bank's position would be significantly improved. A single net sum in respect of all the terminated transactions would be calculated equal to U.S.$3 million (U.S.$7 million + U.S.$5 million - U.S.$6 million - U.S.$3 million). The bank's claim against the insolvent's estate would therefore be for U.S.$3 million. Assuming again a 10% pay-out, the bank would receive U.S.$300,000. The enforceability of close-out netting in the jurisdiction of the bank's counterparty effectively reduces the bank's credit risk from U.S.$19.8 million (U.S.$9 million + U.S.$10.8 million) to U.S.$2.7 million (U.S.$3 million - U.S.$300,000).

# APPENDIX C

## STATUS OF NETTING AS OF DECEMBER 2004

### Europe

| | ISDA Netting Opinion | Enforceability of Close-Out Netting | Statutory Protection for Netting by way of specific netting legislation or general principles of law |
|---|---|---|---|
| Austria | Yes | Yes | Netting Legislation |
| Belgium | Yes | Yes | Netting Legislation |
| Channel Islands | Yes | Yes | Netting Legislation |
| Czech Republic | Being Commissioned | Yes | Netting Legislation |
| Denmark | Yes | Yes | Netting Legislation |
| England | Yes | Yes | General principles of law |
| Finland | Yes | Yes | Netting Legislation |
| France | Yes | Yes | Netting Legislation |
| Germany | Yes | Yes | Netting Legislation |
| Greece | Yes | Yes | Netting Legislation |
| Hungary | Yes | Yes | Netting Legislation |
| Ireland | Yes | Yes | Netting Legislation |
| Italy | Yes | Yes | Netting Legislation |
| Luxembourg | Yes | Yes | Netting Legislation |
| Malta | No | Yes | Netting Legislation |
| Netherlands | Yes | Yes | General principles of law |
| Norway | Yes | Yes | Netting Legislation |
| Poland | Yes | Yes | Netting Legislation |
| Portugal | Yes | Yes | Netting Legislation |
| Russia | No | No | Under Consideration |
| Slovakia | No | Uncertain | Under consideration |
| Spain | Yes | Yes | Netting Legislation |
| Sweden | Yes | Yes | Netting Legislation |
| Switzerland | Yes | Yes | Netting Legislation |
| Turkey | Yes | Yes | Netting Legislation |

**Asia-Pacific**

| | ISDA Netting Opinion | Enforceability of Close-Out Netting | Statutory Protection for Netting by way of specific netting legislation or general principles of law |
|---|---|---|---|
| Australia | Yes | Yes | Netting Legislation |
| Hong Kong | Yes | Yes | General principles of law |
| India | Being commissioned | To be confirmed in ISDA opinion | General principles of law |
| Indonesia | Yes | Yes | General principles of law |
| Japan | Yes | Yes | Netting Legislation |
| Malaysia | Yes | Yes | General principles of law |
| New Zealand | Yes | Yes | Netting Legislation |
| Philippines | Yes | Yes | General principles of law |
| Singapore | Yes | Yes | General principles of law |
| South Korea | Yes | Yes | General principles of law |
| Taiwan | Yes | Yes | General principles of law |
| Thailand | Yes | Yes | General principles of law |

**Americas**

| | ISDA Netting Opinion | Enforceability of Close-Out Netting | Statutory Protection for Netting by way of specific netting legislation or general principles of law |
|---|---|---|---|
| Bahamas | Yes | Yes | Netting Legislation |
| Bermuda | Yes | Yes | Netting Legislation |
| Brazil | No | Yes | Central Bank decree (Oct 2002) |
| Cayman Islands | Yes | Yes | Netting Legislation |
| Canada | Yes | Yes | Netting Legislation |
| Mexico | Yes | Yes | Netting Legislation |
| South Africa | Yes | Yes | Netting Legislation |
| United States | Yes | Yes | Netting Legislation |