

10 May 2017

Mr. Pan Gongsheng
Deputy Governor
People's Bank of China

Dear Deputy Governor Pan,

Re: Request for seminar on close-out netting in China

On behalf of its members, the Asia Securities and Financial Markets Association (ASIFMA) and the International Swaps and Derivatives Association (ISDA) respectfully present to you their thoughts on the importance of close-out netting enforceability in China and different options to achieve this goal. We also wish to extend the offer to organize a closed-door workshop in Beijing to discuss these options in further detail and to investigate the implications of the various netting models.

Importance of close-out netting

We believe it is important for the sake of a well-functioning repurchase agreement transactions (“repo”) and derivatives market in China for regulators to consider strengthening rules governing creditors’ rights. Our experience around the world has taught us that creditors’ rights are essential for market participants to gain confidence in the enforceability of transactions and contracts. This is especially true for derivatives transactions and repos, which are typically traded under master agreements and secured by collateral.

Most documents that are widely used in international financial derivatives and repo markets are drafted as a type of master (netting) agreement under which the parties can enter into a number of different trades and—crucially—on close-out, calculate the net exposure between the parties under all of these trades. Close-out netting applies to transactions between a defaulting firm and a non-defaulting firm and refers to a process involving termination of obligations under the respective agreements with a defaulting party and subsequent combining of positive and negative replacement values into a single net payable or receivable.

The benefits of close-out netting are risk reduction and cost reduction. The risk reduction is twofold: reduction of credit risk and reduction of systematic risk. Credit risk reduction benefits an individual party by reducing its overall exposure to its counterparty. Estimates suggest that calculating credit exposure on a net basis can reduce overall credit risk by as much as 90% percent. Another important benefit is a reduction of systemic risk in the economy. 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—thus reducing systemic risk.

DEVELOPING ASIAN CAPITAL MARKETS

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 reduced so as to allow a more productive use of capital.

Current challenges

Experience has shown that the enforceability of close-out netting, an established risk-management practice in all matured financial markets, is a fundamental requirement for efficient markets. China is currently one of the few major global economies that are not perceived as having enforceable close-out netting protection and there is no law in China which expressly protects the validity and enforceability of close-out netting against an insolvent company.

Close-out netting enforceability in China has historically been unclear, in particular whether a creditor's claim to apply close-out netting is effective after the Chinese counterparty enters into an insolvency proceeding. In September 2013, the Supreme People's Court helped clarify the uncertainty with its interpretation of the Enterprise Bankruptcy Law, ruling that set-off becomes effective when the administrator receives notice from the creditor unless the administrator successfully challenges the notice in court and no longer requires the administrator to take action for set-off to become effective. Despite this, Article 18 of the Enterprise Bankruptcy Law still gives the bankruptcy administrator a power for up to two months after the acceptance of the bankruptcy petition to decide whether to assume or reject any executory contract. So if a contract is not terminated prior to the acceptance of the bankruptcy petition, close-out becomes subject to the power of the administrator under article 18. This has led to concerns of "cherry picking," i.e. that the administrator could choose to assume transactions which are profitable to the bankrupt estate and reject to perform unprofitable ones.

The lack of close-out netting in China puts Chinese institutions at a disadvantage relative to their counterparts in netting-friendly jurisdictions. The lack of certainty regarding enforceability in China means that a bank's exposure to a Chinese counterparty is treated on a gross basis for regulatory capital purposes. Post-crisis regulatory reforms assign much higher capital requirements for non-netted trades. This sharply increases transaction costs but also means that counterparties based in China may be unable to employ over-the-counter (OTC) derivative transactions effectively. Recently, a number of G20 countries have introduced mandatory clearing and margining reform for OTC derivatives which severely limits transactions with counterparties from a non-netting jurisdiction. As a result, Chinese banks and corporates are currently facing tremendous difficulties in the international market not being able to enter into derivatives with their international counterparts or join as clearing members of international clearing houses. Until China is accepted as a netting friendly jurisdiction, Chinese banks and corporates will continue to have this handicap and compete on an unequal footing with their international counterparts. Close-out netting is also a requirement for ESMA recognition of Shanghai Clearing House as a qualifying central counterparty.

Achieving a clean close-out netting opinion for China is even more important in the light of China's recent efforts to attract foreign capital in order to support its move from an export-driven economic model to a model driven by domestic consumption, in part via initiatives such as the "One-Belt-One-Road" (OBOR) strategy, which was launched by the Chinese government in 2013. The OBOR project, or rather, collection of projects, is projected to require investment of as much as \$4 to \$8 trillion. Much of that is expected to be raised in Chinese renminbi, including in the ever-expanding China Interbank Bond Market. Investors and issuers will need to hedge their currency, interest rate, credit and other risks and will only be able to do so in a cost-effective way if the derivatives market in China are deep and liquid. The uncertainty on

close-out netting has made it, and will continue to make it, extremely difficult for China to develop liquid derivatives and repo markets, both of which are required if China's domestic capital markets are to become deep, liquid and accessible to global investors .

Possible solutions

In light of the above, we urge the Chinese authorities to adopt appropriate legislation to ensure that the current uncertainty regarding close-out netting in China be resolved.

For close-out netting to be enforceable it needs to be legally recognised in the jurisdiction of incorporation of the defaulting party, and the insolvency legislation should permit close-out netting in the event of a default or termination event under a master agreement in accordance with the terms of the agreement, both prior to and following the commencement of insolvency proceedings.

In order to achieve enforceability of close-out netting, Chinese authorities may consider the following approaches:


- Include provisions that recognize close-out netting in the pending Bankruptcy, Recovery and Resolution Regulations for Financial Institutions
- Recognise close-out netting in the Securities Law and/or new Futures law

Recognising that the above suggested legislative and regulatory changes may take some time to implement, we believe that a statement from PBOC supporting close-out netting enforceability would provide interim comfort to international market participants and allow them to trade with their Chinese counterparties on a net basis. This would greatly benefit both Chinese banks and financial market infrastructures such as Shanghai Clearing House.

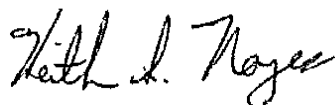
In line with ASIFMA's and ISDA's mission to promote the development of liquid, deep and broad capital markets in Asia, we would like to extend the offer to organize a closed-door workshop in Beijing for representatives from PBOC, the State Council and the Supreme People's Court during which ASIFMA, ISDA, their members and representatives from Chinese financial institutions could present to you the structures and implications touched on above in further detail and answer any questions you might have. We would be happy to work with your team to organize such a closed-door workshop at a date that is convenient for you.

Please do not hesitate to contact either of us or Laurence Van der Loo (lvanderloo@asifma.org) or Jing Gu (jgu@isda.org), should you have any questions.

Sincerely,



Mark Austen
CEO
ASIFMA



Keith Noyes
Regional Director, Asia Pacific
ISDA

CC: Ma Jun, Chief Economist, Research Bureau, The People's Bank of China