ISDA®

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Basel II Team
Banking Policy Department
Hong Kong Monetary Authority

Attn: Mr. Richard Chu

Dear Sirs:

The International Swaps and Derivatives Association, Inc. ("ISDA") is pleased to have the opportunity to offer comments on the proposals concerning bilateral netting agreements in the December 2005 "Consultation Papers on New Capital Adequacy Standards in Hong Kong" (the "Consultation Papers") published by the Hong Kong Monetary Authority (the "HKMA").

ISDA is an international financial trade association whose membership includes more than 670 of the world's largest commercial, merchant and investment banks, corporations, government entities and other institutions from 50 countries on six continents. Its members are the leading participants in the privately negotiated, or over-the-counter ("OTC"), derivatives industry. 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. 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 OTC derivatives transactions worldwide.

ISDA's work in this area is based on substantial experience. For example, since 1987 ISDA has been involved in collecting legal opinions on close-out netting in many jurisdictions. At present, ISDA has received advice from leading counsel in 48 jurisdictions (including Hong Kong) on the enforceability of the early termination and close-out netting provisions of the ISDA Master Agreement for many types of insolvent counterparties. The jurisdictions covered by ISDA's Netting Opinions are set forth in Appendix A. Each ISDA Netting Opinion addresses netting with regard to specified types of counterparties across a broad range of transactions, as described in Appendix B.

ISDA notes that the Annex (the "2005 Annex") to the paper on "Treatment of Netting Arrangements under the Revised Capital Adequacy Framework" (the "2005 Netting Paper") included in the Consultation Papers would amend and restate the HKMA's current criteria for the recognition of bilateral netting agreements. ISDA believes that those criteria were adopted in the form of Annex A (the "1995 Annex") to the HKMA's Guideline No. 4-4 as updated on 6 February 1995.

ISDA has three comments on the 2005 Netting Paper and the 2005 Annex.

1. Paragraph 10 of the 2005 Netting Paper states that the HKMA proposes to extend the recognition of transactions under bilateral netting agreements to cover credit derivatives recorded in the trading book but not credit derivatives recorded in the banking book.

ISDA recently has had extensive discussions on this issue with the Financial Services Authority (the "FSA") in London. The approach taken in paragraph 10 of the 2005 Netting Paper is consistent with the position reflected in the FSA's current guidelines on recognition of netting. ISDA understands that the FSA's original rationale for not allowing the inclusion of banking book credit derivatives within a broad ISDA Master Agreement was the risk of losing the benefit of protection in default of the protection buyer on any one of the transactions included within the Master. The documentation of a credit derivative as a standalone contract ensures that credit risk protection survives the default of the buyer of protection, provided that the required payments continue to be paid to the seller. However, conversely, in the case of a default of the seller of protection, the inclusion of a credit derivative under an ISDA Master Agreement guarantees a higher recovery than its documentation on a standalone basis. Furthermore, even in the event of a default by the buyer of protection, it is very likely that it would be feasible for the liquidator to purchase a new credit derivative, at limited, or even no cost should they wish to renew the credit risk protection. ISDA understands that based upon its discussions with the FSA and conversations between the FSA and several large credit derivative dealers, the FSA is now satisfied that including banking book credit derivatives within the scope of an ISDA Master Agreement is acceptable. We expect the FSA's revised approach to be included in a consultation paper on Strengthening the Capital Standards, which we believe they are planning to issue in February. In light of the above, ISDA recommends that the HKMA revise paragraph 10 of the 2005 Netting Paper to permit netting of both trading book and banking book credit derivatives.

2. In paragraph 1.6 of the 2005 Annex we suggest adding "or any related security agreement, collateral arrangement or other credit enhancement" after "netting agreement" in the first line. Agreements with respect to collateral are not always technically a part of the netting agreement itself.

3. ISDA suggests the deletion of the requirement under the first bullet point with respect to Hong Kong law and the law of the place of incorporation of certain subsidiaries in paragraph 3.1 of the 2005 Annex. It appears that this requirement was not included in the 1995 Annex. Moreover, ISDA thinks that a Hong Kong law opinion should be provided only if Hong Kong is deemed a relevant jurisdiction pursuant to the requirements under the other three bullet points in paragraph 3.1 of the 2005 Annex. The same is true for opinions with respect to the place of incorporation of a subsidiary of an authorized institution. ISDA's Netting Opinions would not satisfy this proposed requirement, and it is not mandated by the Basel Accord.

Thank you for the opportunity to comment. We would be pleased to provide any additional information you might require and answer any questions you might have. Please address any questions or requests to Angela Papesch in Singapore at +65 6538 3879, or Kimberly Summe in New York at +1 212 901 6030.

Yours faithfully

For the International Swaps and Derivatives Association, Inc.

Kimberly Summe

Kimberly Summe	**Angela Papesch**
General Counsel	**Director of Policy and Head of Asia-Pacific Office**

APPENDIX A

Jurisdictions Covered by ISDA's Netting Opinions

1. Australia
2. Austria
3. Barbados
4. Bahamas
5. Belgium
6. Bermuda
7. Brazil
8. British Virgin Islands
9. Canada
10. Cayman Islands
11. Channel Islands (Guernsey)
12. Channel Islands (Jersey)
13. Czech Republic
14. Denmark
15. England
16. Finland
17. France
18. Germany
19. Greece
20. Hong Kong
21. Hungary
22. Iceland
23. India
24. Indonesia
25. Ireland
26. Italy
27. Japan
28. Luxembourg
29. Malaysia
30. Mexico
31. The Netherlands
32. Netherlands Antilles
33. New Zealand
34. Norway
35. Philippines
36. Poland
37. Portugal
38. Scotland
39. Singapore
40. South Africa
41. South Korea
42. Spain
43. Sweden
44. Switzerland
45. Taiwan
46. Thailand
47. Turkey
48. United States

APPENDIX B

Certain Derivative Transactions Addressed By ISDA Netting Opinions

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.[1] 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 (e.g., 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.

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.

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

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, but not the obligation, 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 share 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 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.

Freight Transaction. A transaction in which one party pays an amount or periodic amounts of a given currency based on a fixed price and the other party pays an amount or periodic amounts of the same currency based on the price of chartering a ship to transport wet or dry freight from one port to another; all calculations are based either on a notional quantity of freight or, in the case of time charter transactions, on a notional number of days.

Inflation Transaction. A transaction in which one party pays an amount or periodic amounts of a given currency by reference to interest rates or other factors and the other party pays an amount or periodic amounts of a currency based on a specified rate of inflation.

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.