Legal certainty as to the enforceability of close-out netting and financial collateral arrangements is crucial for any cross-border derivatives transaction in over-the-counter (OTC) derivatives. A number of related issues (for example, conflict of law rules) have become more relevant in recent years as well. The International Swaps and Derivatives Association (ISDA) currently focuses its law reform work on around 30 emerging market jurisdictions across Europe, the Middle East and Africa in order to improve the local legal and regulatory framework. Particular emphasis is given to jurisdictions in central and eastern Europe, the south-eastern Europe/Commonwealth of Independent States region, that is, the EBRD’s countries of operations. This article summarises the ISDA’s views on recent developments in this region.
Introduction: the importance of close-out netting

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.

ISDA has over 830 member institutions from 60 countries worldwide. These members include most of the world’s major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end-users that rely on (OTC) over-the-counter derivatives to efficiently manage the financial market risks inherent in their core economic activities.

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 publishes the ISDA Master Agreement, which is the standard documentation template used for cross-border transactions in OTC derivatives across the globe. Along with standard documentation ISDA publishes industry legal opinions on the enforceability of close-out netting as well as financial collateral arrangements.

The main starting point for every law reform effort aimed at improving legal certainty for OTC derivatives transactions entered into with counterparties from emerging market jurisdictions is the enforceability of close-out netting and financial collateral arrangements (in a very limited number of jurisdictions the issue of anti-wagering provisions needs to be addressed also).

Close-out netting is the primary means of mitigating credit risks associated with OTC derivatives transactions. The risk mitigation
By the middle of 2011 over 40 countries had enacted legislation that provides explicitly for the enforcement of close-out netting. Benefits of netting are substantial: according to the Bank for International Settlements’s regular surveys, netting benefit, measured as the difference between gross mark-to-market value and credit exposure after netting, has been over 85 per cent for many years now.¹

Support for netting is practically universal in the financial industry as well as among policy-makers; by the middle of 2011 over 40 countries had enacted legislation that provides explicitly for the enforceability of close-out netting (several more jurisdictions allow for the enforceability of close-out netting without the need for specific statues). The longstanding consensus among industry and policy-makers suggests that addressing close-out netting is one of the more successful examples of international legal and regulatory harmonisation. Most recently, in July 2011 and November 2011, respectively, the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB) reaffirmed their support for close-out netting.²

In reaffirming its support, however, both BCBS and FSB called for short delays to termination and close-out of insolvent financial institutions in order to allow time to transfer the insolvent firm’s financial contracts to a solvent firm. The general suggestion is to have such delays limited to two business days at most. While highlighting the importance of netting and financial collateral as part of systemic risk reduction, there is the perceived need for a temporary stay in connection with the exercise of transfer powers. A delay is said to be for the purpose of giving resolution authorities time to decide which assets or liabilities of a failing firm should be transferred, and also to effect the transfer. This perception arises from the belief that the ability to close-out early will lead financial creditors to make a “disorderly rush for the exits”. The effect is a temporary stay of the initiation of the close-out netting process, namely, the early termination of transactions following an event of default.

The need for cross-border coordination in matters around bank resolution provides more reasons to ensure that a sound legal framework underlies netting of financial contracts in every jurisdiction.

The objective of this article is to show the necessary conditions for netting to mitigate risk effectively. The first section describes the mechanics of close-out netting. The second section reflects the situation in central and eastern Europe, south-eastern Europe and the Commonwealth of Independent States (CEE/SEE/CIS) region in particular.

What is netting?

Master agreements are regularly used as contracts under which over-the-counter derivative transactions between two counterparties take place. Each transaction is not a separate contract, but is incorporated by reference into a single agreement. Most cross-border transactions in OTC derivatives transactions worldwide are documented under the ISDA Master Agreements. Netting takes two forms in the ISDA Master Agreement (as well as several of national equivalents for domestic transactions). Payment netting takes place during the normal business of a solvent firm, and involves combining offsetting cash flow obligations between two parties on a given day in a given currency into a single net payable or receivable; payment netting is essentially the same as set-off.

The other form of netting is close-out netting, which applies to transactions between a defaulting firm and a non-defaulting firm. Close-out netting refers to a process involving termination of obligations under a contract with a defaulting party and subsequent combining of positive and negative replacement values into a single net payable or receivable. Chart 1 shows how netting works. The defaulting and non-defaulting party are engaged in two swap transactions: for the non-defaulting party, Transaction 1 has a negative replacement cost of USD 1 million while Transaction 2 has a positive replacement cost of USD 800,000. If close-out netting is enforceable, the non-defaulting party is obliged to pay the net difference of USD 200,000 to the defaulting party. Had the net amount favoured the non-defaulting party, the non-defaulting party would become a general creditor to the defaulting party for the net obligation. But if close-out netting were not enforceable, the non-defaulting party would be obliged immediately to pay USD 1 million to the defaulting party but then wait, possibly months or years, for whatever fraction of the USD 800,000 gross amount it recovers in bankruptcy. The result of close-out netting is to reduce credit exposure from gross to net exposure.
The close-out netting process involves three steps: termination, valuation and determination of net balance. Termination means that the non-defaulting party puts an end to the obligations under the Master Agreement. The second step, valuation, is the process of determining the replacement cost of each transaction under the contract. Lastly, determination of net balance means that positive values – those owed to the non-defaulting party – and negative values – those owed by the non-defaulting party – are netted against each other under the single agreement in order to determine a final close-out amount.

What happens next depends on which party owes the netted close-out amount to the other. If the defaulting party owes the close-out amount to the non-defaulting party, the non-defaulting party can apply the value of collateral posted by the defaulting party to the net obligation. Collateral in excess of the net obligation must be returned to the insolvency administrator; alternatively, the non-defaulting party’s residual claim after netting and application of collateral will be treated the same as other unsecured claims, and will be paid at the same time as other unsecured claims as determined by a bankruptcy court. But if the non-defaulting party owes the close-out amount to the defaulting party, it may set off the amount that it owes against the amount owed to it by the defaulting party under other, non-derivative contracts. The non-defaulting party will pay to the insolvency administrator any net close-out amount remaining after set-off.

Why close-out netting is necessary
Close-out netting is an essential component of the hedging activities of financial institutions and other users of derivatives. For swap dealers, who specialise in bringing counterparties together for transferring risk, the need for netting stems from the dealer’s central role in risk intermediation. Each time a dealer enters into a transaction with a counterparty, the dealer takes on exposure to the transferred risk. The dealer does not normally wish to retain the exposure however, so it enters into offsetting hedge transactions. By maintaining a matched book – or more accurately, a balanced book – of offsetting transactions, the dealer avoids unwanted exposure to movements in interest rates, currencies and other sources of market risk. The result of this hedging activity is that, over time, the aggregate of derivatives activity includes a large number of inter-dealer and other hedge transactions that function largely to adjust risk positions and limit exposure to market movements. Indeed, the trillions of dollars of derivative notional amounts outstanding are largely the result of this ongoing hedging and rebalancing process.

Dealer hedge transactions involve many counterparties, all of which pose some risk of default. If the counterparty were to default, the dealer can no longer assume its exposures are hedged. The dealer will consequently find himself exposed to unanticipated market movements. In order to neutralise the exposures, the dealer needs to adjust the portfolio to bring it back into balance by either replacing the defaulted transactions or by unwinding the...
offsetting hedge transactions, or both. Netting and collateral facilitate this rebalancing process; netting, by reducing the exposure that needs to be rebalanced and collateral, by providing resources that can be offset against replacement costs. Even when derivatives are cleared through a central counterparty, it is necessary to balance market risks; if a default occurs under clearing, close-out netting is essential to the ability of the clearing house to manage its risks through rebalancing.

Similar considerations apply to users of derivatives. In contrast to dealers, derivatives users such as corporations or hedge funds do not maintain a matched book, yet they do seek to attain a desired risk profile. A corporation, for example, might use derivatives to control its exposure to currency fluctuations, while a hedge fund might use derivatives in arbitrage or relative value trades. If a dealer were to default, these counterparties would need to replace the defaulted transactions in order to return to their desired risk positions. As with dealers, netting would facilitate returning to the desired exposures.

Necessary conditions for netting
In some jurisdictions, most notably England and other jurisdictions that follow English legal traditions, established insolvency law supports the right of creditors to pursue the close-out netting process following the insolvency of a counterparty. But in many jurisdictions, insolvency laws and other statutes place restrictions on a creditor’s ability to implement the process. In the United States, for example, the Bankruptcy Code does not normally recognise *ipso facto clauses* that allow termination of a contract as a consequence of bankruptcy. Further, the United States and many other jurisdictions place “stays” on the ability of most creditors to pursue their claims against a debtor that files for bankruptcy and to apply collateral posted by the debtor. Lastly, insolvency administrators might engage in *cherry picking*, which involves an insolvency administrator demanding performance of contracts favourable to the bankrupt firm but rejecting contracts burdensome to the bankrupt firm.

In most countries, it has been necessary to enact specific netting legislation in order to achieve statutory recognition of the elements of the netting process described above. More than 40 jurisdictions have enacted – and several more are considering – legislation that explicitly provides for the enforceability of close-out netting. ISDA also collects legal opinions regarding enforceability of the close-out netting provisions of the ISDA Master Agreement with counterparties located in a particular jurisdiction. ISDA currently has netting opinions for almost 60 jurisdictions. And similarly, ISDA has obtained opinions regarding the enforceability of ISDA Credit Support Documents in around 50 jurisdictions.

Country-specific developments in the CEE/SEE/CIS region
In 2011 a large number of jurisdictions across the CEE/SEE/CIS region have experienced significant developments regarding the legal and regulatory framework that affects transactions in OTC derivatives. The paragraphs below summarise and assess developments as of December 2011.

Those jurisdictions in the region that are also EU Member States had to implement the EU directive amending the settlement finality directive and the financial collateral arrangements directive (2009/44/EC; Amending Directive) in 2011. The main feature of the Amending Directive from the derivatives point of view is the addition of credit claims as an eligible type of collateral to financial collateral arrangements. A number of EU Member States have used the opportunity of implementing the Amending Directive to also improve the existing legislation on netting and collateral arrangements.

In Slovenia, the legislator broadened the scope of counterparties eligible for financial collateral arrangements to include corporates. This brings the local collateral regime in line with the new Slovenian netting legislation that was adopted in 2010. As a result of this, positive industry legal opinions can now be obtained.

Thus far, the relevant EU legal framework does not provide for any substantive provisions on close-out netting. Neither the EU directives on Settlement Finality (98/26/EC), Winding-up of Credit Institutions (2004/EC), Financial Collateral Arrangements (2002/47/EC) nor the EU Banking Directive (2006/48/EC) or Insolvency Regulation (1346/2000) contain any such provisions. They merely make reference to netting agreements.
Amendment to the Bankruptcy Act in Poland has done away with uncertainty regarding enforcement of financial collateral arrangements.

Lithuania, for the first time, adopted substantive netting legislation while implementing the Amending Directive. Thus far, the relevant EU legal framework does not provide for any substantive provisions on close-out netting. Previously, the country had been one of the four remaining EU Member States without any substantive law on netting. Previously and similar to Bulgaria, Estonia and Latvia, only the initial EU Directive on Financial Collateral Arrangements had been implemented. However, this directive does not provide for substantive provisions on close-out netting. It only assumes that netting agreements are enforceable in each EU Member State based on previously existing local law.

In Bulgaria, besides no netting legislation being in place, the existing framework for collateral transactions continues to be sub-optimal. The implementation of the Amending Directive led to increased uncertainties as to the inclusion of non-EU based entities that enter into financial collateral transactions. These issues need to be addressed in the future.

Significant progress has been made in Poland in 2011. Amendments to the Bankruptcy Act have done away with uncertainty, which had so far prevented market participants from obtaining positive industry opinions on the enforceability of financial collateral arrangements. The latest amendments expressly state that collateral transactions (and securities lending transactions) fall within the scope of eligible transactions under the existing netting regime.

In early 2011 a new Law on Collateral entered into force in the Czech Republic. It consolidates the various pieces of collateral-related provisions scattered across a number of laws into a single Act. However, some ancillary provisions outside of the new law regarding the conflict of law rules relating to securities held as collateral are out of sync with international standards. Industry has approached the local authorities about this. Such international standards include the conflict of law provisions in, *inter alia*, the Hague Securities Convention.

While in the Slovak Republic the existing insolvency regime has been clarified to expressly state that measures applied under the so-called involuntary administration do not negatively impact the validity and enforceability of netting agreements, other concerns raised by market participants remain unresolved for the time being. The main concerns are about the scope of eligible counterparties for both netting and collateral agreements as corporates remain outside the scope. This limited scope is contrary to the trend across all Member State jurisdictions. An additional concern stems from new requirements to disclose financial contracts entered into with Slovakian public entities. The new provisions stipulate that non-disclosed transactions may become unenforceable (as of January 2012).

In Hungary, several pieces of legislation have been adopted which are not necessarily in sync with the existing wider local regime for netting and collateral agreements. A new law on the insolvency of certain enterprises that are deemed “of national importance” has been introduced. Thus far, the legislator has not adopted any list of entities that are considered to fall within this group. Neither has it been expressly clarified if the new provisions are meant to be outside of the existing (positive) legal framework for netting and collateral arrangements in Hungary. Another law adopted with effects on derivatives transactions deals with loans and mortgages denominated in foreign currency. The new provisions allow repayment of foreign currency-denominated loans and mortgages at exchange rates that are way below market rates. The aforementioned new laws raise several issues as to the compatibility with EU law. As the new laws override existing contractual arrangements agreed upon by the counterparties, a degree of legal uncertainty is being introduced. The economic terms of these contracts were used as a guideline for the economic conditions of the hedging transactions related to the relevant mortgage and loan agreements.

In Romania, the local legal regime for netting and collateral transactions has been subject to some reservations expressed by market participants. Existing inconsistencies were not removed at the time of implementing the Amending Directive. However, certain developments that stem from draft provisions prepared for more general purposes of the Civil Code (for example, proposals to introduce the concept of “economic hardship”) and the Insolvency Act (for example, acceleration upon insolvency of the debtor) may cause additional problems.
These issues have to be clarified before legal certainty for transactions with Romanian counterparties increase and market participants will be able to obtain positive legal opinions.

CEE/SEE jurisdictions outside of the EU area where significant developments relating to derivatives have occurred include Serbia and Croatia.

In Serbia, new provisions have been added to the Bankruptcy Act that allow for “insolvency set-off”. From the current wording in the law it is not entirely clear if this terminology is meant to include forms of netting other than by way of set-off as well. The latter is just one among several ways of achieving netting. Furthermore, the new Foreign Exchange Act has not clarified a number of existing uncertainties around currency trading. Market participants will continue to work with local authorities.

Croatia has undertaken efforts to implement various pieces of EU legislation before its accession to the European Union in 2013. However, inconsistencies across various pieces of Croatian legislation with regard to the definition of close-out netting remain. Industry has made several submissions to the authorities to highlight the issues.

In the CIS region the three jurisdictions most relevant to the derivatives markets in terms of volumes are Russia, Kazakhstan and Ukraine. Jurisdictions with nascent market activities include Armenia, Azerbaijan and Georgia.

After several years of debate, Russia has enacted substantive netting legislation that entered into force in the summer of 2011. For the first time, netting with certain Russian counterparties will be enforceable. However, netting will become operational and enforceable only once two pieces of secondary legislation have entered into force. The lead regulator needs to enact a regulation on eligible documentation used for transactions with Russian counterparties as well as a regulation on trade repositories and reporting of these transactions. At this stage the scope of the latter regulation remains unclear. It will be crucial to define the reporting requirements in a way that is manageable from an operational perspective and in line with emanating global standards (for example, CPSS-IOSCO). Once these two regulations are in force, market participants and industry will be able to obtain netting opinions on Russia. This is significant progress. One major issue that needs to be addressed is an upgrade of the Russian legal framework for collateral transactions (in particular, the recognition of title transfer arrangement).

In Kazakhstan, the current legal regime does not provide for the enforceability of netting and collateral arrangements. Amendments to the Bankruptcy Code, adopted in 2009 to address restructuring of financial institutions, did not address this issue. A draft law currently under consideration to achieve what is referred to as “risk minimisation in the banking sector” does not include any such provisions either, despite legislating for capital market transactions that include OTC derivatives. This draft law certainly requires heightened attention from market participants.

Over the last couple of years, several attempts have been made in Ukraine to draft comprehensive legislation to cover all issues related to derivatives in a single law. However, these attempts have failed and not surprisingly no such attempt has succeeded in any other jurisdiction. It usually is more efficient and practical to address derivatives-related issues in a number of different laws. Previous drafts have shown insufficient reflection of market realities and structures and were therefore abandoned. In June 2011, another attempt has been undertaken to revive this draft bill. It remains to be seen if comments from the markets will be reflected in any re-draft or may lead to an approach that addresses the issues in a more appropriate way.

It appears worthwhile to mention several law reform projects at regional and global levels, which are likely to have an impact on jurisdictions across all regions. With regard to the legal framework for netting and collateral transactions in all EU jurisdictions, one would look with great attention to the EU initiatives on cross-border crisis management and bank resolution, the proposed netting directive/regulation (both due in early 2012), as well as the forthcoming review of the EU Insolvency Regulation (in mid-2012). Global projects initiated in 2011 by the FSB (Financial Stability Board) and UNIDROIT (International Institute for the Unification of Private Law) on cross-border banking resolution...
and global principles for close-out netting, respectively, will provide useful guidance for further law reform affecting the derivatives markets in the CEE/SEE/CIS region.

**Conclusion**

Significant progress has been made in emerging market jurisdictions across the CEE/SEE/CIS region in 2011. Against a backdrop of ongoing multi-layered activities at the global, regional and national levels, market participants sometimes observe the lack of a great degree of coordination. Looking ahead, market participants will have to keep an eye on any inconsistencies between the various projects.

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**Notes**

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