BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Netting of Financial Agreements Bill

Consultation Paper

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PART C THE PROPOSED NETTING OF FINANCIAL AGREEMENTS BILL 13

Bank Negara Malaysia invites comments on the provisions of the proposed Netting of Financial Agreements Bill as set out in Part C of this consultation document by **23 September 2014**. Please provide your name and the organization you represent (where applicable) and to provide reference on the provision/clause you are commenting on. Comments or queries may be forwarded by email to **feedback@bnm.gov.my**.

PART A OVERVIEW

1. Background

1.1 Close-out netting is an important risk management tool in the financial market. It is a mechanism which is used by financial institutions and other financial market participants to reduce risk exposure in the event of a counterparty default for bilateral financial transactions that have been entered into, in particular for transactions that have a high counterparty and market risk such as derivatives and repurchase transactions.

2. What is close-out netting?

2.1 The close-out netting mechanism is embedded in financial contracts entered into by these above-mentioned institutions. The mechanism comes into operation (which can be either by way of a declaration or automatically), when one of the events specified in the financial contract (such as the default or insolvency of a counterparty) materialises. Once triggered, the close-out netting mechanism allows all the transactions under the financial contract to be terminated and the value for each of the transactions to be determined. The sum value of all the transactions will then be aggregated whereby a single net amount becomes payable by one party to the other. The close-out netting mechanism ensures this single net amount will be the amount payable rather than the gross amount for each individual transaction under the financial contract.

3. The importance and benefits of close-out netting

3.1 Close-out netting is important as it allows parties in the financial market to perform financial transactions with reduced exposure to credit and market risk. Without the benefit of close-out netting, a party needs to calculate its risk exposure to a particular counterparty on a gross basis (i.e. for each of the many transactions that may be entered into under the contract). As a consequence, a non-defaulting party is exposed to credit and market risks that are volatile and difficult to estimate and manage. There may be rapid

changes in the market values for the transactions against which the non-defaulting party may not be able to protect itself while at the same time is unable to terminate the contract and re-hedge positions. The close-out netting mechanism reduces these exposures whereby the termination of transactions will prevent participants from being exposed to further volatility and uncertainty in the financial market as well as confining counterparty credit risk to a single net amount payable under the contract. The close-out netting process mitigates risks which otherwise, if not managed, could have a contagion effect or cause systemic risk that threatens the stability of the financial markets.

3.2 In addition, close-out netting reduces the cost of carrying on business and effecting transactions in Malaysia since lower capital can be set aside by financial institutions to meet regulatory requirements when dealing with financial transactions. This in turn will translate into lower cost of transactions between financial institutions with their counterparties and customers. With lower capital charges, financial institutions are able to undertake more transactions, trade in financial instruments more efficiently and further develop the capacity to provide new and innovative financial products to consumers.

3.3 The Malaysian corporate sector will likewise benefit from a well established legal framework that supports close-out netting whereby they will have a viable avenue to manage their market risks. This is in view that increasingly more Malaysian corporates are undertaking financial transactions such as derivatives. Regulatory authorities on the other hand can exercise better oversight and surveillance over the financial markets with the net position of the financial transactions.

4. Legal impediments to close-out netting in Malaysia

4.1 While parties may agree to incorporate a close-out netting mechanism under their financial contracts, such a mechanism may currently not be enforceable against Malaysian counterparties. This is a result of several statutory

provisions under Malaysian legislation which have been construed by the market as having the ability to affect the enforceability of close-out netting rights[1].

5. The contribution of a netting legislation to the domestic financial market

5.1 Many jurisdictions acknowledge the importance of establishing in place a legal framework that recognizes the enforceability of close-out netting as an effort to increase the competitiveness of their financial market. Towards this end, the Prime Minister announced in the 2014 Budget Speech that BNM will lead an initiative to develop a netting legislation to further promote the development of the domestic financial market. The netting legislation will provide legal assurance for the enforceability of the close-out netting mechanism under certain types of financial contracts by removing legal impediments or uncertainties to netting as posed under existing legislation.

5.2 With the ability to enforce close-out netting in Malaysia, it is envisaged that Malaysian counterparties would be able to undertake more financial transactions with both local and foreign counterparties, hence contributing to an increased volume of transactions and vibrancy in the financial market. It will also increase the competitiveness of the financial market whereby costs of transactions will be lower thereby driving the growth of more innovative products in the market.

6. Considerations

6.1 The drafting of the Netting of Financial Agreements Bill has taken into account elements that are required to ensure that the close-out netting mechanism under certain financial contracts will be enforceable under Malaysian law. Towards this end, international market groups such as the International Swaps and Derivatives Association (ISDA) have been consulted. The draft Bill also reflects the recommendations made by other regulatory agencies

[1] Please refer to paragraph 9.2 for a list of provisions which have been identified or construed as having the ability to affect the enforceability of close-out netting rights.

and market players.

6.2 It is to be noted that the Netting of Financial Agreements Bill is not intended to address other issues such as the validity of a financial contract or the regulation of financial transactions or conduct of financial institutions dealing with these financial instruments. The Netting of Financial Agreements Bill neither obliges an institution to enter into a financial transaction nor does it empower an institution to enter into financial transactions where the law or constituent document of the institution does not allow or imposes limits on the volume of transactions that may be entered into. The Netting of Financial Agreements Bill also does not prevent relevant regulators from restricting or imposing conditions and requirements in respect of financial market activities that may be performed by their regulated entities.

PART B POLICIES AND GUIDING PRINCIPLES

7. Definition of a "netting provision"

7.1 The objective of the Netting of Financial Agreements Bill is to provide legal certainty to the enforceability of a close-out netting mechanism under Malaysian law. As a close-out netting mechanism is embedded in a contractual provision under financial market contracts, the Netting of Financial Agreements Bill provides statutory assurance on the enforceability of a "netting provision" under certain "qualified financial agreements". A "netting provision" is defined as a provision that allows parties under a "qualified financial agreement", upon the occurrence of the events specified by the parties, to terminate transactions, calculate termination values of the transactions and determine a single net amount of the termination values that becomes payable by one party to the other in accordance with the procedures set out in the "qualified financial agreements".

7.2 To cater for market development in the future whereby the netting mechanism may take a different form from the current mechanism, the Minister of Finance, on the recommendation of the relevant authorities[2], is empowered under the Netting of Financial Agreements Bill to prescribe other forms of netting or set-off provision to qualify as a netting provision entitled for protection under the proposed legislation.

8. Scope

8.1 Under the Netting of Financial Agreements Bill, the scope of financial contracts covers a master agreement in respect of "qualified financial transactions" whilst a "qualified financial transaction" includes an over-the-counter derivative, a repurchase transaction or a securities borrowing and lending of unlisted debt securities under the Real Time Electronic Transfer of Funds and Securities System. Islamic financial instruments such as an Islamic derivative and a buy-sell back agreement will also qualify as transactions covered under

[2] Relevant authorities include Bank Negara Malaysia, Securities Commission, Malaysia Deposit Insurance Corporation, Pengurusan Danaharta Nasional Berhad and any other authority whose reach of statutory supervision or oversight may extend to a person who deals in a qualified financial transaction.

the draft legislation. These financial instruments are typically, or are permitted to be, traded in the Malaysian financial market.

8.2 Parties to a financial contract may provide collateral in respect of the transactions they enter into. In this respect, the Netting of Financial Agreements Bill also provides legal certainty for the close-out netting in respect of collateral provided for qualified financial transactions. Parties posting collateral in respect of their derivatives transactions, for instance, may rely on the Netting of Financial Agreements Bill to enforce close-out netting rights against the collateral provided, whether by way of title transfer or otherwise.

8.3 The Netting of Financial Agreements Bill provides the Minister of Finance with the flexibility to determine any other agreement or arrangement in respect of a financial transaction that may be entered into by parties in the financial markets to be a "qualified financial agreement". This will provide for changes necessary as the markets evolve to be in line with future market developments and international best practices. The decision making process by the Minister will be complemented by a robust governance process which will include a consultative process with relevant agencies and stakeholders that will influence or be impacted by policies and issues concerning qualified financial agreements.

9. Enforceability of a qualified financial agreement

9.1 The Netting of Financial Agreements Bill provides that the netting provision of a qualified financial agreement is enforceable in accordance with its terms. This is intended to provide legal certainty on enforceability of such netting provisions notwithstanding existing statutory provisions that have been construed by the market as having the effect of preventing close-out netting.

9.2 The provisions that have been identified so far are namely section 29A and section 41 of the Pengurusan Danaharta Nasional Berhad Act 1998 as well as section 346C of the Capital Markets and Services Act 2007 (referred to in the Bill as

"specified provisions"). Please refer to **Appendix 1** for a further explanation of each of the provisions.

10. Temporary stay

10.1 While close-out netting may serve as a useful risk management tool for financial institutions and other market industry in the bilateral context, the immediate exercise of close-out netting against a troubled financial institution in time of crisis, may cause systemic risk. Under such circumstance, there is a need for a brief suspension on close-out netting mechanism (particularly in the context of the resolution of financial institutions) to allow the relevant authorities the time needed to decide whether and how to resolve a troubled institution in an orderly fashion so as to mitigate risks to financial stability.

10.2 In this respect, the Minister of Finance, on the recommendation of the relevant authorities, is empowered to impose a period of temporary stay on the rights of close-out netting protected under the Netting of Financial Agreements Bill. Such period will be imposed for the purposes of the existing temporary stay mechanism or moratorium provided under the Financial Services Act 2013, the Islamic Financial Services Act 2013, the Malaysia Deposit Insurance Corporation Act 2011 and the Pengurusan Danaharta Nasional Berhad Act 1998. For greater certainty, the Netting of Financial Agreements Bill also provides that the period of stay imposed under the proposed legislation will prevail over any other period of stay as may be prescribed under the above-mentioned existing legislation.

10.3 The period for temporary stay to be imposed by the Minister of Finance will be implemented in accordance with international best practice as set out in the "Key Attributes of Effective of Resolution Regime for Financial Institutions" issued by the Financial Stability Board in October 2011(which based on current international practice that is not more than 2 days).

10.4 The Netting of Financial Agreements Bill also provides, as a matter of avoidance of doubt, that the conditions associated with the stay mechanism

under the Financial Services Act 2013, the Islamic Financial Services Act 2013 and the Malaysia Deposit Insurance Corporation Act 2011 will continue to apply. For instance, these provisions clarify that where a financial contract has been transferred to another financial institution or bridge institution ("a third party"), the third party shall assume all the rights and obligations under the financial contract. If the financial contract is not transferred at the end of the stay period, the non-defaulting party may then proceed to exercise the close-out netting right. The authorities are also not allowed to "cherry-pick" on the transactions under the financial contract when transferring the financial contract to the third party.

11. Application

11.1 The Netting of Financial Agreements Bill will have a mechanism to ensure that close-out netting would remain effective despite the legal uncertainty resulting from the ambiguity in the provision of a later law or new interpretation of existing law by the market. From the experience of Malaysia as well as other jurisdictions, such problem may arise from a legislative provision that confers broad powers on regulators where there may not be a specific intent to affect close-out netting under those provisions. The need to preserve the sanctity of close-out netting moving forward arises in view of a principle of law that a later statute would prevail where there is an inconsistency between the legislation and a later legislation. It is therefore important to ensure that such later legislation should not unnecessarily defeat the purpose of the Netting of Financial Agreements Bill.

11.2 It is proposed that the Minister, on the recommendation of the relevant authorities, is empowered to prescribe a provision in other legislation as a "specified provision" under the Netting of Financial Agreements Bill. Once a statutory provision is designated as a "specified provision", close-out netting will be enforceable despite the legal uncertainty that may be posed by the "specified provision".

Appendix 1

List of "non-netting friendly" provisions

No	Section	Remarks
1.	S29A and section 41 of the Pengurusan Danaharta Nasional Berhad Act 1998	Section 29A provides that the appointment of a Special Administrator under the Danaharta Act shall not be regarded as giving rise to a right for a person to terminate an agreement or accelerate the performance of an obligation. Section 41 states that on the appointment of the Special Administrator, a moratorium for a period of twelve months shall take effect during which no steps may be taken by any parties to set off any debt owing to the affected person in respect of any claim against the affected person except with the prior written consent of the Corporation.
2.	S346C of the Capital Markets and Services Act 2007	Under section 346C, the Securities Commission may issue a directive requiring any person to take any measure as the Commission may consider necessary in the interest of monitoring, mitigating or managing "systemic risk in the capital market".

PART C THE PROPOSED NETTING OF FINANCIAL AGREEMENTS BILL

NETTING OF FINANCIAL AGREEMENTS BILL 2014

ARRANGEMENT OF CLAUSES

PART I
PRELIMINARY

Clause

1. Short title and commencement
2. Interpretation

PART II
NETTING PROVISION

3. Enforceability of a netting provision under a qualified financial agreement
4. Period of stay
5. Continued application of relevant provisions in other written laws

SCHEDULE

A BILL

I n t i t u l e d

An Act to provide for the enforceability of netting provision under financial agreements and to provide for related matters.

[ ]

ENACTED by the Parliament of Malaysia as follows:

PART I
PRELIMINARY

Short title and commencement

1. (1) This Act may be cited as the Netting of Financial Agreements Act 2014.

(2) This Act comes into operation on a date to be appointed by the Minister by notification in the *Gazette*.

Interpretation

2. (1) In this Act, unless the context otherwise requires—

"derivative" means any agreement including an option, a swap, futures or forward contract, whose market price, value, delivery or payment obligations is derived from, referenced to or based on, but not limited to, securities, commodities, assets, rates (including interest rates, profit rates or exchange rates) or indices and shall include an Islamic derivative;

"Islamic derivative" means a derivative made in accordance with Shariah;

"Islamic securities" means securities which are in accordance with Shariah;

"Minister" means the Minister charged with the responsibility for finance;

"prescribed" means prescribed under this Act from time to time by order published in the *Gazette*;

"relevant authority" means:

(a) Bank Negara Malaysia which continues to exist under the Central Bank of Malaysia Act 2009;

(b) Securities Commission established under the Securities Commission Act 1993;

(c) Malaysia Deposit Insurance Corporation which continues to exist under the Malaysia Deposit Insurance Corporation Act 2011;

(d) Pengurusan Danaharta Nasional Berhad established under the Pengurusan Danaharta Nasional Berhad Act 1998; or

(e) any other authority whose reach of statutory supervision or oversight may extend to any person who deals in a qualified financial transaction;

"securities" includes Islamic securities;

"specified provision" means a provision in a written law set out in the Schedule;

Qualified financial agreements

(2) For the purpose of this Act –

(a) "qualified financial agreement" means –

(i) a master agreement, with a netting provision, in respect of one or more qualified financial transactions, and for the avoidance of doubt, where a master agreement is also in respect of one or more transactions that are not qualified financial transactions, the master agreement shall be a qualified financial agreement only with respect to the transactions that are qualified financial transactions;

(ii) an agreement relating to financial collateral, including a title transfer credit support agreement, with respect to one or more qualified financial transactions under a master agreement referred to in subparagraph (i); or

(iii) any other agreement or arrangement that may be prescribed under paragraph 3(5)(a) of this Act;

(b) "netting provision" means a provision in a qualified financial agreement which provides that upon the occurrence of the events specified by the parties, all obligations owed by one party to another party under a qualified financial transaction are reduced to or replaced with a single net amount which may involve the following steps:

(i) termination of qualified financial transactions entered into under the qualified financial agreement;

(ii) calculation of termination values owed by the parties to each other in respect of each of the qualified financial transactions under subparagraph (i); and

(iii) determination of a single net amount of the termination values under subparagraph (ii) which becomes payable by one party to the other; or

(iv) any other mechanism which has the effect of determining a single net amount as may be prescribed under paragraph 3(5)(b) of this Act,

in accordance with the qualified financial agreement;

(c) "qualified financial transaction" means a transaction that is referred to in subsection 3(3) of this Act,

(d) “financial collateral" means an interest or a right that secures payment or performance of an obligation under a qualified financial agreement, including a title transfer credit support agreement and for the purpose of this Act means:

(i) cash or cash equivalents, including negotiable instruments and demand deposits;
(ii) securities, a securities account or a right to acquire securities; or
(iii) futures agreement or futures account;

(e) "title transfer credit support agreement" means an agreement under which title to property has been provided for the purpose of securing the payment or performance of an obligation in respect of a qualified financial agreement.

(3) Any reference in this Act to “this Act” shall, unless otherwise expressly stated, be deemed to include a reference to any order prescribed under this Act.

PART II
NETTING PROVISION

Enforceability of a netting provision under a qualified financial agreement

3. (1) The netting provision of a qualified financial agreement in respect of a qualified financial transaction shall be enforceable in accordance with its terms.

PROVIDED that when there is a stay prescribed under section 4 of this Act in circumstances of the specified provisions of Part 2 of the Schedule, this section shall prevail notwithstanding any other law currently in force to the contrary.

(2) For purposes of subsection (1), the enforceability of the netting provision shall take into consideration any financial collateral which may include a title transfer credit support agreement.

(3) This section shall apply to a qualified financial transaction which includes:

(a) over-the-counter derivatives;
(b) repurchase, reverse repurchase, buy-sell back with respect of securities;
(c) a lending or borrowing of unlisted debt securities under the Real Time Electronic Transfer of Funds and Securities System; or
(d) any other transaction as may be prescribed by the Minister on the recommendation of the relevant authority.

(4) This section shall be given effect notwithstanding the specified provisions set out in Part 1 of the Schedule.

(5) For the purposes of this Act, the Minister may, on the recommendation of the relevant authority, prescribe:

(a) an agreement or an arrangement which contains a mechanism to convert several claims and obligations in respect of a qualified financial transaction into a single net amount as a qualified financial agreement in paragraph 2(2)(a)
(b) a mechanism that has the effect of determining a single net amount for purposes of netting provision in paragraph 2(2)(b); ; and
(c) a provision of a written law as a specified provision in the Schedule.

Period of stay

4. The Minister may, on the recommendation of the relevant authority, prescribe such period of stay for the purposes of the specified provisions set out in Part 2 of the Schedule

and such period of stay shall prevail notwithstanding any other period of stay as may be provided under any such specified provisions.

Continued application of relevant provisions in other written laws

5. For the avoidance of doubt, nothing in this Act shall affect the continued application of the provisions of:

(a) subsections 115(3) to 115(7) and subsections 180(2) to 180(5) of the Malaysia Deposit Insurance Corporation Act 2011 [*Act 720*];

(b) subsections 209(3) to 209(6) of the Financial Services Act 2013 [*Act 758*]; and

(c) subsections 220(3) to 220(6) of the Islamic Financial Services Act 2013 [*Act 759*],

with respect to qualified financial agreements.

SCHEDULE

[Section 3(4) and section 4]

Specified Provisions

Part 1

1. section 29A and section 41 of the Pengurusan Danaharta Nasional Berhad Act 1998 [Act 587].
2. section 346C of the Capital Markets and Services Act 2007 [Act 671].
3. any provision of a written law as may be prescribed under paragraph 3(5)(c) of this Act.

Part 2

1. section 115(3) and section 180(1) of the Malaysia Deposit Insurance Corporation Act 2011.
2. section 209(2) of the Financial Services Act 2013.
3. section 220(2) of the Islamic Financial Services Act 2013.
4. section 41 of the Pengurusan Danaharta Nasional Berhad Act 1998.
5. any provision of a written law as may be prescribed under paragraph 3(5)(c) of this Act.

Explanatory Statement

1. This Bill seeks to provide for the enforceability of netting provision under financial agreements and to provide for related matters.

2. *Clause 1* contains the short title of the proposed Act.

3. *Clause 2* contains the definition of certain words and expressions used in the proposed Act.

4. *Clause 3* seeks to provide that the netting provision of a qualified financial agreement shall be enforceable in accordance with its terms except during such period of stay as may be prescribed by the Minister under the proposed Act. This clause further clarifies that the enforceability of the netting provision may take into account financial collateral including title transfer credit support agreement. The provision is to be given effect notwithstanding the specified provisions set out in Part 1 of the Schedule. The Minister is empowered under this clause to prescribe additional "netting provision", "qualified financial transaction", "qualified financial agreement" and "specified provision" upon the recommendation of the relevant authorities.

5. *Clause 4* seeks to provide that the Minister may prescribe such period of stay for the purposes of the specified provisions set out in Part 2 of the Schedule upon the recommendation of the relevant authorities and such period of stay shall prevail notwithstanding any other period of stay as may be provided under any such specified provisions.

6. *Clause 5* seeks to provide for the continued application of relevant provisions in other written laws.

FINANCIAL IMPLICATIONS

This Bill will not involve the Government in any extra financial expenditure.

[…]