Response to feedback received – Consultation Paper on Netting of Financial Agreements Bill

1. INTRODUCTION

1.1 Bank Negara Malaysia ("the Bank") issued a Consultation Paper on the Netting of Financial Agreements Bill 2014 ("NFA") on 9 September 2014 which proposed to enact a legislation to provide legal certainty for the enforcement of close-out netting arrangements under certain types of financial contracts. The NFA was approved by the *Dewan Rakyat* on 26 November 2014 and *Dewan Negara* on 1 December 2014. It is expected to come into force in the first quarter of 2015.

1.2 The Bank appreciates the constructive feedback provided by the industry and has taken into consideration the feedback in finalising the proposed NFA. More than 50 responses were received from the industry with comments mostly from the banking industry and industry associations such as the International Swaps and Derivatives Association (ISDA) and the Persatuan Pasaran Kewangan Malaysia (PPKM). Key feedback received and responses are summarised below.

2. INDUSTRY COMMENTS AND RESPONSES

Scope of qualified financial transactions

2.1 Some respondents sought clarification as to whether the scope of qualified financial transactions under the proposed NFA include the following:

(a) Foreign currency spot;
(b) Centrally cleared derivatives transactions;

Foreign currency spot

2.2 For the purpose of the NFA, the scope of qualified financial agreement does not include foreign currency spot transactions. Market participants that engage in foreign currency spot transaction which involves the exchange of one currency for another currency on the settlement date at pre-agreed spot rates are exposed to settlement risk, rather than an exposure to counterparty default risk. Such settlement risk exposure, which also arises from other types of transactions such as the purchase of bonds and equities, is not within the scope of the close-out netting mechanism (i.e. termination, valuation, and aggregation to a single net amount).

Centrally cleared derivatives transactions

2.3 The proposed NFA does not include centrally cleared derivatives transactions, although the proposed NFA has an empowering provision which allows additional types of qualified financial agreement and transactions to be

specified. To the extent that if central clearing is implemented in Malaysia, the legal framework governing central clearing of derivatives would be reviewed and enhanced to facilitate multi-lateral netting in order for market participants to benefit from the efficiency of central clearing.

Financial collateral

2.4 A number of respondents suggested that the scope of financial collateral under the NFA be expanded to include alternative types of credit risk mitigants, such as guarantees and physical assets.

2.5 Although parties to financial transactions may negotiate for various credit risk mitigants to be used to reduce counterparty risk exposures, the NFA is drafted with primary consideration given to current market practices where cash and other high-quality liquid securities are typically and widely used as collateral to financial transactions given the ease of valuation as compared to alternative credit risk mitigants such as real property.

2.6 The Bank is also of the view that guarantee is an arrangement, which allows a creditor to claim against the guarantor any amount owed to the creditor, in the event of default, and does not necessarily have the effect of reducing counterparty risk exposure. In this context, guarantee arrangement does not fall within the scope of financial collateral in the NFA.

Period of temporary stay

2.7 Some respondents suggested that the period of stay should be incorporated into the NFA to provide greater certainty to market participants, while some have raised concerns on the discretion of the Minister to determine the stay period.

2.8 Under the NFA, the Minister will only prescribe a period of stay upon the recommendation of the relevant authorities, which include Bank Negara Malaysia, Perbadanan Insurans Deposit Malaysia and Pengurusan Danaharta Nasional Berhad. The period of stay will be set out in a subsidiary legislation (i.e. prescribed by the Minister by way of an order published in the *Gazette*) so as to provide flexibility to align the period of stay with international practices, as necessary. To alleviate the concerns of the market, the revised NFA also includes a provision whereby advance notice will be given to market participants should there be a need to make any changes to the period of stay, to the extent practicable. The Bank expects a period of stay of no longer than 2-business days to be prescribed in line with the international practices, and should continue to be the case to maintain the netting-friendly status.

"Cherry picking" of financial transactions

2.9 Some respondents suggested that the NFA should provide an assurance that regulatory authorities would not selectively choose financial transactions that may be terminated and those which may not ("cherry-picking"), in the event of a resolution.

2.10 The application of the temporary stay under the NFA is subject to the conditions provided under Part III of the Schedule to the NFA[1], which among others which provide statutory assurance that regulatory authorities would not selectively choose financial transactions that may be terminated with the same counterparty. Such safeguard is in line with the "Key Attributes of Effective Resolution Regimes for Financial Institutions" issued by the Financial Stability Board.

GOING FORWARD

2.11 The NFA is expected to come into force in the first quarter of 2015. The NFA will provide legal certainty to the ability of parties to enforce close-out netting rights for qualified financial agreements.

Bank Negara Malaysia
8 January 2015

[1] Legislation mentioned in Part III of the Schedule in the NFA are the Malaysia Deposit Insurance Corporation Act 2011, Financial Services Act 2013 and the Islamic Financial Services Act 2013.