



International Swaps and Derivatives Association, Inc.  
360 Madison Avenue, 16th Floor  
New York, NY 10017  
United States of America  
Telephone: 1 (212) 901-6000  
Facsimile: 1 (212) 901-6001  
email: [isda@isda.org](mailto:isda@isda.org)  
website: [www.isda.org](http://www.isda.org)

6 November 2009

Via FedEx and Email

Mr. José Miguel Angél Nacur Gazali  
General Counsel  
Chilean Central Bank  
Agustinas 1180  
Santiago, Chile

CC: Mr. Jorge Desormeaux Jimenez - Deputy Governor, Mr. Kevin Cowan Logan - Director of the Financial Policy Division, and Mr. Beltrán de Ramón A. - Director of Financial Operations

**Re: Resolutions No. 1427 and No. 1457 – close-out netting arrangements involving Chilean banks and institutional investors**

Dear Mr. Gazali,

The International Swaps and Derivatives Association, Inc. (ISDA)<sup>1</sup> is grateful for the opportunity we had during our recent visit to Santiago to meet with you to discuss Chilean netting regulations. Further to that meeting we would like to draw your attention to some specific concerns of our membership. In particular we would like to discuss how Resolution No. 1427 of August 7, 2008 ("R-1427"), limiting early termination events that are permitted by the Chilean Central Bank, and Resolution No. 1457 of January 22, 2009 ("R-1457"), suspending netting during certain pre-bankruptcy events, both applicable when one of the parties involved is a local bank or institutional investor, have both adversely impacted Chilean and international participants of the OTC derivatives market.

For reasons set forth below, ISDA is particularly eager to provide all possible assistance to and cooperate with the Chilean Central Bank and the appropriate authorities in Chile in order to facilitate statutory support for OTC derivatives, the legal enforceability of the ISDA Master Agreement and, in particular, close-out netting in Chile and thereby foster greater harmonization with international standards.

---

<sup>1</sup> 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 currently has more than 825 members from 57 countries on five continents.

*Resolutions No. 1427 and No. 1457 limit the close-out netting arrangements with Chilean banks and institutional investors*

We understand that under R-1427 and R-1457, when one of the parties involved is a local bank or institutional investor and certain pre-bankruptcy actions or sanctions are applied and/or taken with respect to such local bank or institutional investor as a result of its financial instability, netting will be suspended unless it results from one of the following early termination events:

- a) mandatory liquidation or cancellation of licenses by the regulator;
- b) voluntary termination of the bank or institutional investor's operations with prior consent of the regulator; or
- c) default in payment of a material obligation under a derivative contract governed by the ISDA Master Agreement.

*Resolutions No. 1427 and No. 1457 have adversely impacted both Chilean and international participants of the OTC derivatives market*

The determination of whether credit exposure is likely to be net or gross on a counterparty has a binary nature, that is, international market participants consider whether the legal position of close-out netting for a specific jurisdiction is favorable or unfavorable. Where there are any legal restrictions on netting, international market participants will consider a jurisdiction as "non-netting" and thus will account for exposures on a gross basis. As a result, the fact that a country is a non-netting jurisdiction has a negative impact in the number of counterparties and amounts per transactions because of the higher price required by the credit models of international banks for non-netting jurisdictions. Related to the liquidity issue, a lower cost of credit with a workable netting regime may optimize the use of credit lines or even increase them. As a result of R-1427 and R-1457, Chile has been confirmed as a "non-netting" jurisdiction by international market participants.

R-1427 and R-1457 have created uncertainty with regard to the derivatives market in Chile and disincentives for international investors in their extension of credit to Chilean banks or institutional investors because international market participants cannot confidently net their derivatives exposure against their Chilean counterparties. As a consequence, the number of international market participants is limited and Chilean banks and institutional investors reach their credit limit much earlier so their ability to trade has become more expensive. Ultimately, Chilean banks and institutional investors are at a competitive disadvantage when compared to entities located in other Latin American jurisdictions where netting is recognized, such as Colombia, Peru, Brazil and Mexico (as set forth in Appendix A hereto).

In addition, as a consequence of the enactment of R-1427 and R-1457, the regulatory regime applicable to Chilean banks and institutional investors became more restrictive to the applicability of netting. Before the Resolutions, close-out netting was unconditionally allowed in all pre-bankruptcy scenarios. It is our understanding that the spirit of the Chilean Capital Markets Reform of 2007 was simply to clarify the concept of "connected obligations" (*obligaciones conexas*) for the applicability of netting in post-bankruptcy events.

In order to avoid this, ISDA would like to respectfully offer its assistance to the Chilean Central Bank as it works to mitigate the risk of any such disadvantages and to promote legal certainty among international market players accessing Chile's financial markets. In particular, we would be very keen on providing all possible assistance to and cooperating closely with the Chilean Central Bank and the appropriate authorities in Chile in order to make appropriate regulatory changes to ensure that the relevant regulation expressly recognize the enforceability of close-out netting arrangements at all times during the life of a transaction in respect of banks and institutional investors. To that effect, R-1427 and R-1457 would need to be amended or augmented to specifically provide that (i) the applicable rules in pre-bankruptcy situations are not modified and follow the general principles of the Chilean legal system; and (ii) the transactions entered into between the same parties under the same ISDA Agreement are

considered “connected” for purposes of both the Chilean Bankruptcy and Banking Laws and therefore can be netted, providing also symmetry of rights among International and Chilean banks, and institutional investors.

*The concept of close-out netting*

Most contracts that are widely used in international financial derivative markets are drafted as a type of master or framework agreement. Each of these master agreements is designed as a master netting agreement under which the parties can enter into a number of different trades and, on close-out, calculate the net exposure between the parties under all of these trades. Close-out netting in relation to OTC derivative transactions is the ability of a party under a master agreement for such OTC derivative transactions (such as an ISDA Master Agreement) to net the mark-to-market values of all existing transactions under the master agreement upon their early termination following the default of its counterparty or other specified events, including a range of insolvency events prior to an official bankruptcy. Appendix B provides a specific example of how risks and costs may be reduced via close-out netting.

*The benefits of close-out netting*

The benefits of close-out netting are risk reduction and cost reduction. The risk reduction is twofold: reduction of credit risk and the consequent reduction of systemic risk. Credit risk reduction benefits an individual party by reducing its overall exposure to its counterparty by anywhere from 40 to 60 percent. By reducing credit risk at each node in the network of relationships between market participants, close-out netting also has an important beneficial effect on systemic risk. For that reason, the Basel Committee on Banking Supervision recently emphasized the importance of further convergence and strengthening of national frameworks of close-out netting to mitigate the risks of cross-border contagion.<sup>2</sup>

Recognizing the value of close-out netting, the central banks and regulators of G10 countries and other jurisdictions have permitted, subject to prudential conditions, the recognition of netting for capital adequacy and large exposure purposes. Other benefits for market participants include more efficient use of credit lines and the ability to maintain lower reserves to cover exposures.

According to the May 2009 BIS Tri-annual Survey published by the Bank of International Settlements (as set forth in Appendix C hereto), the total notional amount outstanding of all OTC derivatives transactions (as of December 2008) was USD 592 trillion. The total mark-to-market value of these outstanding transactions was USD 33.9 trillion (5.7% of notional amount). After applying close-out netting the total mark-to-market credit exposure was USD 5.0 trillion (0.8% of notional amount), a reduction of 85.2%.

We hope that our comments are helpful to the Chilean Central Bank. ISDA wholeheartedly endorses the spirit underlying any efforts to provide a robust statutory framework and greater legal certainty for Chile. We would be very glad for the opportunity to work closely with you to address those issues we have identified. If ISDA can be of any help in this process, we hope that you will not hesitate to contact me at telephone number +1 212 9016031.

Sincerely,

Katherine Darras  
General Counsel, Americas  
[KDarras@isda.org](mailto:KDarras@isda.org)

---

<sup>2</sup> Report and Recommendations of the Cross-border Bank Resolution Group, at 35 (September 2009), available at <http://www.bis.org/publ/bcbs162.pdf?noframes=1>.

## APPENDIX A

### CLOSE-OUT NETTING REGIMES IN LATIN AMERICA

Resolutions No. 1427 and No. 1457 differ significantly from close-out netting regimes applicable to local banks and institutional investors located in other Latin American jurisdictions. Netting regulations in Colombia, Peru, Brazil and Mexico are summarized below.

#### *Colombian law recognizes close-out netting arrangements involving local banks and institutional investors*

The Colombian Financial Reform Bill that will likely take effect in 2009 authorizes early termination and close-out netting in the context of bankruptcy and restructuring procedures for cross-border OTC financial derivative transactions involving a Colombian bank, institutional investor or commercial corporation. The new legislation sets out certain conditions for netting, including the registration of derivative contracts according to forthcoming regulations that will likely be passed before the end of the year. The new legislation will benefit legacy agreements once they are registered.

#### *Peruvian law recognizes close-out netting arrangements involving local banks and institutional investors*

Legislative changes that took effect in Peru in 2008 authorize early termination and close-out netting for derivative transactions involving Peruvian banks, insurance and reinsurance companies. Circular No G-142-2009 sets out certain conditions for netting, including the filing of derivative contracts with banking authorities. Legacy agreements can benefit from netting once they are filed. Other institutional investors benefit from netting under contractual law.

#### *Brazilian law recognizes close-out netting arrangements involving local banks*

Article 119 of the Brazilian Bankruptcy Law recognizes netting in relation to transactions contracted within the Brazilian National Financial System (the "NFS"). While it is not clear whether cross-border derivative transactions are considered as being within the NFS, Article 126 of the Bankruptcy law requires equal treatment of creditors of the same rank. Therefore, an attempt by a bankruptcy court to invalidate netting arrangements of cross-border transactions while at the same time enforcing netting between Brazilian counterparties would likely not prevail.

Financial institutions in insolvency are subject to the Brazilian Bank Insolvency Law, but the legal effect of early termination clauses and close-out netting is the same for banks and companies because of the close connection between the Brazilian Bank Insolvency Law and the Brazilian Bankruptcy Law.

#### *Mexican law recognizes close-out netting arrangements involving local banks and certain institutional investors*

The Mexican Law on Commercial Reorganizations addresses netting in the context of banks, certain institutional investors and corporations, superseding any other insolvency provisions with respect to the subject matter it covers. Article 105 requires mandatory netting in financial derivative transactions on the date of the declaration of insolvency, according to the terms agreed by the parties. This is an exception to the "cherry-picking" powers given to the insolvency trustee under relevant laws.

**APPENDIX B****EXAMPLE OF RISK REDUCTION VIA CLOSE-OUT NETTING**

Swaps and other derivative transactions can be said to have a value to one or other of the parties. This value derives from the underlying rate, asset or risk to which the derivative relates. For example, the value of a straightforward fixed-for-floating interest rate swap derives from anticipated market interest rates for the currency concerned. To the fixed rate payer, the swap will have a value if, to replace the swap now, it would have to pay a higher fixed rate (in return for LIBOR) than it is required to pay under the existing swap. The swap would be, in that sense, an asset for the fixed rate payer in these circumstances, and a liability for the floating rate payer. In other words, the fixed rate payer is “in-the-money” and the floating rate payer is “out-of-the money”.

Over the course of time, a bank may enter into a number of different interest rate swaps with a counterparty. At any point in time, under some of those swaps the bank may be in-the-money, while under others it may be out-of-the-money. If the counterparty were to become insolvent, the bank would attempt to terminate all outstanding swaps with the counterparty. If all those outstanding swap transactions had been documented under an ISDA Master Agreement, then they would have been entered into on the basis that they constituted a single agreement with the Master Agreement. The purpose of this “single agreement” approach is to facilitate close-out netting by avoiding “cherry picking”.

The term “cherry picking” refers to a power that some insolvency officials have under the insolvency laws of certain jurisdictions to reject certain contracts burdensome to the insolvent company while affirming contracts beneficial to the insolvent company.

Generally, where an insolvency official has the power to reject or affirm contracts, a counterparty to a rejected contract must file a claim for moneys owed (or for damages) against the estate of the insolvent company in respect of the rejected contract, for which it can expect to receive no more than a fraction of the value, while continuing to perform its obligations to the insolvent company under any affirmed contracts.

If a bank has a number of swaps with an insolvent company, “cherry picking” results in those swaps which are out-of-the-money to the insolvent company being rejected and those swaps which are in-the-money being affirmed. Assuming the swaps are unsecured, the counterparty is in the disastrous position of being forced to pay full value in respect of the swaps which are out-of-the-money to itself while likely to receive only part value (if any) in respect of the swaps which are in-the-money to itself.

The ISDA Master Agreement attempts to overcome this problem by making it clear that the Master Agreement and all transactions entered into under it constitute a single agreement between the parties which must therefore be affirmed or rejected by the insolvency official as a whole.

Normally, upon declaration of an early termination date for a Master Agreement by reason of an insolvency default, all transactions are terminated and their value is determined. As noted above, some of these swaps, depending on rates prevailing at the time of termination, may be in-the-money and some may be out-of-the-money to the non-defaulting party. The values for the swap transactions are converted to a single currency and netted against each other to produce a single “settlement amount”.

The benefits of netting the values of individual transactions upon termination are clear. Suppose a bank had entered into four interest rate swaps with a counterparty which subsequently became insolvent and that on the date the insolvency petition was presented the values of those swaps to the bank were as follows:

Swap 1 .....	U.S.\$7 million
Swap 2 .....	U.S.\$5 million
Swap 3 .....	U.S.\$-6 million
Swap 4 .....	U.S.\$-3 million

Positive figures indicate that the bank is in-the-money and that the swap is, in that sense, an asset for the bank. Negative figures indicate that the bank is out-of-the-money and that the swap is, in that sense, a liability for the bank.

Assume that the transactions were terminated and valued on the day the petition was presented. If the insolvency official appointed to deal with the counterparty's estate were able to cherry pick, the bank would be obliged to pay U.S.\$9 million, representing the value of the transactions which were, in effect, liabilities of the bank and assets of the counterparty. The bank would also have a claim against the insolvent's estate for U.S.\$12 million, representing the value of the transactions which were, in effect, assets of the bank and liabilities of the insolvent. Assuming the bank was only paid 10% of its claim against the estate, it would have paid U.S.\$9 million and received U.S.\$1.2 million.

If close-out netting, on the terms of the ISDA Master Agreement, were enforceable as against the insolvency official, the bank's position would be significantly improved. A single net sum in respect of all the terminated transactions would be calculated equal to U.S.\$3 million (U.S.\$7 million + U.S.\$5 million - U.S.\$6 million - U.S.\$3 million). The bank's claim against the insolvent's estate would therefore be for U.S.\$3 million. Assuming again a 10% pay-out, the bank would receive U.S.\$300,000. The enforceability of close-out netting in the jurisdiction of the bank's counterparty effectively reduces the bank's credit risk from U.S.\$19.8 million (U.S.\$9 million + U.S.\$10.8 million) to U.S.\$2.7 million (U.S.\$3 million - U.S.\$300,000).

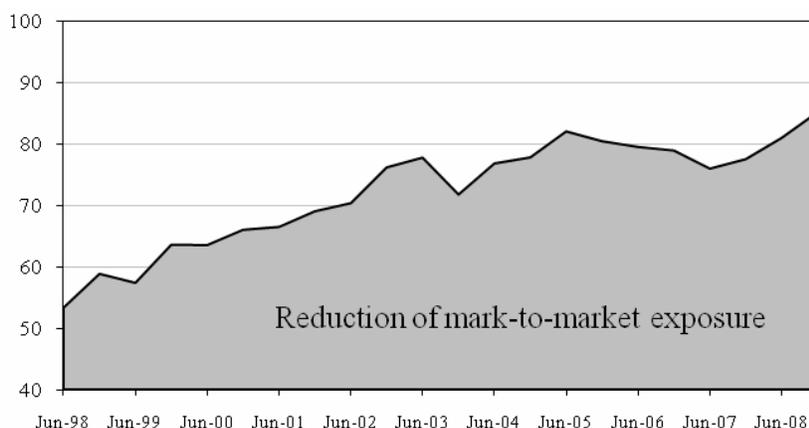
The determination of whether credit exposure is likely to be net or gross on a counterparty has a binary nature, that is, international market participants consider whether the legal position of close-out netting for a specific jurisdiction is favorable or unfavorable. Where there are any legal restrictions on netting, international market participants will consider a jurisdiction as "non-netting" and thus will account for exposures on a gross basis.

**APPENDIX C**

**RISK REDUCTION THROUGH CLOSE-OUT NETTING: EVIDENCE**

- Bank for International Settlements, May 2009
  - As of December 31, 2008, total notional amount of all outstanding OTC derivatives was \$592.0 trillion
  - The total mark-to-market value of outstanding OTC derivatives was \$33.9 trillion (5.7% of notional amount)
  - After applying close-out netting, total credit exposure was \$5.0 trillion (0.8% of notional amount), a reduction of 85.2% from mark-to-market value

**All Banks, 1998-2008**



- U.S. Office of the Comptroller of the Currency, 2<sup>nd</sup> Quarter 2009
  - As of June 30, 2009, close-out netting reduced counterparty credit exposure at U.S. banks by 88.0%
  - 63% of the credit exposure that remained after netting was covered by collateral

**US banks, 1996-2009**

