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Dr Mohd Isa Hussain
Deputy Under Secretary
Ministry of Finance Malaysia
Investment, MOF (Inc.) and Privatisation Division
5th Floor, South Block, Precint 2
Ministry of Finance Complex
Federal Government Administrative Centre
62592 PUTRAJAYA
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Dear Dr Isa,

Danaharta Act and Close-out Netting

1. Thank you very much for hosting and chairing the meeting on 12 August. ISDA and its members are very appreciative of the support of the Ministry of Finance and of all the work that Prokhas Sdn Bhd and Bank Negara Malaysia has done to try to ensure that close-out netting can be recognized by ISDA's members as being enforceable in Malaysia for regulatory capital purposes.

2. As you know, the recognition of the enforceability of close-out netting in Malaysia will bring significant benefits. Exposures can be recognised on a net instead of gross basis which will result in more efficient use of credit lines and lower reserves being required to satisfy regulatory capital requirements. Lower reserves and posting of collateral for net instead of gross exposures will lead to reduced costs. With reduced costs and greater liquidity in the OTC derivatives markets due to the increased volume of trading that can be undertaken, it will give Malaysian counterparties access to a broader spectrum of risk management tools at a better price. According to the Bank for International Settlements Report of May 2008, as of December 2007, the total notional amount of all outstanding OTC derivatives was US\$596 trillion. The total mark-to-market value of these outstanding transactions was US\$14.5 trillion (2.4% of the notional amount). After applying close-out netting, the total mark-to-market credit exposure was reduced to just US\$3.3 trillion (0.5% of the notional amount), a reduction of 77.6%. The extent to which the enforceability of close-out netting can reduce systemic risk is thus obvious.

3. To recapitulate, the concerns raised by the Danaharta Act in relation to the enforceability of close-out netting are as follows:

- (a) Under Section 29A, the appointment of a special administrator by Danaharta over an “affected person” (as defined in Section 21) cannot be treated as giving rise to a right to terminate transactions.
- (b) Under Section 41(1)(d)(iv), upon such appointment, a moratorium of 12 months (which can be extended) comes into force during which “...*no steps may be taken 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.*”

4. To achieve close-out netting enforceability for Malaysian counterparties, the most expedient way forward is to opt for the issuance of a policy statement instead of amending the Danaharta Act. The proposed policy statement takes advantage of the proviso in Section 41(1)(d)(iv), namely: “...*no steps may be taken to ...set off any debt owing ... except with the prior written consent of the Corporation.*”

5. Thus, we had proposed that Danaharta issue a policy statement that would essentially state that, as a policy, Danaharta is providing prior written consent for amounts due under outstanding “Eligible Financial Contracts” documented under an ISDA Master Agreement to be set off. Thus, the policy statement would provide a blanket waiver allowing set off for amounts due under outstanding “Eligible Financial Contracts” documented under an ISDA Master Agreement, as far as the application of Section 41(1)(d)(iv) of the Danaharta Act is concerned. The proposed list of “Eligible Financial Contracts” is attached.

6. Once the policy statement is issued, even if a special administrator is appointed over an affected person (which is a party to the ISDA Master Agreement) the prohibition against set off during the moratorium period provided under Section 41(1)(d)(iv) of the Danaharta Act will not be effective insofar as amounts due under outstanding “Eligible Financial Contracts” documented under the ISDA Master Agreement are concerned. This will allow close-out netting under the ISDA Master Agreement to take place in regard to such “Eligible Financial Contracts”, resulting in the determination of a single net sum being due to or from the affected person. Where the net sum is owed by the affected person, the counterparty’s ranking in respect of that net sum is *pari passu* with any other unsecured creditor of that affected person. Where the net sum is owed to the affected person, that sum will be paid over to the special administrator by the counterparty.

7. ISDA (through informal consultations with its members) believes that this policy statement, once issued, would effectively remove the concern stemming from Section 41(1)(d)(iv) of the Danaharta Act. The concern stemming from Section 29A of the Danaharta Act would still subsist, i.e., that the appointment of a special administrator cannot itself be treated as a trigger for terminating outstanding transactions under the ISDA Master Agreement. However, it is expected that the counterparty to the affected person will quite likely be able to rely on other specified events of default or other termination events (for e.g., failing to make a payment due under an outstanding transaction) to terminate the outstanding transactions. For this reason, the repeal of the Danaharta Act or the amendment of the Danaharta Act to exempt “Eligible Financial Contracts” from its application would provide the most comprehensive

solution. Nevertheless, we recognize that such repeal or amendment would take time and thus support the issue of the policy statement as a “quick fix”.

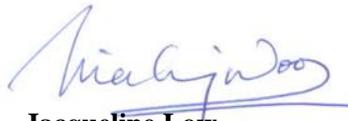
8. We would like to thank the Ministry of Finance, Prokhas Sdn Bhd and Bank Negara Malaysia once again for all the efforts that it has made in regard to this matter. We look forward to receiving confirmation that the policy statement will be issued soon. Please do not hesitate to contact Ms Angela Papesch (APapesch@isda.org) or Ms Jacqueline Low (jlow@isda.org) at +65 6538 3879 if you have any questions or require any further information.

Sincerely yours,

For the International Swaps and Derivatives Association, Inc.



Angela Papesch
Director of Policy and
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Jacqueline Low
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Eligible Financial Contracts

- (a) a currency or interest rate swap;
- (b) a spot, future, forward or other foreign exchange agreement;
- (c) a commodity swap;
- (d) a repurchase agreement;
- (e) a basis swap;
- (f) a cap, collar or floor transaction;
- (g) a forward rate agreement;
- (h) a currency or interest rate future;
- (i) a currency or interest rate option;
- (j) an equity derivative, such as an equity or equity index swap, equity forward, equity option or equity index option;
- (k) a derivative relating to bonds or other debt securities or to a bond or debt security index, such as a total return swap, index swap, forward, option or index option;
- (l) a credit derivative, such as a credit default swap, credit default basket swap, total return swap or credit default option;
- (m) an energy derivative, such as an electricity derivative, oil derivative, coal derivative or gas derivative;
- (n) a weather derivative, such as a weather swap or weather option;
- (o) a bandwidth derivative;
- (p) a freight derivative;
- (q) a carbon emissions derivative;
- (r) an inflation derivative;
- (s) a property derivative;
- (t) a derivative transaction that is compliant with Syariah principles;
- (u) a spot, future, forward or other commodity transaction;
- (v) an agreement to buy, sell, borrow or lend securities, such as a securities repurchase or reverse repurchase agreement, a securities lending agreement or a securities buy/sell-back agreement;
- (w) an agreement to buy, sell, borrow or lend commodities, such as a commodities repurchase or reverse repurchase agreement, a commodities lending agreement or a commodities buy/sell-back agreement;
- (x) an agreement to clear or settle securities transactions or to act as a depository for securities;
- (y) any other agreement, contract or transaction similar to any agreement, contract or transaction referred to paragraphs (a) to (u) and that is of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap or other derivatives markets (including terms and conditions incorporated by reference in such agreement) and that is a forward, swap, future, option or spot transaction with respect to one or more reference items or indices relating to (without limitation) interest rates, currencies, commodities, equity securities or other equity instruments, debt securities or other debt instruments, precious metals, energy products, electricity, weather, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated

- with a financial, commercial or economic consequence, or economic or financial indices or measures of economic or financial risk or value;
- (z) any swap, forward, option, contract for differences or other derivative in respect of, or combination of, one or more agreements or contracts referred to in paragraphs (a) to (y).