### Definition

Close out netting refers to the ability of a party under the ISDA Master Agreement to net the mark-to-market values of all existing transactions upon early termination of all existing transactions under the ISDA Master Agreement. The early termination follows the default of a counterparty or other specified events, including a range of insolvency events prior to an official bankruptcy.

### Benefits of Close-out Netting

<table>
<thead>
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<th>1. Risk Reduction</th>
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<td>a. Reduction of credit risk - enable derivatives participants to protect against adverse market changes following default of a counterparty by reducing credit exposure from gross to net exposure</td>
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<td>b. Consequent reduction of systemic risk – by reducing the 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</td>
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- Excerpt from the UNIDROIT Principles: “The reason is that if, in the event of default, the counterparty market participants were to be required to calculate their claims on a gross basis instead of being creditors for the net amount only, the non-defaulting party might be exposed to levels of credit risk and market risk that are difficult to estimate and manage. The situation would be further exacerbated by the fact that there may be rapid changes in market values for the relevant types of transaction as well as uncertainty as to the risk of repudiation of contracts during the insolvency proceeding, against which the non-defaulting party might not be able to protect itself whilst being unable to terminate the contracts and re-hedge the position on the basis of its termination rights under the close-out netting provision.”

2. Cost Reduction
   a. Ability to maintain lower reserves required to satisfy regulatory capital requirements –
      i. Facilitates the rebalancing process for swap dealers’ portfolio in response to unanticipated market movements by reducing the exposure that needs to be rebalanced
   b. As they are able to calculate exposure on a net basis, counterparties are able to offer additional credit to parties in jurisdictions with adequate netting. Moreover, netting allows for more efficient use of credit lines as derivatives participants consequently have lower capital requirements
   c. The Basel Committee requires a bank to satisfy its national supervisor that the legal basis for netting is clear in order to net exposures for regulatory capital.
      - That includes obtaining “written and reasoned legal opinions” that confirm the enforceability of netting under the relevant agreement.
      Therefore, this has risk management and pricing implications for determining whether or not to transact with counterparties in those “non-netting” jurisdictions.

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<th>Elements of Effective Close-out Netting</th>
<th>Effective netting includes the following:</th>
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<td>1. allows for the termination following all events of default as provided in ISDA Master Agreement, instead of termination rights limited to only those related to entry into resolution or other bankruptcy-related events of default,</td>
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| Issues re. Non-Netting Jurisdictions | The determination of whether credit exposure is likely to be net or gross on a counterparty has a binary nature – international market participants consider whether the legal position of close-out netting for a specific jurisdiction is favorable or unfavorable.

Where there are legal restrictions on netting, international market participants will consider a jurisdiction as “non-netting” and, thus, will account for exposure on a gross basis. |
| New Margin Regulations and Non-Netting Jurisdictions | Individual regulatory authorities across many G-20 countries have started to develop margin rules consistent with the final margin policy framework for non-centrally cleared, bilateral derivatives issued by the BCBS-IOSCO. |

**Risk of transacting with counterparties in Non-Netting jurisdictions:**

- The EU\(^2\) and Japan\(^3\) have established certain exemptions from margin requirements for trades with Non-Netting Counterparties, while Australia and Hong Kong have also proposed exemptions.

- The final margin rules by Prudential Regulators in the United States\(^4\) provide that, if a netting opinion (or other legal advice supporting netting) cannot be obtained, then a regulated entity must treat trades as non-netted. |

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\(^1\) Final margin rules have been issued in the United States, Europe Union, Japan, Switzerland and Canada, while Australia, Hong Kong, Singapore, South Africa and India have issued draft proposals for margin rules for non-centrally cleared derivatives.

\(^2\) Under the EU margin rules, regulated entities are exempted from posting margin to Non-Netting Counterparties and are also exempted from collecting margin from them if certain additional requirements are met, including a ratio under 2.5% for trades with Non-Netting Counterparties when compared to the total notional amount of the entity’s OTC derivatives portfolio.

\(^3\) Under the Japanese margin rules, trades with Non-Netting Counterparties who conduct OTC derivative transactions in the course of trade are fully exempted from margin requirements.

\(^4\) The CFTC has not yet adopted rules dealing with Non-Netting jurisdictions but they will likely address the issue in their final cross-border rules.
on a gross basis for the purposes of calculating the margin it collects and may net those trades for purposes of calculating the margin it posts. These rules do not include an exemption for trades with Non-Netting Counterparties, which has resulted in interpretative questions regarding the calculation mechanics for meeting the requirement to “collect gross” and “post net” when facing Non-Netting Counterparties.

- Liquidity costs - entities subject to margin rules that are required to post margin face the risk that posted margin may not be returned in the event of the Non-Netting Counterparty's default "if insolvency laws provide administrators with the power to reject or affirm certain derivative contracts in a manner advantageous to the insolvent counterparty".

- Operational burdens – due to the complications of trying to figure out this requirement, these entities may decide not to do business, or reduce considerably the trading, with Non-Netting Counterparties.

- Given liquidity costs and counterparty risk considerations, ISDA has argued that entities with US Prudential Regulators margin rules’ requirements that face counterparties in Non-Netting jurisdictions should not be required to post or collect margin to or from that counterparty, at least subject to a 5% limit on the total amount of swaps with Non-Netting Counterparties, measured by notional swap amounts.

Economic impact to Non-Netting Jurisdictions:

Economic and practical issues with imposing a margin requirement when facing Non-Netting Counterparties are likely to result in a dramatic reduction of trading activity by entities subject to margin rules in Non-Netting Jurisdictions until such jurisdictions are able to put legislation supporting the enforceability of netting in place.

| Netting Legislation at National Level | Worldwide around 50 jurisdictions have enacted specific netting legislation (http://www.isda.org/docproj/stat_of_net_leg.html). In some jurisdictions, close-out netting is enforceable pursuant to general principles of law. Netting legislation is currently pending a number of jurisdictions across the globe. Jurisdictions in Latin America with effective close-out netting legislation in place: |

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5 80 FR 74903. Sec. _5(a)(4).  
7 Similarly, while the ratio in the EU Rules has been proposed as 2.5%, there is ongoing advocacy to raise it to 5% on the basis that a 2.5% threshold is not sufficient to allow EU counterparties to continue executing OTC derivative contracts with Non-Netting Counterparties. 

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Current ISDA work in other LatAm jurisdictions includes Argentina and Chile.