| Industry Comments | CBB Initiative |
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| **A bank noted that** while Close-Out Netting may be beneficial to market participants, it can also be seen as contrary to the general and established principles of insolvency law. As such, the CBB will need to balance the enforceability of Close-Out Netting with national policy and regulatory considerations. | Noted. |
| **A bank noted that** in Bahrain the payment system comprises of separate and distinct systems for transferring funds between payers and payees, between banks, and between banks and other financial institutions. As such there will need to be harmonization between the legislation and regulation that define high value payment systems (RTGS), and Close-Out Netting.<br><br>In the present framework of banking and insolvency law, some uncertainties attach to the effectiveness of the RTGS arrangements. These uncertainties focus on the application of the "Zero Hour Rule" to RTGS arrangements. | Noted. |
| **A bank noted that** when a court-ordered liquidation commences, any payments or transfers of property made by the company thereafter are void, subject to certain exceptions such as payments made by the liquidator. It has been suggested that a court-ordered liquidation may be taken to have commenced at the beginning of the day on which the order was made ("the Zero Hour Rule"). Accordingly, any payments made by a bank between midnight and the time the order was made could be void, including RTGS payments and payments made to settle multi-lateral net positions. Similar rules can also apply where a company enters a voluntary administration. Such an outcome could undermine the irrevocability of those payments and create liquidity problems in the payment system. | Noted. |
| **A bank noted that** the CBB will need to address and clarify these many issues in the banking and payment regulations, and align the judicial and insolvency law and case precedence.<br><br>Without in any way reducing the substance of this initiative, the current consultation paper represents only the liquidation component of a larger suite of issues. It is our suggestion that given the scope and scale of the considerations, an integrated and coordinated solution is necessary. We recommend the CBB first to hold an industry briefing, followed up with the formation of a collaborative working group. This working group in turn will need to be supported by international bodies, including but not limited to ISDA. | Disagree.<br><br>The CBB is introducing rules on closed-out netting only, not re-writing insolvency and liquidation laws. |

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| **A bank noted the following with regard to "Multi-Branch Netting":**<br><br>**The bank** understands that as part of the Regulation, Multibranch Netting will also be enforceable between a Bahrain counterparty and a Branch or Agency of a Foreign Party. | Noted. |
| **A bank noted the following:**<br>"collateral"(iv) The general reference to assets commonly used as collateral in the Kingdom of Bahrain may introduce uncertainty. We suggest that all common forms of collateral are included in the regulation, i.e. the regulation should read collateral such as (but not limited to) cash, standby letters of credit, securities, etc.<br><br>"collateral arrangement"(iii) We propose replacing " by or to" with "issued by or issued to". | Disagree. A generic term is better.<br><br>Disagree. Collateral can be original / transferred (doesn't necessarily originate with the issuer). |
| **A bank noted the following:**<br>With respect to netting:<br><br>1. We think this hits the right points and we like the clarification that a Qualified Financial Contract is not deemed to be gambling or a wager.<br><br>2. Netting and its impact on other legislation (set-off for banks, insolvency, preferred counterparties) to be fully considered.<br><br>3. Title transfer should be expressly protected from recharacterisation as a security interest.<br><br>4. Clarity as to what rehypothecation rights exist and the enforceability of the obligation to redeliver only equivalent collateral under title transfer collateral arrangements. | 1. Noted.<br><br>2. Noted.<br><br>3. Disagree. Title transfer is not sufficient in itself to rule out being secured interest.<br><br>4. Disagree. "rehypothecation" is obvious and not sure what needs classifying in respect of "redelivery". |
| **A bank noted the following:** | |

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| With respect to security and insolvency more generally, and thus the ability of banks to receive from a competent external law firm a legal opinion suitable for the purpose of being able to apply the benefits of netting from a regulatory capital point of view, it may be worth considering the following:<br><br>1. Self-help remedies in respect of secured property should be clear and straightforward to execute both pre- and post-insolvency. Administrative processes that introduce either delay or some potential element of discretion by the concerned administrative office, or provide an opportunity for the creditor to attempt to disturb the enforcement process, should be avoided. The would mean, for example, ensuring that default and disposal of collateral provisions will need to be clear as to priority as against any other Bahraini law provision (set-off for example) and the perfection filings proposed should then protect the filer against an non-declared security interest (save perhaps for custodial liens and the like).<br><br>2. Situs and enforcement due consideration to be given to enabling the security interest created in collateral to be enforced against movable property, requiring a analysis of whether floating charges will work in Bahrain and against what types of assets.<br><br>3. The Bahraini enforcement process: a process where the enabling legislation should provide a simple way to ensure Bahrain courts and to the degree possible, other GCC courts will recognize the security and or judgments. This may provide an opportunity for competitive advantage, if treaties exist or can be put in place to ensure reciprocal enforcement of judgments in GCC courts.<br><br>4. Warehouse receipts and documents of control: it would be useful to ensure that language is added dealing with the nature of the interest (title or constructive title) and the rights of the quasi-title holder where dealing with security over movable assets held in warehouses or via other mechanism where taking possessory title is difficult or impractical. In particular we are thinking of trade finance transaction here. Also worth considering is the question of commingled goods and the allocation thereof.<br><br>5. Clarity around the applicability of legal notions related to corporate benefit, financial assistance, look-back periods and voidable transactions (ideally short periods rather than long periods would apply).<br><br>6. Governing law: clarity as against Shari'a law or language to confirm that Shari'a is respected by | 1. Agree, but cannot re-write the real security law of Bahrain.<br><br>2. Disagree; this is a product of real security law.<br><br>3. Disagree; this is a product of judicial enforcement and reciprocality.<br><br>4. Disagree, these real security concepts would complicate and already complicated subject.<br><br>5. Disagree. This is a corporate validity<br><br>6. A Sharia approval could be considered. |

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| the legislation thus defeating attempt to challenge the legislation and security under it on such basis.<br><br>7. Confirmation of any creditors preferred at law or insolvency.<br><br>8. Ideally, no stamp or documentation taxes would be contemplated.<br><br>9. Arabic language to not be required (although parties are free to transact in Arabic if they so wish) as a formality to perfect or ensure validity of the arrangements.<br><br>10. Future assets, such as balances in current accounts, to be considered to allow good security to be taken over such assets.<br><br>11. Interest: clarity as to whether default interest can be charged and if it can be collected.<br><br>12. Consideration and clarity as to whether parallel debt obligations are enforceable and supported.<br><br>13. Ideally security agents should not have to be locally registered or licensed counterparties.<br><br>14. Third-party enforcement of security by way of rights acquired via assignment etc. to be catered for. Clear and efficient auction process to be considered for efficient sale or real property and other assets. | 7. Disagree; this is a product of insolvency law.<br><br>8. Noted.<br><br>9. Not necessary.<br><br>10. Disagree; this is not about real security law.<br><br>11. Disagree; this is a product of trading/ prohibition of riba.<br><br>12 - 14. Noted. |
| **A bank noted the following:**<br><br>Matters of capacity, authority, compliance with local regulatory rules and the effect of any defects in these areas on the contract and a party's ability to enforce it (for example, ideally the contract will not be void and unenforceable as a result, at least with respect to a good faith counterparty). Also worth considering if third parties can enforce under the contract and to what degree. | Noted. |
| **A bank noted the following:**<br>1- Definition of "Qualified financial contracts": we should highlight the large scope of the contracts governed and we assume that CBB has already studied the suitability of such large definition to the financial markets in the Kingdom of Bahrain. | 1. Noted. |

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| 2- Definition of "persons": we believe that this definition should include the Central Bank of Bahrain and the Public authorities. Financial institutions enter into qualified financial contracts and netting agreements as defined by the Proposed Regulation with these entities for the purposes of hedging their exposure.<br><br>3- Enforceability of a Netting Agreement: Close-out Netting will be a deviation from the current applicable bankruptcy laws (as clearly drafted in Article 2.1 (a)). The Close-out netting allows the non-defaulting party to immediately collect payment from a defaulted counterparty even in the event of a bankruptcy. These provisions make derivative counterparties senior to almost all other claimants in bankruptcy. As this is a special treatment, a law should enact the Close-out Netting provisions. We assume that CBB has already taken all steps required to check the constitutionality of the Proposed Regulation as per the deviation from the current bankruptcy laws in the Kingdom of Bahrain.<br><br>4- Prior qualified financial contracts: Article 4 of the Proposed Regulation does not treat the question related to the applicability of the Proposed Regulation to prior qualified financial contracts and netting agreements already executed. | 2. Noted.<br><br>3. Disagree.<br><br>CBB did not take this step, but Article 108 says 'notwithstanding any other law".<br><br>4. Legislation does not have retrospective effect. |
| **A bank noted** that the Legal enforceability (Article 2) of close-out netting and financial collateral arrangements is crucial for any cross-border derivatives transaction in over-the-counter (OTC) derivatives. We would like CBB to take this point into consideration during the enforcement of Close Out Netting. | Noted. |
| **A bank noted that** Close out netting works best in jurisdictions where there is legal and regulatory harmonization. The CBB's proposed regulation states that 'the provisions of a netting agreement which provide for the determination of a net balance of the close out values, market values, liquidation values or replacement values calculated in respect of accelerated and/or terminated payment or delivery obligations or entitlements under one or more qualified financial contracts entered into, will not be affected by any applicable insolvency laws limiting the exercise of rights to set off, offset or net out obligations, payment amounts or termination values owed between an insolvent party and another party.<br><br>For good order's sake, it is appropriate that any regulation proposed by CBB with respect to close out netting under a market contract, be endorsed by the legal framework. In the case of Bahrain, this is | Noted.<br><br>Disagree; but we could have a law. |

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| Legislative Decree No. 11 of 1987, promulgating the Bankruptcy and Composition Law. As it stands today, this Law does not recognize close out netting as a means of terminating a contract, due to default/bankruptcy. **The bank** hence feels that it is prudent to enact specific netting legislation in order to achieve the statutory recognition of the netting process. | |
| **A bank noted that:**<br>The proposed consultation paper states that 'any powers of the liquidator to assume or repudiate individual contracts or transactions, will not prevent the termination, liquidation and/or acceleration of all payment or delivery contracts entered into, under or in connection with a netting agreement, and will apply, if at all, only to the net amount due in respect of all such qualified financial contracts in accordance with the terms of such netting agreement.' Unless there is the appropriate legal framework in place, there is the risk that entities in Bahrain can approach the local courts to place 'stay orders' on the ability of creditors to pursue their claims against a debtor that files for bankruptcy and to apply collateral posted by the debtor. There is also the risk of bankruptcy administrators engaging in 'cherry picking' i.e. demanding performance of contracts favorable to the defaulting entity, but rejecting contracts onerous to the defaulting firm. The risk of cherry picking can be desisted if local legislation affirms the enforceability of the single agreement structure, in which all transactions under a master agreement with the counterparty, are treated as one contract. | Disagree. |
| **A bank noted that:**<br>The CBB should also consider the case, where the assets and liabilities of the defaulted counterparty, are taken over by another institution. If a transfer does not occur during a specified period, market participants in Bahrain should have the ability immediately to terminate their contracts with the insolvent institution. Secondly, if the institution that assumes the liabilities itself becomes insolvent or otherwise defaults at a later date, termination and close out netting rights should be available to counterparties vis a vis the new institution. | Disagree. |
| **A bank noted that:**<br>Another issue which we feel should be considered, is the harmonization of payment systems and close out netting. Clarity is required in cases where there are unsettled payments or 'in progress' settlement transactions impacting counterparties of a market contract, when an intermediary market participant (e.g. a correspondent bank) in an approved payments system (SWIFT, RTGS) goes into external administration. All payments/transfers/settlements should have the same effect it would have had, if the defaulting participant had gone into external administration on the next day. | Disagree.<br><br>Agree. |

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| **A bank noted the following:**<br><br>"netting agreement"(ii) From a commercial perspective, we would suggest not using the definition "master-master netting agreement", perhaps "umbrella master netting agreement" would be better (if not itself perfect).<br><br>"qualified financial contracts"(v) It would be useful to including "a collateral arrangement".<br><br>"qualified financial contracts"(z) Replace "Bank" with the "CBB".<br><br>"title transfer collateral arrangement" This definition includes security arrangements as a title transfer arrangement. This is odd because title transfer arrangements usually provide for an outright transfer of title to the collateral taker by the collateral provider and at the same time the creation of a contractual obligation of the collateral taker to return the collateral when the underlying exposure is extinguished (with a related 'right' for the collateral provider). Security arrangements may not necessarily require a physical transfer and not involve a transfer of title, but rather the creation of a security interest (which is less than the full title). It would be better for an outright transfer of title as opposed to a security arrangement.<br><br>Also, what is an irregular pledge?<br><br>Article 2 Can the CBB remove a qualified financial contract from the list? If so, this would create uncertainty if there was not sufficient clarity regarding how and when the CBB can do so. A clarification will be useful is if this is purely to add financial contracts, or to add/remove. | Noted.<br><br>Noted. This will be corrected. |
| **A bank requested** the CBB to confirm that "bond future options" and "interest rate swaptions" will also be regarded as qualified financial contracts. | Noted. |
| **A bank noted:**<br>➢ Relationship with other legislation<br><br>As the letter notes, the draft regulation is based predominantly on a template developed by ISDA. That template is the Model Netting Act 2006, which the draft Regulation tracks almost verbatim. | |

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| ISDA's accompanying memorandum on the implementation of netting legislation based on the Model stresses that careful consideration be given to identifying in detail the relevant areas of local law which could potentially conflict with the effectiveness of netting agreements, so that all relevant issues are adequately covered by local legislation. These would typically fall in one or more of the following categories:<br><br>• insolvency laws (including provisions of local law enacted for the prevention of insolvency), which most frequently are the primary obstacle;<br>• any specific mandatory provisions enacted for the protection of debtors generally (i.e., in addition to insolvency law) or for the protection of certain categories of debtors;<br>• gaming laws; and<br>• general principles of contract law.<br><br>Hopefully such issues were indeed considered by the authors of the draft Regulation, but for avoidance of doubt it might be advisable to add a provision to the effect that if there is any conflict between the draft Regulation and any other existing Bahrain law, the draft Regulation prevails.<br><br>Ironically, there may in fact be a conflict between the draft Regulation and Art. 108 of the CBB Law that gave rise to it (particularly 108(c)). | As Article 108 of the CBB Law says regulation takes effect "notwithstanding any other law". |
| **A bank noted:**<br><br>➢ Scope of application<br>The heading refers to close-out netting under a market contract, suggesting the Regulation only applies to such contracts. There are potentially 2 difficulties with this:<br><br>• The expression 'market contract' is defined in the CBB Law as "A contract concluded in accordance with the regulations of the Central Bank and Paragraph (a) of Clause (108) of this law". It's not at all clear what this means.<br>The draft Regulation deals with the netting of "qualified financial contracts" (as defined). This appears to be a much wider class of contracts than the market contracts that may be contemplated by Art. 108 of the | "Market contracts" means "qualified financial |

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| CBB Law. | contracts". |
| **A bank noted:**<br>➢ Drafting style<br>There are a few residual references to 'section' that should have been changed to 'Article'. References to 'subsection' are OK. | Noted |
| **A bank noted that** the Regulations has confined their application to cases under the applicable laws in Bahrain. As the current experience of the banking industry revealed banks can rely on jurisdictions other than the Kingdom of Bahrain, it is submitted that the Regulations shall apply in cases of insolvency under any laws not only under Bahrain. | No, The CBB only have jurisdiction over Bahrain. |
| **A bank noted that** the purpose of these Regulations seems to be recognition of netting agreements between banks. It is submitted that the Central Bank shall encourage the adoption of Netting-out Agreements between banks by requiring to have in place such agreements. | No, the CBB does not intervene in private contracts between banks and their counterparties. |
| **A bank noted that** Article 2 of the proposed Regulations confines the application of the Regulations to cases of insolvent party. Netting Agreements can cover wide range of events of default including the failure to pay, or failure to perform or comply with other financial obligations or insolvency in the country of the principal office etc. It would be advisable if the Regulations are extended to cover wide instances of default. | No, it's the responsibility of institutions to protect themselves upon *solvent* default. |
| **A bank noted that** their business does not involve market contracts. Hence, the close-out netting is not applicable to their bank. | Noted |
| **A bank noted the following:**<br>1- The Paper should start with a permeable explaining the scope of the document and its purpose (we actually had to read the Paper several times to understand its scope).<br>2- Section 3 of the Paper is very ambiguous leaving grounds for misunderstanding and disputes from a legal point of view. This section needs to be revamped. | Disagree<br>Disagree |
| **A bank noted the following:**<br>1.1 "liquidator": 'deals with' should be 'administers'. | The CBB is aware. |

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| 1.1 "qualified financial contract": In item (z) of the definition, 'Bank' should be 'CBB'.<br><br>2.1 This should be subsection 4 of Article 1.<br><br>In (g), after 'liquidator', insert 'or otherwise' (as such an order might emanate from a body that is not a court or a liquidator).<br><br>3 3 Renumber as 2.<br><br>Part II Also, the heading "Part II : Multibranch Netting" should be deleted, as there is no Part I. | Agree, will be corrected.<br><br>Noted, all numberings will be corrected.<br><br>Disagree<br><br>Noted, all numberings will be corrected.<br><br>Noted, all numberings will be corrected. |
| **A bank noted that** the netting arrangement will be useful only when:<br>a. An insolvency occurs (provided the insolvent party is established in the Kingdom of Bahrain);<br>b. The non-insolvent party holds a credit position towards the insolvent party; and<br>c. The existing financial contract provides for netting arrangements.<br><br>The Islamic banking community is not expected to benefit much from the Proposed Law as the overwhelming majority of the Islamic financial institutions do not encourage active participation in derivative markets. This is likely to be one of the reasons why the Tahawwut (Hedging) Master Agreement which was jointly launched by ISDA and IIFM in March 2010 after years of discussions and consultations is not actively practiced in the derivate markets.<br>The Islamic financial institutions are mostly involved in asset backed financing and therefore, in the event of default, the usual collateral enforcement process will be practiced. | Noted. |
| **A bank noted the following:**<br><br>1. **Insolvent Party**:- An insolvent party is defined as a party in relation to which an insolvency proceeding under the laws of the Kingdom of Bahrain has been instituted. What will be the | It will entirely depend on the context. |

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| implication of vexatious or frivolous proceedings? | |
| 2. In addition, does the term "insolvency proceeding" cover a voluntary winding up or composition with creditors? | Disagree |
| 3. **Existing Agreements**:- The prevailing agreements between the parties may not have any provision relating to netting arrangements. Will CBB enforce amendment to existing agreements or issuance of an addendum in this respect? | Disagree- this will not be endorsed. |
| 4. **Definition of netting (iv)**:- The term "estimated" should be included after the word "calculated". | Disagree- In Paragraph (iv) it is only "calculated" because it is a "net balance" (i.e. a precise calculation has taken place and no "estimation" is involved. |
| 5. **Enforceability of a Qualified Financial Contract:-** The Proposed Law states that contracts pertaining to games, gaming, gambling, wagering, lotteries and related activities shall not be deemed void or unenforceable by reasons of any laws. This clause needs to be further clarified as it may cause a potential Sharia issue in the court of law. | This issue will never occur for Islamic institutions because all their activities will be Shari'a compliant to begin with. |
| **A bank noted the following:**<br>1. Close-Out Netting as indicated has huge impacts on capitalization requirements and under the current environment this might be helpful for banks. | Noted |
| 2. However, this could result in the complete opposite impact as well, which could be that a trend starts under which banks do not place money market funds with each other or refuse to reciprocate without the Close-Out Netting Agreement which might affect illiquid banks. | Noted |

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| 3. The other issue that I would like to highlight that this concept is based on draft regulation developed by ISDA and this might be much more easy for conventional banks to adopt to rather than Islamic Banks and Financial institutions due to Sharia standardization. | Admittedly, it's more relevant for conventional banks, but it is not a hardship on Islamic institutions. |
| 4. The consultation paper itself seems to be catering towards conventional instruments and qualified financial contracts. | Please refer to the previous response. |
| 5. The objectives of this regulation seem to be driven by Bankruptcy and Liquidation procedures i.e. how to mitigate the related risks which were previously covered under the "Right of Sett-Off". However, due to insolvency proceedings the implementation of Right of Sett-Off is limited compared to Close-Out Netting. (Right of Sett-Off and Close-Out Netting are similar in nature where the assets and liabilities of two counterparties can be settled against each other as agreed from the outset of any transaction. However, it is our understanding from the consultation paper that Close-Out Netting can be enforced in a default scenario and furthermore is not subject to the counterparty filing for bankruptcy and entering liquidation procedures; where as a Right of Sett-off can be enforced in default scenario however challenged in the event of a bankruptcy and liquidation proceedings. Of course this is subject to the actual legal documentation with respect to the underlying agreements entered into by the parties.) | Noted. |
| 6. It will probably help promote a less risky environment in terms of counterparty credit and reduced legal enforcement related costs. | Noted |
| 7. Legal enforcement will however be a key issue. Since this could relate to cross-border and multi-jurisdictions unless the CBB is looking to promote this locally only and later with the wider GCC central banks. | Noted |
| 8. As previously, the ISDA and the IIFM have jointly worked on the Master Hedging Agreement we should recommend that the same process is followed to achieved a standardized form for the Close-Out Netting Agreements. | Noted |

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| 9. The topic is extremely relevant to Islamic banks since the asset based/backed structured and secured financing structures since Close-Out Netting could cover security and collateral on financing arrangements. | Noted |
| **ISDA noted that** Several ISDA members had a look at the draft as well. One member bank came back to me asking about the reasons behind the draft wording **in** the provision in respect of stays/moratorium etc is slightly narrower than the ISDA template and excludes reference to administrative agencies. I don't know the reason for this. It may just be that there are no such relevant administrative agencies, but if it is intended to preserve certain rights of a particular authority/agency, it would be good to understand what these are. I have copied the relevant provision below.<br><br>*"(g) Preemption. No stay, injunction, avoidance, moratorium, or similar proceeding or order, whether issued or granted by a court, administrative agency, or liquidator or otherwise, shall limit or delay application of otherwise enforceable netting agreements in accordance with subsections (a), (b) and (c) of [this section of this Act]."* | The CBB is aware. |