

The Brief

October 2006

The Derivatives Group

Capital treatment of credit derivatives

New Rules issued by the French Banking Commission

Is attached an English translation, for information purposes, of the letter sent earlier last week by the French Banking Commission ("FBC") to the International Swaps and Derivatives Association® ("ISDA").

The letter confirms that, with immediate effect, credit protections bought by banks through OTC credit derivatives treated in the banking book will no longer need to be documented in a ring-fenced and tailored master-agreement, to permit a capital relief, as previously required by FBC in Annex 15 to its publication "Methods for calculating international capital adequacy ratio".

That issue was early identified by several regulators in Europe as one area of industry concerns. Annex 15 indeed used to deny any capital relief to the buyer of credit protection if the relevant Transaction was not (i) documented separately from the rest of the transactions portfolio with the seller and (ii) adapted to reflect the terms of a guarantee by notably deleting most Events of Default and Termination Events.

This important and timely change, which comes after more than 2 years of dialogue and discussions between ISDA London Office, assisted by our team in Paris, and the FBC means that:

- (i) there is no longer restriction on netting credit derivatives;
- (ii) firms will, under usual conditions, be able to treat contractual netting as risk-reducing; and
- (iii) inclusion of credit derivatives transactions within netting master-agreements will not render the protection ineligible for the purpose of relief from regulatory capital.

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Although the new version of Annex 15 has not yet been circulated by FBC, it is believed that the previous "guarantee" approach being abandoned for a pure "netting" one, most of the documentation conditions set forth thereto will go. Questions however remains about certain of them, *e.g.* the mandatory appointment of an independent third party Calculation Agent.

Members of the Derivatives Group remain at your entire disposal to further discuss the above.

Best regards.

Yours sincerely,

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Annex

French Banking Commission's new position on capital treatment of credit derivatives under close-out netting master-agreements

(Unofficial English Translation - For Information Purposes Only)

THE GENERAL SECRETARY OF
THE FRENCH BANKING COMMISSION

Mrs Emmanuelle SEBTON
Mr Richard METCALFE
International Swaps and Derivatives Association
One New Change
LONDON EC4M9QQ
UNITED KINGDOM

Paris, 21 September 2006

Dear Madam, Dear Sir,

Following your letter dated 17th February, 2006 and the various exchanges that have followed with the services of the General Secretary of the *Commission bancaire*, in particular during the meeting of 14th September, 2006, I confirm you that the prudential effect of a credit protection provided by a credit derivative booked in a banking portfolio will not be subordinated anymore to the existence of a specific contract or to a segregation within a standard Master Agreement, as was formerly the case pursuant to Appendix XV of the Methods for calculating international capital adequacy ratios.

This new provision, with immediate effect, mainly aims at taking into account the effectiveness of financial transactions netting under French law and the evolution of the European legal environment following the implementation of the Collateral Directive 2002/47. In addition, it meets the will of minimizing the incurred losses by the non-defaulting party to a credit derivative contract. Finally, it proves our concern not to make French banks bearing the difficulties and risks linked with the signature of two master agreements with a same counterparty.

Yours sincerely,

Danièle Nouy

The present memorandum is a summary of certain legal reforms introduced or to be introduced in France. It is circulated for information purposes only and should not be used as the basis for any business or investment decision without specific legal assistance.

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