Romania

Advisory Services for the Establishment of a Framework for the Use of Derivatives and the Execution of Swap Transactions in Romania (P156803)

Output No. 1b
Guidelines on Internal Procedures for the Negotiation of ISDA Master Agreements and related Confirmations

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Disclaimer

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Preface

As Romania's Ministry of Public Finance (MoPF) continues to modernize its debt management process, one of its objectives is to actively explore funding opportunities in different markets and currencies to diversify the investor base, issue long-term tenors and take advantage of arbitrage opportunities to reduce funding costs. However, pursuing this objective may entail raising its debt portfolio's exposure to currencies and interest rates beyond what is acceptable by its debt management strategy. Accordingly, the MoPF has decided to use derivative products for risk management (hedging) purposes to delink the funding activity from the foreign currency and interest rate exposure of the debt portfolio.

The need for the use of derivative products is reflected in the exposure to USD as the country tapped the USD segment of the international markets in recent years. By using cross currency swaps, for example, the government would be able to tap investor demand for USD in foreign markets and at maturities of up to 20/30 years, while maintaining the foreign currency exposure in EUR. This is particularly important given that Romania is a highly euroized country.

Based on experiences from other sovereigns, a sound derivatives framework should be put in place before undertaking derivatives transactions, within which all relevant aspects of the planned derivatives operations should be tackled in detail. This is also recommended by the IMF-World Bank Revised Guidelines for Public Debt Management (issued on April 1, 2014, based on the Guidelines for Public Debt Management, adopted in 2001 and amended in 2003; http://treasury.worldbank.org/bdm/htm/guidelines_publicdebt.html). A sound derivatives framework should allow the use of derivatives for risk management (hedging) purposes only and may limit the use of derivatives to hedging the currency and/or interest rate risk associated with managing the public debt.

While it is important to have good execution practices in place, it is also very important to have risk management policies and procedures that clearly define the rationale for entering into the derivative transactions.

In response to a request from the MoPF, the World Bank is providing advisory services and the necessary training to MoPF staff to assist the ministry in developing the legal and operational framework (policies, procedures, norms) to use derivatives, such as interest rate and cross currency swaps, solely for risk management (hedging) purposes. This will facilitate the implementation by the MoPF of the debt management strategy, allowing for the diversification of funding sources while maintaining the portfolio exposure risk at the levels set in the approved strategy.

To enable the MoPF to achieve the above objective, the advisory services program was designed to include three broad outputs: 1. Legal; 2. Pre-Trade Processes and Execution; and 3. Post-Trade Processes.

In addition, the following six components, which fall under the above three outputs, have been identified as key areas of the advisory services program provided by the World Bank: Legal; Pricing and Valuation; Risk Management; Execution; Post-Trade Processes; and Training.

Objective and Deliverables of Legal Output 1b. The main objective of the advisory program's Legal Output 1b is to provide guidelines to the MoPF on Internal Procedures for the Negotiation of ISDA Master Agreements and related Confirmations, in the context of executing derivatives transactions.

Deliverables under Output 1b include (i) a three-and-a-half-day technical workshop (one of two workshops under the Legal Outpout) in Bucharest for MoPF staff and other relevant stakeholders; and (ii) this report with guidelines on internal procedures for the negotiation of ISDA agreements and related confirmations.

In conjunction with Output 1b, Dr. Zsolt Szita, international expert counselling Hungary's Government Debt Management Agency Private Company Limited by Shares[1], authored this report with Guidelines on Internal Procedures for the Negotiation of ISDA Master Agreements and related Confirmations. In addition, a World Bank team comprised of Bart Servaes (Lead Counsel), Gaukhar Kaliaskarova (Senior Counsel), and John Balafoutis (Lead Financial Officer) delivered a three-and-a half day technical training workshop in Bucharest Oct. 17-20, 2016. John Balafoutis, as Project Task Team Leader, also coordinated delivery of the Legal Output with support from the rest of the advisory services team.

The World Bank team wishes to thank the Romanian authorities for their kind hospitality and logistical support for the mission to Bucharest under this component, as well as participants' active engagement in the technical workshop and meetings. They express their special gratitude to the Ministry of Public Finance Director General, Stefan Nanu, and his team.

[1] The Hungarian debt management entity, the Government Debt Management Agency Private Company Limited by Shares (abbreviated name in English: GDMA Pte. Ltd.; *in Hungarian*: Államadósság Kezelő Központ Zártkörűen Működő Részvénytársaság; abbreviated name in Hungarian: ÁKK Zrt.)

Summary

Romania intends to use derivatives – cross currency and interest rate swaps - to hedge the risks associated with its funding activities in foreign currencies, mainly US dollars. The difference in market access is the key motivation for Romania to issue in US dollars. The debt management strategy of Romania forms the context for entering in derivatives transactions. Transforming the US dollar exposure into EUR would be in line with the strategic targets imposed by Romania's debt management strategy.

Interest rate and cross currency swaps can be traded in the over-the-counter markets with swap counterparties (i.e. dealers, brokers, market makers). MoPF can hedge their exchange rate or interest rate risk by entering into a swap transaction. In a fixed coupon USD bond, MoPF pays fixed coupons on the USD notional. Through swaps, MoPF can convert the USD fixed liability to either a USD floating liability or a EUR fixed liability. The market for USD and EUR swaps is well developed and customizable to suit the exact cashflow needs of the MoPF.

Executing derivatives transactions requires establishing a suitable organizational structure and taking actions so that legal framework and legal documents, procedures, risk management guidelines, credit approvals, IT infrastructure, segregation of responsibilities and other processes are in place to ensure a smooth flow of the trade from front office to middle office to back office.

This document provides a set of guidelines on internal procedures for the negotiation of ISDA Master Agreements and related Confirmations. It is complemented by a separate document (Legal Output 1a) which provides guidelines on the development of a general legal framework for using derivatives. It also provides guidance on internal regulations and procedures related to entering into derivatives transactions.

Guidelines on internal procedures for the negotiation of ISDA Master Agreements and related Confirmations. Such guidelines will facilitate the steps that need to be taken prior to undertaking derivatives transactions. These should include initial template documentation to be provided by the MoPF; setting up of a group of eligible counterparties for the various derivatives instruments to be concluded; and seeking external legal advice, at least for the initial documentation.

Special attention should be given from the perspective of the sovereign (Romania) to the most commonly negotiated clauses of the Schedule to the ISDA Master Agreement, such as Termination Events, Waiver of Immunity, Portfolio Reconciliation and Dispute Resolution.

Internal regulations. Internal regulations should allow for flexibility, and they should cover such topics as Operational Rules of Procedure and Risk Management Rules of Procedure. The former may include rules on the negotiation process; conclusion of transactions; and monitoring of collateral. The latter may include rules on the selection and monitoring of counterparties; and setting of counterparty credit limits.

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Glossary / Acronyms

“**CSA**” – Credit Support Annex

“**Draft Order**” – the draft of the order for the approval of methodological norms regarding the use of derivatives in the public government debt-related risk management operations, which is a ***proposed*** piece of legislation

“**GDTPD**” – General Directorate of Treasury and Public Debt in Romania’s Ministry of Public Finance

“**ISDA**” - International Swaps and Derivatives Association, Inc.

“**MoPF**” - Romania’s Ministry of Public Finance

“Revised Guidelines” – the IMF-World Bank Revised Guidelines for Public Debt Management issued on April 1, 2014 (based on the Guidelines for Public Debt Management, adopted in 2001 and amended in 2003)

I. Deliverable 1b - Guidelines on MoPF internal procedures for the negotiation of ISDA Master Agreements and related Confirmations

These guidelines do not represent, and shall not be interpreted as, provision of legal advice or a recommendation as to any particular matter covered herein even though they touch on certain legal agreements and regulations. The World Bank Group is not acting as legal counsel to the Ministry of Public Finance of Romania. As to any specific legal matter or agreement to which the Ministry of Public Finance may be a party, it is encouraged to seek advice of its own legal counsel.

These guidelines are intended to facilitate the steps that need to be taken prior to undertaking derivatives transactions. They should include initial template documentation to be provided by the MoPF; setting up of a group of eligible counterparties for the various derivatives instruments to be concluded; and seeking external legal advice, at least for the initial documentation.

Special attention should be given from the perspective of the sovereign (Romania) to the most commonly negotiated clauses of the Schedule to the ISDA Master Agreement, such as Termination Events, Waiver of Immunity, Portfolio Reconciliation and Dispute Resolution.

Unless defined in this document, the meaning of the terms used in these guidelines is as set in Section 14 of the ISDA Master Agreement.

1.1. Guidelines on the negotiation process of ISDA Master Agreements and CSAs

1.1.1. Initial documentation to be provided by the MoPF

19. In order to decrease the burdens and risks related to monitoring of different legal documentations and wide range of complex terms and conditions, it is advisable to prepare a template (model) documentation which will serve as basis and starting point for all potential counterparties in the derivatives operations. Accepting this method for the negotiations may ensure that the negotiation process is driven by the MoPF, and sovereign-specific clauses are transparent from the start of the negotiations. Furthermore, it will be much easier to handle the parallel drafting process of setting up the group of eligible counterparties for the planned instruments to be used for risk management (hedging) purposes in relation to public debt management.

20. This template documentation shall include the Schedule[2] and the credit support documentation (typically Credit Support Annex, "CSA"). It is also advisable to prepare those deliverable documents (to be enlisted under Part 3. (b) of the Schedule), which will be potentially requested by the counterparties, such as a legal opinion on authority to conclude the ISDA Master Agreements on the side of the sovereign entity (so-called "capacity opinion"). (Other accompanying parts of the documentation can be a template confidentiality agreement and a guarantee agreement.)

[2] A decision should be made on the choice between the 1992 version of the ISDA Master Agreement (Multicurrency-Cross Border) and the 2002 version of the ISDA Master Agreement as published by the International Swaps and Derivatives Association, Inc. ("ISDA"). Both versions are still widely used. The World bank (IBRD) still uses the 1992 ISDA Master Agreement version. Hungary's ÁKK also uses the 1992 ISDA Master Agreement version. It seems that the 2002 Agreement is more readily used and accepted by derivatives dealers (banks and other financial institutions), as the main changes to the 1992 Agreement were proposed mainly by the banking community, while derivatives users seem equally comfortable using the 1992 Agreement. Annex 2 of this report provides a review of key differences between the 1992 and 2002 ISDA Master Agreements.

1.1.2. Setting up a group of eligible counterparties for the various derivatives instruments to be concluded

21. A competitive environment may entail lower costs for financing, therefore it is indispensable to build the initial groups of eligible counterparties with whom an ISDA Master Agreement is to be concluded in such a way so that each group for a particular type of derivative instrument or a given market (such as USD-EUR cross-currency swap, etc.) would ideally consist of at least 4-6 potential bidders. (For more on number of counterparties, see Output 2a, p. 44.)

22. It is also advisable to use a two-round selection process when a given derivative instrument, a discrete transaction, is executed, starting with the long list of eligible counterparties and narrowing that down to the most competitive ones in the second round. This may lead to more effective competition among short-listed counterparties in the bidding process, which can result in decreased costs.

1.1.3. Regular monitoring of the template documentation

23. Markets develop and regulations evolve on an ongoing basis, and in parallel to the growing sophistication of practices and customs. This requires the regular monitoring of the template documentation. Hence, it is reasonable to check the quality and consistency of the template frequently, at least yearly. In this respect, as to international developments, ISDA's member services (newsletters, protocols, etc.) could provide valuable inputs.

1.1.4. External legal advice to be sought at least for the initial documentation

24. Taking into account the complexity of the ISDA Master Agreement and the related documentation, the governing law of which shall be either English law of New York law, and also the legal risks of an erroneously prepared legal documentation, it is well-founded to involve a law firm having the expertise and strong references for drafting and negotiating derivatives, and more precisely ISDA documentation. In parallel, internal capacities and competencies should be built up within the debt management entity in order to ensure the on-going legal management of the ISDA documentation, and to develop capacity to manage internally the drafting of such documentation in the long run.

1.2. Description of the most relevant sovereign-related clauses in the ISDA Master Agreement or to be included therein, and analysis of the legal risk related thereto

25. Under this Section, we will highlight those typical clauses in the Schedule of the ISDA Master Agreement which, in the case of a sovereign counterparty (such counterparty hereinafter is deemed to be Party B), have relevance or is advisable to amend on the basis of the specific nature of such counterparty. It should be noted that the clauses highlighted below are under the 1992 version of the ISDA Master Agreement (ISDA Master Agreement – Multicurrency Cross Boarder 1992 Version). Thus, for implementing these in the newer 2002 version due reconciliation is advisable.

26. It should also be noted that as to the Credit Support Annex the title transfer type under English Law is the most common and would be advisable to use. On the other hand, this annex does not have sovereign-specific implications, thus the terms of the CSA should be formalized in accordance with general practice and following the internal risk management rules of the given sovereign (Romania).

1.2.1. Guideline No. 1.

27. Though there might be tools and methods in a given jurisdiction (e.g., Romania) to collect detailed information on and to monitor a broad number of sub-sovereign entities (such as ministries, agencies, state-owned enterprises, etc.), in practice it is rather difficult to monitor these entities, at least for a government debt management entity. This may lead to "technical" default situations or unwanted defaults, since the activity of these entities may not be possible to monitor by a given debt management entity concluding the ISDA Master Agreement.

Therefore, in order to avoid Events of Default and Termination Events under Section 5(a)(v) - Default Under Specified Transaction, Section 5(a)(vi) - Cross-Default, or under Section 5(a)(vii) - Bankruptcy, or under Section 5(b)(iv) - Credit Event Upon Merger of the ISDA Master Agreement, it is advisable to use the following wording in Part 1. (a) of the Schedule which ensures that in case of Party B being the sovereign no entities would fall into the category of Specified Entity:

Part 1. ***Termination Provisions (of the ISDA Schedule to the Master Agreement).***

(a) *"**Specified Entity**" means in relation to Party A for the purpose of:-*

Section 5(a)(v), [•]

Section 5(a)(vi), [•]

Section 5(a)(vii), [•]

Section 5(b)(iv), [•]

and in relation to Party B for the purpose of:-

Section 5(a)(v), none

Section 5(a)(vi), none

Section 5(a)(vii), none

Section 5(b)(iv), none

* * *

1.2.2. Guideline No. 2.

28. Cross Default provisions are quite customary in international financing transactions. In the case of the ISDA Master Agreement, the Cross Default provision deals with default by a party, its Credit Support Provider, or the Specified Entities in respect of “Specified Indebtedness”.

29. “Specified Indebtedness” is defined in Section 14 of the ISDA Master Agreement as any obligation in respect of borrowed money, a definition which is quite broad and ambiguous. Thus, if left *as-is* that would entail risks. From the banking counterparties’ side, it is quite customary to exclude deposits taken by a bank in the ordinary course of its business. Therefore, it is advisable that the meaning of “Specified Indebtedness” is amended in the Schedule so that it is:

(i) clarified that short-term errors of administrative or operational nature are carved-out from this Event of Default;
(ii) restricted and narrowed down to that basket of financial indebtedness which is corresponding to the Transactions concluded under the ISDA Master Agreement.

30. It should be noted that this Event of Default only applies if it is specified in Part 1. of the Schedule as applicable. If it is “switched on” in respect of one party, then this Event of Default will be triggered where there is a default in respect of Specified Indebtedness which exceeds the “Threshold Amount” (see below). Generally speaking, sophisticated counterparties will require this type of default to be mutually applicable.

31. The level of the “Threshold Amount” (to be specified in the Schedule in respect of each party) is the amount of affected Specified Indebtedness that must be affected by the default before the Event of Default is triggered. Another way of seeing this is as the level of unsecured exposure each party will allow the other before any call for collateral is made. Some market participants prefer to specify this amount as a proportion of shareholders’ equity or net worth, others prefer a specific figure which can range from zero to X million, depending on the underlying risk management policies.

The latter approach has the general advantage of certainty and is easy to monitor. Furthermore, with respect to a sovereign entity the concept of equity is simply not applicable. Therefore, it is advisable to use a specific figure as Threshold Amount. Thresholds are discussed in more detail in Output 2a (see pp. 13-14, and p. 29).

An ideal wording in the above respect might be formulated as follows:

Part 1. ***Termination Provisions (of the ISDA Schedule to the Master Agreement).***

(c) *The "**Cross Default**" provisions of Section 5(a)(vi) of this Agreement, as modified below, will apply to Party A and to Party B. Section 5(a)(vi) of this Agreement is hereby amended by the addition of the following at the end thereof:*

"provided, however, that notwithstanding the foregoing, an Event of Default shall not occur under either (1) or (2) above if (a) the event or condition referred to in (1) or the failure to pay referred to in (2) is a failure to pay caused by an error or omission of an administrative or operational nature; and (b) funds were available to such party to enable it to make the relevant payment when due; and (c) such relevant payment is made within [three] Business Days following receipt of written notice from an interested party of such failure to pay."

If such provisions apply: -

*"**Specified Indebtedness**" will have the meaning specified in Section 14 (but will exclude deposits received by a party in the ordinary course of its banking business) in relation to Party A and will mean External Indebtedness (as defined in Section 14 as amended by Part 5(a)(iv) of this Schedule) in relation to Party B.*

*"**Threshold Amount**" means EUR [•]*, or its equivalent in any other currency or currencies in relation to Party A and Party B.*

Note:
* To be set in accordance with underlying risk management policies. Thresholds are discussed in more detail in Output 2a that covers credit risk management issues (especially see pp 13-14, and illustration on p 29).

* * *

1.2.3. Guideline No. 3.

32. Credit Event Upon Merger as a Termination Event entitles a party to terminate all Transactions if its counterparty merges with another body and the resulting entity is materially less creditworthy. This clause has relevance because of the counterparty risk implications emanating from the higher probability that the less creditworthy entity will not be able to fulfil the obligations undertaken earlier.

This Termination Event only applies if specifically stated and in the case of a sovereign counterparty, where transformation of sovereign states is not so common and is regulated differently (by public international law), it is justifiable to apply it unilaterally, i.e. to Party A only.

An ideal wording in the above respect might be formulated as follows:

Part 1. ***Termination Provisions.***

(d) *The "**Credit Event Upon Merger**" provisions of Section 5(b)(iv) of the ISDA Master Agreement will apply to Party A (amended as follows) and will not apply to Party B. Section 5(b)(iv) of this Agreement is hereby amended by the substitution of the following therefor:*

"(iv) ***Credit Event Upon Merger.*** *A Designated Event (as defined below) occurs with respect to a party, any Credit Support Provider of the party or any applicable Specified Entity of the party (any such party or entity, "X"), and such Designated Event does not constitute an event described in Section 5(a)(viii) but the creditworthiness of X, or, if applicable, the resulting, surviving, or transferee entity of X, as the case may be, is materially weaker than that of X immediately prior to such action (and in such event X or such resulting, surviving or transferee entity of X will be the Affected Party); provided, however that the phrase "materially weaker" means that the senior long term debt or deposits of the resulting, surviving or transferee entity is or are, as the case may be, rated less than [BBB-]* grade by Standard & Poor's Corporation ("S&P") or FITCH Ratings Ltd. ("FITCH") or [Baa3]* grade by Moody's Investors Service, Inc. ("Moody's"). For the purposes hereof, a Designated Event shall mean that, after the date of this Agreement:*

(1) X consolidates or amalgamates with or merges with or into, or transfers all or substantially all its assets (or any substantial part of the assets comprising the business concluded by X as of the execution date hereof) to, or reorganises, incorporates, reincorporates or reconstitutes into or as, another entity,

(2) another entity transfers all or substantially all its assets to, or reorganises, incorporates, reincorporates or reconstitutes into or as X, or

(3) any person or group of related persons acquires directly or indirectly the beneficial ownership of equity securities having the power to elect a majority of the board of directors of X or otherwise acquires directly or indirectly the power to control the policy making decisions of X, or

(4) X effects any substantial change in its capital structure by means of the issuance, incurrence or guarantee of debt or the issuance of (A) preferred stock or other securities convertible into, or exchangeable for debt or preferred stock or (B) in the case of entities other than corporations, any other form of ownership interest

(5) X enters into an agreement providing for any of the foregoing."

Note:
* To be set in accordance with underlying risk management policies.

* * *

1.2.4. Guideline No. 4.

33. Downgrade clause as an Additional Termination Event ("ATE") is a counterparty risk mitigating tool, that allows counterparties to terminate and close out outstanding Transactions, if the credit rating of the counterparty falls below the trigger rating level. Since credit default is often preceded by a rating downgrade, this ATE can significantly reduce the counterparty credit risk by pre-emptively terminating the exposure. Nevertheless, it should be noted that there is still a risk that the counterparty may default without going through a severe downgrade, or prior to being downgraded belatedly. Customarily, the Downgrade clause is applied mutually (or at least counterparties dealing with a sovereign will seek to apply it mutually), hence triggering rating levels are to be set carefully, in accordance with the underlying risk management policy. Romania, however, is currently rated at minimum investment grade by all major rating agencies. As such,

mutually applying the lowest investment grade as a trigger for the downgrade clause may entail high risks for the sovereign. For example, it may trigger unexpected cash calls from counterparties under an ATE clause if an unexpected credit rating downgrade of Romania occurs and result in increased liquidity risk in such scenario. To mitigate such risks, the sovereign may negotiate the level of the downgrade clause lower than investment grade for itself while maintaining it at least at minimum investment grade for its counterparties. Of course, doing so may require adjusting the collateral and other amounts/requirements accordingly.

An ideal wording in the case of a sovereign counterparty might be formulated in the Schedule to the Master Agreement as follows:

(h) ***Additional Termination Event*** *will apply.*

The following shall constitute an Additional Termination Event: ***Downgrade***

Section 5(b) of this Agreement shall be amended by the insertion of the following additional provision:

"(vi) ***Downgrade.***

(A) The rating issued or maintained by Standard & Poor's Corporation ("S&P") or FITCH Ratings Ltd. ("FITCH") or Moody's Investors Service, Inc. ("Moody's") related to the senior long term debt or deposits of Party A (in which case Party A will be the Affected Party) or to the long term, unsecured, unsubordinated debt obligations of Party B (in which case Party B will be the Affected Party) is downgraded as follows:

(I) with respect to Party A, below [BBB-] by S&P or FITCH or [Baa3]* by Moody's;*

(II) with respect to Party B, below [•] by S&P or FITCH or [•]* by Moody's;*

provided, that in case of split rating classifications the lower rating shall apply; or

(B) Party A (in which case Party A will be the Affected Party) or Party B (in which case Party B will be the Affected Party) ceases to be rated by any two of S&P, Moody's and FITCH."

Note:
* To be set in accordance with underlying risk management policies.

* * *

1.2.5. Guideline No. 5.

34. The definition of Affiliate in Section 14 of the ISDA Master Agreement is quite broad and for similar reasons, as discussed above in relation with the risk associated to the category of Specified Entity, it seems advisable to restrict this definition on the side of the sovereign counterparty to those entities which are easy-to-control-and-monitor, or even to disapply this notion (similarly to Specified Entity). Obviously, the latter is more advantageous and easier to handle by a sovereign.

This might be formulated as follows in Part 4(j) of the Schedule to the Master Agreement:

Part 4. ***Miscellaneous***

*"**Affiliate**" will have the meaning specified in Section 14. of this Agreement in respect of Party A, but Party B shall be deemed to have no Affiliates.*

* * *

1.2.6. Guideline No. 6.

35. Taking into account the corporate background and starting point of the ISDA Master Agreement, there are several specific clauses which need to be tailored to fit into the sovereign context.

While clauses as Status, Merger Without Assumption, and Tax Event Upon Merger apply to Party A (the commercial counterparty), they are understandably inapplicable in the case of a sovereign counterparty. Instead of the corporate-like clauses, moratorium and external indebtedness are more important and common, which are to be analysed in a more detailed manner.

36. Similarly to the corporate-like bankruptcy, a moratorium in the sovereign practice means suspension of financial or payment obligations by a given country generally, for a certain period of time, customarily declared by that country's government. Potential counterparties negotiating an ISDA Master Agreement with a sovereign will evidently propose their suggested wording. Nevertheless, it is advisable to use the wording which is customarily used by the given sovereign in its financing instruments. Moratorium is narrowed down to external indebtedness, given the obvious economic rule that foreign exchange resources are limited for a given country.

These provisions might be formulated in the Schedule to the Master Agreement as follows:

Part 5. ***Other Provisions***

(a) ***Specific Amendments for Sovereign Counterparties***

(i) ***Section 3(a)(i).*** *The "Status" provisions of Section 3(a)(i) shall not apply to Party B.*

(ii) ***Section 5(a)(viii) and Section 5(b)(iii).*** *The provisions of Section 5(a)(viii) (Merger Without Assumption) and Section 5(b)(iii) (Tax Event Upon Merger) shall not apply in respect of Party B.*

(iii) ***Section 5(a)(vii).*** *The "bankruptcy" Event of Default set forth in Section 5(a)(vii) shall not apply to Party B. In place thereof, the following shall be an Event of Default for Party B for the purposes of Section 5(a)(vii):*

*"**Moratorium.** Party B fails or is unable to pay its debts generally as they become due or Party B shall declare any general moratorium on payment of its External Indebtedness by reason of financial difficulties or shall make any similar arrangement with and for the benefit*

of its creditors, or Party B requests a general rescheduling of any amount of its External Indebtedness."

(iv) ***Section 14.*** *Section 14 is amended by the addition of the following definition:*

*"**External Indebtedness**" means any obligation (whether present or future, contingent or otherwise, as principal or surety or otherwise) in respect of borrowed money which (i) is payable or denominated in, or which, at the option of the entity entitled to payment, may be paid in, any currency other than the lawful currency of [•]* and (ii) is payable to any person domiciled or resident outside [•]* or any entity not established under the laws of [•]*, whether or not having a separate legal entity."***

Note:
* The jurisdiction of the sovereign counterparty.
** The definition is to be formalised in accordance with the customarily used definition of the given sovereign in its financing instruments.

* * *

1.2.7. Guideline No. 7.

37. Sovereigns generally benefit from two forms of immunity: jurisdiction and execution. The ISDA Master Agreement touches upon both forms.

38. A state's immunity to jurisdiction results from the belief that it would be inappropriate for one state's courts to call another state under its jurisdiction. Therefore, states are immune from the jurisdiction of the courts of another state.

39. The state will also have immunity from enforcement (i.e. execution), as it would be improper for the courts of one state to seize the property of another state.

40. However, these forms of immunity can generally be waived by the sovereign. Therefore, potential private counterparties will be anxious to ensure that any sovereign immunity is waived, while, from the side of the sovereign this waiver should be limited and exceptions should only be made with caution. As a general proposition under most legal systems, certain assets belonging to the state should not be available for satisfaction of the execution of a judgement; for example, the country's foreign embassies, or consular possessions.

The wording for this purpose should be in line with the applicable rules of the given sovereign. For example, this might be formulated in the Schedule to the Master Agreement in the following manner:

Part 5. ***Other Provisions***

(•) ***Waiver of Immunities****.*

(i) *Section 13(d) shall be amended by the insertion of the following wording at the end of that Section:*

"provided that, the waiver of immunity in respect of Party B contained herein shall not extend to (i) "premises of the mission" as defined in the Vienna Convention on Diplomatic Relations signed in 1961, (ii) "consular premises" as defined in the Vienna Convention on Consular Relations signed in 1963, (iii) any other property or assets used solely or mainly for official state purposes in [•] or elsewhere, (iv) military property or military assets or property or assets of the [•]* related thereto, and (v) non-transferable national assets as defined in or in accordance with applicable laws."*

(ii) Section 3(a)(v) shall be amended by the insertion of the words "and, in respect of Party B, to the laws of [the name of the sovereign counterparty] restricting the waiver of immunity in relation to any (i) "premises of the mission" as defined in the Vienna Convention on Diplomatic Relations signed in 1961, (ii) "consular premises" as defined in the Vienna Convention on Consular Relations signed in 1963, (iii) any other property or assets used solely or mainly for official ("non-commercial") state purposes in [•] or elsewhere, (iv) military property or military assets or property or assets of the [•]* related thereto, and (v) non-transferable national assets as defined in or in accordance with applicable laws" after the word "application" in the fifth line.*

Note:
* The jurisdiction of the sovereign counterparty.

* * *

1.2.8. Guideline No. 8.

41. The European Market Infrastructure Regulation (EMIR) is a body of European legislation for the regulation of over-the-counter derivatives. EMIR was introduced by Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories, dated 4 July 2012, and has serious effects on the derivatives industry. Although sovereign debt management institutions are exempt from the scope of EMIR, nevertheless potential counterparties are financial market participants falling under the obligations of the regulation of EMIR. This will entail a reconciliation obligation which has to be administratively handled on the counterparty's side as well. (Output 2a, which covers counterparty credit risk, also discusses EMIR; see pp. 15-16 for the implications of EMIR, and pp. 46-47 for a discussion on whether Romania should consider adopting the rules and procedures of the EMIR framework.)

A wording for this purpose might be formulated and be added in the Schedule to the Master Agreement at the end of Part 5. Other Provisions in the following manner:

Part 5. ***Other Provisions***

Portfolio Reconciliation and Dispute Resolution

(1) Agreement to Reconcile Portfolio Data

The parties agree to reconcile portfolios by one-way delivery of Portfolio Data.

(a) On each Portfolio Reconciliation Date, Party A will provide Portfolio Data to Party B.

(b) If Party B identifies one or more discrepancies which it determines, acting reasonably and in good faith, are material to the rights and obligations of the parties in respect of one or more Transaction(s), it will notify Party A in writing as soon as reasonably practicable and the parties will consult with each other in an attempt to resolve such discrepancies in a timely fashion for so long as such discrepancies remain outstanding, using, without limitation, any applicable updated reconciliation data produced during the period in which such discrepancy remains outstanding.

(c) If Party B does not notify Party A that the Portfolio Data contains discrepancies by [x:xx] p.m. local time in Bucharest on the fifth Joint Business Day following the later of the Portfolio Reconciliation Date and the date on which Party A provided such Portfolio Data to Party B, Party B will be deemed to have affirmed such Portfolio Data.

(2) Dispute Identification and Resolution Procedure

The parties agree that they will use the following procedure to identify and resolve Disputes between them:

(a) if Party B identifies one or more discrepancies contained in the Portfolio Data sent by Party A which Party B determines, acting reasonably and in good faith, are material to the rights and obligations of the parties in respect of one or more Transaction(s) and notifies Party A, the parties will consult with each other in an attempt to resolve any such discrepancies in a timely fashion for so long as such discrepancies remain outstanding, using, without limitation, any applicable updated reconciliation data produced during the period in which such discrepancy remains outstanding. If such attempts are not successful, either party may identify a Dispute by sending a Dispute Notice to the other party;

(b) on or following the Dispute Date, the parties will consult in good faith in an attempt to resolve the Dispute in a timely manner, including, without limitation, by exchanging any relevant information and by identifying and using any Agreed Process which can be applied to the subject of the Dispute or, where no such Agreed Process exists or the parties agree that such Agreed Process would be unsuitable, determining and applying a resolution method for the Dispute; and

(c) with respect to any Dispute that is not resolved within five Joint Business Days of the Dispute Date, refer issues internally to appropriately senior members of staff of such party or of its Affiliate, adviser or agent in addition to actions under (b) immediately above (including actions under any Agreed Process identified and used under (b) immediately above) and to the extent such referral has not occurred as a result of action under (b) immediately above (including any Agreed Process);

(d) without prejudice to the rights, powers, remedies and privileges provided by law, failure by a party to take any actions required by or to otherwise comply, or any inaccuracy of the representation and warranty, in either case, will not constitute an Event of Default or Termination Event in respect of such party.

***(3) Classification pursuant to EMIR**:*

(a) Party A represents that it is a financial counterparty as defined in Article 2 para 8 EMIR.

(b) Party B represents that it is an exempted entity as defined in Article 1(4)a) of EMIR.

(4) Notices:

(a) The following items may be delivered to Party A at the e-mail address set out below:

Notice of Discrepancy of Portfolio Data: [•]

Dispute Notice: [•]

(b) The following items may be delivered to Party B at the e-mail address set out below:

Portfolio Data to be sent to: [•]

Dispute Notice: [•]

(5) Definitions

For the purposes of this section:

*"**Agreed Process**" means any process agreed between the parties in respect of a Dispute including, without limitation, the process in Section 13 of this Agreement as may be amended between the parties.*

*"**Data Reconciliation**" means, in respect of a party receiving Portfolio Data, a comparison of the Portfolio Data provided by the other party against such party's own books and records of all outstanding Transactions between the parties in order to identify promptly any misunderstandings of Key Terms (see below).*

*"**Dispute**" means any dispute between the parties (a) which, in the sole opinion of the party delivering the relevant Dispute Notice, has arisen in connection with Data Reconciliation and (b) in respect of which a Dispute Notice has been effectively delivered.*

*"**Dispute Date**" means, with respect to a Dispute, the date on which a Dispute Notice is effectively delivered by one party to the other party save that if, with respect to a Dispute, both parties deliver a Dispute Notice, the date on which the first in time of such notices is effectively delivered will be the Dispute Date. Each Dispute Notice will be effectively delivered if delivered in the manner agreed between the parties for the giving of notices in respect of this Agreement.*

*"**Dispute Notice**" means a notice in writing which states that it is a dispute notice for the purposes of Part 7 and which sets out in reasonable detail the issue in dispute (including, without limitation, the Transaction(s) to which the issue relates).*

*"**EMIR**" means Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories dated 4 July 2012.*

*"**Joint Business Day**" means any day except Saturday and Sunday on which banks are open for general business at the seat of Party A and at the seat of Party B.*

*"**Key Terms**" means, with respect to a Transaction and a party, the valuation of such Transaction and such other details the relevant party deems relevant from time to time which may include the effective date, the scheduled maturity date, any payment or settlement dates, the notional value of the contract and currency of the Transaction, the underlying instrument, the position of the counterparties, the business day convention and any relevant fixed or floating rates of the Transaction. For the avoidance of doubt, "Key Terms" does not include details of the calculations or methodologies underlying any term.*

*"**Portfolio Data**" means, in respect of a party providing or required to provide such data, the Key Terms in relation to all outstanding Transactions between the parties in a form and standard that is capable of being*

reconciled, with a scope and level of detail that would be reasonable to Party A if it were the receiving party. Unless otherwise agreed between the parties, the information comprising the Portfolio Data to be provided by Party A on a Portfolio Reconciliation Date will be prepared as at the close of business on the immediately preceding Local Business Day of, and as specified in writing by, Party A.

*"**Portfolio Reconciliation Date**" means [•] of each year, and if such day is not a Joint Business Day, the next following Joint Business Day.*

1.3. Requirements of a sound risk management framework to examine and handle risks before initiating the negotiations with potential counterparties

42. Even though these guidelines are being provided under the Legal Output of the Advisory Services, we should highlight the necessity of having in place a well-developed risk management framework (ideally collected into one document, such as a set of Risk Management Rules of Procedure; see section 1.4. of this report) within which all relevant aspects (such as the selection of counterparties, setting of limits, separation of responsibilities, segregation of duties, adequate controls, monitoring of risks, etc.) of the planned derivatives operations should be tackled in detail. For this purpose, a set of appropriate and useful guidelines on risk management can be found in the IMF-World Bank Revised Guidelines for Public Debt Management, under sections 5, which discuss a Risk Management Framework. These should be followed with due respect to the particular set-up and prevailing characteristics of Romania. In additions, guidance on risk management issues is included in the other Outputs. For example, see Output 3b on post-trade processes, pp. 73-76, where operational risk management is discussed; Output 2b on derivatives execution, pp. 12-13; and Output 2a on counterparty credit risk, p. 31, and pp. 35-40.

1.4. Guidelines as to Internal Regulations

These guidelines do not represent, and shall not be interpreted as, provision of legal advice or a recommendation as to any particular matter covered herein even though they touch on certain legal agreements and regulations. The World Bank Group is not acting as legal counsel to the Ministry of Public Finance of Romania. As to any specific legal matter or agreement to which the Ministry of Public Finance may be a party, it is encouraged to seek advice of its own legal counsel.

Internal regulations and procedures should allow for flexibility, and they should cover such topics as Operational Rules of Procedure and Risk Management Rules of Procedure. The former may include rules on the negotiation process; conclusion of transactions; and monitoring of collateral. The latter may include rules on the selection and monitoring of counterparties; and setting of counterparty credit limits. The two sets of rules would both need to be put in effect prior to executing any derivatives transactions, as the rules are closely linked. For example, the implementation of many operational rules of procedure depends on what is specified by the risk management rules of procedure.

Guidelines on internal procedures are also provided in the other reports under the three Outputs of these Advisory Services, in each case as they specifically relate to the relevant report's topic. For example, Output 2a contains guidelines on internal procedures related to counterparty credit risk management, while Output 3b contains similar guidelines related to post-trade processes.

The purpose of the following section is to provide a summary of guidelines on internal operational and risk management procedures based on actual practices followed by other European Union DMOs, such as Hungary's ÁKK Zrt.

1.4.1. Relevant regulations for Operational Rules of Procedure

Introduction

43. In this part we summarize the general features of the internal regulations and procedures which are of utmost importance for the establishment of sound practices when derivatives transactions are prepared and concluded. In this process, the Treasury Department or Front Office and the Risk Management Department or unit (as part of the Middle Office) of any given debt management entity are the key role players with respect to the workflows of these institutional units. Given the size of Romania's General Directorate of Treasury and Public Debt (GDTPD) and its current organizational setup of three Offices (Front, Middle and Back), certain functions may be assigned to be performed temporarily by units or staff within one or more of these three Offices, instead by separate departments. For example, unlike in other larger DMOs or Ministry of Finance departments in other countries, where the credit function might be performed by a credit department, and risk management functions may be performed by a risk management department, these functions may be assigned to distinct units or dedicated staff within one or more of the three GDTPD Offices, based on current availability and capacity of MoPF resources. In the absence of such distinct units or dedicated staff at the present time, these would have to be established or assigned, respectively, for the purpose of undertaking derivatives transactions.

44. We consider the following caveats are important to note:

- Regardless of the setup and allocation of responsibilities that the MoPF will decide to put in place for the purpose of undertaking derivatives transactions, the separation of responsibilities within a given institutional unit (such as the Front Office) is advantageous in order to ensure that adequate controls are built into the processes;
- the separation of the business activity (typically handled by the Treasury Department or Front Office) and management of the risks related thereto (typically done by a Risk Management Department or unit as part of the Middle Office) better serves controls and governances; within the MoPF's GDTPD, any business activity, as described above, should be handled by the Front Office, while responsibility for risk management should reside in the Middle Office;
- the description of tasks and workflows below is shared here as a theoretical case for illustration purposes and should be treated as a broad overview; therefore, an actual set of *Operational Rules of Procedure* to be followed by the MoPF should be fitted and tailored into the regulatory environment and underlying circumstances of the MoPF's GDTPD directorate;
- similarly, supporting tasks and procedures of the related activities (such as settlement, accounting, etc.) should also be tailored correspondingly;
- IT system shall be referred below in a general sense, as the general system for position keeping, accounting, risk management, etc.;
- Decision-Making Body shall be construed as the competent person or committee (e.g. comprised of the heads of the Front and Middle Offices and the head of the Legal Department or the relevant legal counsel) authorized to decide on the given transaction, condition, etc., as applicable; the level of authorization might depend on the number of transactions in a year; for example, if the number of transactions done in a year is low, then the Minister can approve each trade (as seen in other countries); if the number of transactions is large, a delegation of authority can be mad, to allow a high-ranking official within the MoPF (e.g. General Director of GDTPD) to authorize each transaction; also see Output No. 2b, Derivatives Execution Guidelines, pp. 9, 15;
- Last, but not least, these Guidelines as to internal regulations and this set of Operational Rules of Procedure may be amended during the delivery of these Advisory Services, or later on, to elaborate on the regulations and rules shared here, or to expand on these by incorporating new regulations and rules.

In accordance with the first caveat above, we consider the following typical staff roles one would expect to find in an entity tasked with public debt management and undertaking derivatives transactions for risk management (hedging) purposes. Focus is on the functional responsibilities of each role, as the actual staff titles may differ among similar entities (e.g., DMOs or Ministries of Finance) in different jurisdictions.

- Portfolio Manager/Debt Manager – staff of the Treasury Department (typically Front Office staff) responsible for the whole or the relevant part of the debt portfolio and/or debt issuance. At the MoPF, these would be Front Office staff who may also be responsible for raising funds by issuing bonds in the capital markets.
- Dealer – staff of the Treasury Department responsible for the conclusion of derivatives transactions (may also be known as trader). Based on best practices, the roles of debt manager and dealer should be separate and held by different Treasury Department staff. At the MoPF, however, given the size of the GDTPD department and the low volume of expected transactions, dealers could be Front Office staff that will have explicit authorization to trade and, for the time being, may also be involved in debt management and bond issuance (see immediately above), but should not trade on the basis of their own hedging recommendations but only on the hedging recommendation of other Front Office (or Middle Office) staff.

- Head of Treasury Department – the person heading the Treasury Department; for MoPF, the equivalent would be the General Director of Treasury and Public Debt and/or the Head of the Front Office.
- Risk Manager - staff of the Risk Management Department being responsible for the risks related to the activities of the Treasury Department, including counterparty credit risk management, if the latter is not performed by a separate department or unit. Within the MoPF's GDTPD, these should be designated staff in the Middle Office, which would be assigned either in a unit within the Middle Office, or at a minimum will be made responsible for managing risks related to Front Office activities and transactions entered into by the Front Office, including responsibility for counterparty credit risk management.

In relation to Romania's MoPF, following is a list summarizing MoPF staff/role titles or Offices which may correspond to the staff titles/roles and departments/units listed immediately above and mentioned in these guidelines:

- Portfolio Manager – Debt Manager/Front Office staff
- Treasury Department – Front Office
- Dealer – Front Office staff that will be authorized to trade (trader); may also have the role of debt manager and be responsible for part of the debt portfolio with the caveat that they should not trade on the basis of their own hedging recommendations (see previous paragraph)
- Head of Treasury Department – General Director of GDTPD and/or Head of the Front Office
- Risk Manager – staff in the risk management unit within the Middle Office, or dedicated Middle Office staff assigned to perform the risk management function, including counterparty credit risk management

Following are guidelines on internal procedures regarding the negotiation and conclusion of transactions, as well as monitoring of collateral, respectively:[3]

- regulation of the negotiation process
- regulation of conclusion of transactions
- regulation of monitoring the collateral

1.4.1.1. Regulation of the Negotiation Process

45. Based on information gathered during the February 27-28, 2017 mission to Bucharest, the Romanian government's intention is that debt management operations-related derivatives activity shall be planned to be initiated and built up through one process, intending to put in place all prerequisites related to such activity.

46. Taking into account the guideline set forth under 1.1.2. above in Section II., in this initial phase a large number of negotiations for ISDA Master Agreements and CSAs is to be managed in parallel in order to ensure that the number of eligible counterparties adequately supports the underlying purpose of managing risks. Thus, to allow flexibility, it would be reasonable to manage and govern this process as a single multi-faceted project from the start and not to regulate it in a set of internal rules of procedure. Within this project, the guidelines for the negotiation process, set forth under 1.1. in Section II. above that are to be followed, as well as the authority to decide on the initiation of this project, might be included in the proposed Draft Order that is being considered, as the latter is envisioned to include "methodological norms regarding the use of derivatives in the public government debt-related risk management operations."

[3] Additional guidance on internal procedures related to operational risk management are included in Output No. 3b, Derivatives Post-Trade Processes, pp. 73-76 (7. Operational Risk Management).

1.4.1.2. Regulation of Conclusion of Discrete Transactions

47. To ensure better governance when applying the ISDA Master Agreements vis-á-vis swap counterparties in the course of concluding discrete transactions, the following general tasks should be assigned to staff and described in a set of Operational Rules of Procedure in order to cover the general work and document flow:

Treasury Department

Portfolio Manager:

1. He/she assesses the changes taking place with regards to the debt portfolio due to the underlying cash-flows, and he/she plans the hedging transactions in line with the country's debt management strategy and/or the reference (benchmark) portfolio[4] based thereon.

2. He/she puts forward a proposal regarding the recommended transactions (transaction type, quantity, size, term, connected portfolio element) to the Decision-Making Body, following reconciliation with the risk manager. The impact of the planned transaction to the portfolio must be demonstrated in the proposal, in light of the respective benchmark(s)/indicators.

3. In accordance with the decision of the Decision-Making Body, he/she determines in writing the parameters of the hedging transaction, and delivers it to the managers of the respective departments of the Front Office (i.e. to the Head of the Treasury Department (GDTPD's General Director) and the head of the department responsible for the underlying financing instrument (Head of the Front Office)) for the purpose of checking and countersigning thereof.

4. In line with the counterparty limit utilisation table provided by the Risk Management Department and the provisions of the Risk Management Rules of Procedure that should already be in place, he/she shall make a proposal (taking into account the principle of rotation of counterparties in transaction execution, the principle of risk diversification, etc.) regarding the scope of potential counterparties (at least 4-6) with which the bidding process is to be initiated and shall deliver this proposal to the managers in charge of the respective departments of the Front Office (i.e. to the Head of the Treasury Department (GDTPD's General Director) and the head of the department responsible for the underlying financing instrument (Head of the Front Office)) for the purpose of countersigning thereof.

5. He/she shall deliver the approved list of counterparties, with which the bidding process is to be initiated, to the dealer.

6. Following execution of the derivatives transaction, he/she shall exchange the respective confirmation(s) with the counterparty in writing, in line with the applicable ISDA Master Agreement.

7. Should there be a dispute of legal nature with the counterparty regarding the wording of the confirmation, he/she shall forward the confirmation to the appropriate staff in the Legal Department.

[4] For background see paragraph 64. of the Revised Guidelines.

8. He/she shall deliver the final version of the confirmation to the Settlement Department, unit or staff, as the latter would be responsible for settlement of transactions as part of the tasks that should be performed by the Back Office.

9. He/she shall double-check whether the transaction recorded in the IT system by the dealer (see next section) conforms to the underlying ISDA Confirmation.

Treasury Department

Dealer:

1. The dealer is allowed to enter into a derivatives transaction only and exclusively according to the decision of, and based on the authorization from, the Decision-Making Body, in line with the dealer limits defined for the given dealer in the Risk Management Rules of Procedure that should already be in place.[5]

2. He/she shall issue the request for quotes to the counterparties via the communication channels set in the ISDA Master Agreement (i.e. e-mail, telefax, etc.), and then, if required, he/she shall negotiate in further detail on a telephone equipped with a recorder.

3. The dealer shall be obliged to perform the preliminary counterparty limit check in the IT system in the course of the transaction recording process in accordance with the applicable rules of the system. If the system indicates that the counterparty limit has been exceeded or that there is no counterparty limit, the dealer may change the status of the transaction to “Checked” only after he/she has obtained the written authorization for the given excess of limit (as specified in the Risk Management Rules of Procedure). In such case, the Treasury Department (Front Office) shall be obliged to notify the Risk Management Department in advance or immediately after the transaction has been concluded. If the written authorization, as defined above, is lacking, the transaction shall not be approved.

4. He/she shall price the swap using the software application used by the entity (such as SWPM functionality on Bloomberg) based on the request for quotes.

5. He/she shall collect and evaluate the bids submitted through the communication channels set in the ISDA Master Agreement or on the phone, and shall record these conversations. Relation to this, he/she shall review draft termsheets from dealers or a create a termsheet.

6. He/she shall enter into the transaction (execute) with the counterparty submitting the best bid. This is the most sensible approach at the very beginning. However, as the portfolio size grows, and if it turns out that the portfolio is very concentrated (i.e. most of the trades are done with just one counterparty), one should try to execute further trades with other counterparties to prevent concentration risk (see Output No. 2b, Derivatives Execution Guidelines, p. 33).

7. Prior to execution of the transaction, it is recommended to obtain draft ISDA confirmations and review with special attention to any “non-standard” clause that the counterparty might add for risk mitigation purposes (e.g., mandatory early termination clauses, extinguisher features, re-couponing, etc.). In such event, legal clearance is needed (see Output No. 2b, Derivatives Execution Guidelines, pp. 15-

[5] Also see Output No. 2b, Derivatives Execution Guidelines, pp. 9, 15.

17). Following execution of the transaction, he/she shall request a confirmation under the ISDA Master Agreement from the counterparty following execution of the transaction.[6]

8. The concluded transaction shall be confirmed in writing subsequently, and such confirmation will be delivered to the portfolio manager by the dealer.[7]

9. The dealer shall record the concluded transaction in the IT system on the day of the transaction in accordance with the given template of the system.

10. The dealer shall enter and activate the concluded transaction in the software application (such as SWPM functionality on Bloomberg) and then, on the same day, he/she shall forward the transaction corresponding to the records of the IT system to the Risk Management Department for the purpose of subsequent mark-to-market valuations.

11. He/she shall notify in writing the portfolio manager of the Treasury Department, the relevant departments, units or staff of the Middle Office (i.e. Planning Department, Risk Management Department) and the Back Office (i.e. Settlement Department, the Accounting Department), about the conclusion of the transaction[s], immediately after such transaction[s] have been recorded in the IT system.

[6] Regarding confirmations, see also Output No. 3b, Derivatives Post-Trade Processes, p. 44 (4.4.3. ISDA Legal Confirmations).

[7] It is advisable to perform a check by the Settlement Department, unit or staff in the Back Office as well, based on the confirmation sent by the counterparty. It is advisable to perform this control by a comparison, at a minimum, of the sold and purchased currency types, the amounts, the value dates, the exchange rates and the payment instructions.

1.4.1.3. Regulation of Monitoring the Collateral

48. When applying the ISDA CSA vis-á-vis swap counterparties the following general tasks should be typically assigned to staff and described in a set of Operational Rules of Procedure in order to cover the general workflow for monitoring the collateral:

Treasury Department

<u>*Dealer*</u>

1. He/she shall keep an electronic record of the specific conditions of the ISDA Master Agreements and related Credit Support Annexes (CSAs), based on the negotiations held with the counterparties and the respective final form of the underlying documents.

2. If the scheduled valuation is not received from the given counterparty on the valuation day by the set notification time specified in the applicable ISDA CSA, he/she shall request it from the counterparty on the valuation day, without delay.

3. If, based on the calculation made by the Risk Management Department, an extra valuation is required to be made with the given counterparty, then he/she shall ensure that such valuation is requested from the counterparty.

4. If the received valuation is not sent to the address set in the ISDA CSA (typically e-mail), then he/she shall deliver the valuation to the appropriate staff in the Risk Management Department without delay.

5. Based on the reconciliation held with the Risk Management Department, he/she shall notify the counterparty whether the counterparty receiving the valuation accepts or rejects the valuation.

6. In the event the counterparty receiving the valuation does not accept the valuation, it shall initiate negotiations with the counterparty as outlined in the ISDA CSA.

7. If the negotiations as per point 6. above are without result, he/she shall provide for commissioning an independent calculation agent as per the respective ISDA CSA.

   If the valuation of the calculation agent is not sent to the address set in the ISDA CSA, then he/she shall deliver the valuation to the appropriate staff in the Risk Management Department without delay.

8. If collateral is to be provided or requested on the basis of the valuation, then he/she shall record in the IT system the transaction of placing or receiving collateral for the value date as per the ISDA CSA concluded with the given counterparty, together with the appropriate interest rate and interest amount, in line with the corresponding template of the IT system.

9. Interest payments shall be settled with the counterparties on the basis of reconciliations held for each interest period (usually monthly), based on the counterparty's notification. If the interest notice is not received from the given counterparty according to the underlying ISDA CSA, he/she shall request it

from the counterparty regarding the interest period without delay. If the calculation sent by the counterparty does not correspond to the internal calculation of the counterparty receiving the valuation, he/she shall initiate reconciliation with the counterparty.

10. He/she shall record the reconciled due interest payments in the IT system.

11. He/she shall submit for filing the valuations delivered by the Risk Management Department and countersigned by the Head of the Treasury Department (the General Director of GDTBD or the Head of the Front Office).

12. He/she shall submit for filing the interest payment[s] and related calculations countersigned by the Head of the Treasury Department (the General Director of GDTBD or the Head of the Front Office).

Head of the Treasury Department

1. He/she shall countersign the valuations delivered and signed by the Risk Management Department, as long as the received valuation – according to the calculations of the Treasury Department – complies with the rules of the Risk Management Department specified below.

Risk Management Department

Risk Manager

1. He/she shall perform the valuation of the hedge agreements (e.g. swap transactions) based on market value, on a daily basis, with the help of a software application (such as the SWPM functionality on Bloomberg). He/she shall record the valuation in the IT system.

2. Based on the valuation of the swap transactions, he/she shall reconcile with the appropriate staff of the Treasury Department the valuations expected on a particular day and any demands vis-á-vis the counterparties.

3. He/she shall cross-check the valuation made by the counterparty (or calculation agent) with the internal calculation of the counterparty receiving the valuation. If the debt management entity (GDTPD's Middle Office) acts as the calculation agent, it shall perform the valuation to be sent. He/she shall deliver the valuations to the Treasury Department (Front Office) for countersignature and simultaneously he/she shall make a proposal to accept or reject the valuation made by the calculation agent.

4. If the valuation submitted by the counterparty is not acceptable, he/she shall participate in the negotiations held with the counterparty (see item 6. in previous section) and shall opine on the appointment of a third party acting as a calculation agent.

5. He/she shall keep track of the credit rating of the counterparties having an ISDA CSA concluded and he/she shall notify the Treasury Department about any possible or foreseeable change regarding the respective credit ratings.

1.4.2. Relevant regulations for Risk Management Rules of Procedure

Introduction

49. The general approach and practice of government debt management entities, based on the principle (sound practice) of segregation of duties, is that risk management activities are performed within the institution primarily, but not exclusively, by a separate unit, typically a Risk Management Department which is part of the Middle Office. This Risk Management Department must be separated from those units which, through their activities, undertake risks in the course of the day-to-day management of government debt. Given the size and setup of the MoPF's GDTPD department, in lieu of establishing a Risk Management Department, risk management activities may be performed for the time being by a unit within the Middle Office, or at a minimum by designated staff in the Middle Office who will be assigned this role, perhaps in addition to their other duties. Nonetheless, it should be made clear in the procedural guidelines that the risk management function is a distinct function separated from those GDTPD units (e.g., the Front Office) who undertake risks, as described above.

50. In general, the Risk Management Department shall monitor and measure the *business risks* undertaken by the government debt management entity (GDTPD), make proposals to establish the respective risk management practice regarding the given risks, cooperate in handling the risk and check the risk management practice of other organizational units.

51. As derivatives transactions form part of the debt management function, in the course of performing the above-mentioned activities, any given Risk Management Department shall fulfil primarily the following general – not risk-specific – tasks, ideally also set forth in a set of Risk Management Rules of Procedure, such as those described in this section:

1. It shall make a proposal regarding the size of the counterparty limits, thus mitigating the risk assumed by the derivatives transactions, it shall maintain such limits and it shall keep a register on the amount of such limits and their utilisation, which shall be available to the department concluding the derivatives transactions, i.e. the Treasury Department (Front Office).

2. It shall ensure that the currently effective counterparty limits are set and maintained in the position management IT system. It shall check whether the limits are observed, and if any limits are possibly exceeded, it shall report this to the Decision-Making Body and the person or committee authorised to decide on the limits, and shall also notify the concerned dealer and their immediate supervisor. The person or committee authorised to decide on the limits shall decide about the amount of the limits based on the proposal submitted by the Risk Management Department.

3. It shall deliver its opinion on any new transaction types proposed to be introduced by the business area of the government debt management entity in terms of the risks involved.

52. The majority of the business risks monitored and measured by the Risk Management Department and associated with the derivatives operations are incurred in the course of the activities of the department concluding the derivatives transactions, i.e. the Treasury Department (Front Office). The Treasury Department shall have the following general – not risk-specific – obligations related to the undertaking and management of risks:

1. In the course of their dealing activities, the Treasury Department shall be obliged to comply with the risk mitigation requirements and limits imposed in terms of the undertaken business risks, as well as the procedural rules related to the limits;

2. The Treasury Department must ensure that only the dealers holding the required authorization shall have the right to conclude the specific transactions, and only up to the limits set for them. If no valid limit is set for the given transaction, the authorized dealer shall have the right to conclude the transaction subject to the required authorization;

3. The Treasury Department may initiate the setting of a new limit or the amendment of the existing limits by the Risk Management Department;

4. The Treasury Department shall take part in establishing the risk management practice regarding the given risk. (In this regard, the Treasury Department shall deliver its opinion on the debt management benchmarks/indicators and may initiate amendment thereof by the Risk Management Department.)

53. It should be noted that as far as the *operational risks* are concerned, other internal units of a given debt management entity (GDTPD) which are affected by the respective risk type should also have risk management tasks in the course of engaging in derivatives activities, such as the IT Department, Legal Department, Accounting Department, Planning Department, Settlements Department (Back Office). Therefore, appropriate care should be taken that these and other related tasks are regulated by the provisions of the Risk Management Rules of Procedure.

54. *Legal risk* in the context of derivatives activities means the risk which arises when the enforceability of the transactions and agreements concluded and the scheme which is legally most favourable for the given counterparty cannot be ensured. Legal risk may result, among others, from non-compliance with the legislation and also from unpredictable and unfavourable changes in the legal environment.

Following are guidelines on internal procedures regarding the selection of potential counterparties, setting of limits, and monitoring of counterparties:[8]

- regulation of the selection of potential counterparties
- regulation of setting of limits
- regulation of monitoring of counterparties

[8] Additional guidance on internal procedures related to risk management and monitoring, especially counterparty credit risk, and relevant reporting are included in Output No. 2a, pp. 35-40.

1.4.2.1. Regulation of the Selection of Potential Counterparties

55. Counterparty risk is incurred when the counterparty is not willing or not able to fulfil its obligations undertaken in the contract. Prudent risk management practices handle this type of risk before and after the conclusion of a given contract, such as the ISDA Master Agreement.[9] Settlement risk is incurred if the transaction is rescinded (cancelled) prior to its conclusion, whereas non-performance risk is incurred if the transaction is cancelled following its conclusion.

56. When concluding ISDA Master Agreements with potential counterparties and in the course of concluding transactions, the following responsibilities should be assigned to staff and described in a set of Risk Management Rules of Procedure so that the entire general workflow is covered:

Risk Management Department

1. The Risk Management Department performs a preliminary evaluation of the potential counterparties mentioned in the proposal of the Treasury Department, and evaluates their compliance with the minimum requirements to be eligible to become and remain a derivative counterparty, which are to be defined in the Risk Management Rules of Procedure and in the bilateral agreements.[10]

2. The Risk Management Department shall deliver its opinion on the planned terms and conditions of the given ISDA Master Agreement in cooperation with the Legal Department and the Treasury Department.

3. The Risk Management Department shall prepare the counterparty limit system valid for the given transaction types and, based on this, shall make a proposal on the amount of the counterparty limits and their modification (if need be).

4. The Risk Management Department shall revise the counterparty limits defined based on the given limit system at least once a year.

5. The Risk Management Department shall provide for setting and updating the respective limits (counterparty-, dealer-, etc.) in the IT system, in accordance with its internal regulation.

6. With respect to swap transactions concluded with collateral agreements, the Risk Management Department shall countersign the calculation containing the current market value of the swap(s) sent

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[9] It should be noted that the Revised Guidelines highlight another approach to handling counterparty risk, i.e. to clear derivatives via a central counterparty, which is a method that might also be considered. The respective part of the relevant guideline under the title of *5.2 Risks arising from the use of derivatives, credit risk, and settlement risk* is the following:

“68. **When derivatives are used to manage debt portfolio risk positions, debt managers should be aware of the financial cost and redemption scenarios that could arise, as well as of the potential consequences of derivatives contracts (e.g., in case of a downgrade of a market counterparty).** Derivatives imply taking credit risk as they rely on the commitment of a counterparty to honor its financial obligations. Collateral agreements are effective instruments to limit losses in the event of counterparty default. If the government can clear derivatives via a central counterparty (CCP), the single contract between the government and the original counterparty is replaced by two separate contracts in which the CCP is counterparty to each of the two original parties. Thus, the counterparty risk is transferred to the CCP. […]”

[10] For background, see Step 2 **Setting individual counterparty risk limits** in Output No. 2a - Derivatives Counterparty Credit Risk Management.

by the given counterparty qualifying to be the calculation agent, based on its own calculations. In the event the debt management entity acts as the calculation agent, the Risk Management Department shall determine the current market value of the swap(s) and send it to the Treasury Department for the purpose of forwarding it to the counterparty.

Treasury Department

1. The Treasury Department shall make all efforts to achieve and reach dealing principles and agreements reducing counterparty risk. For that purpose, it shall act as an initiator in relation to the potential counterparties to promote the application of international standard framework agreements.

2. The Treasury Department shall keep the Risk Management Department up-to-date about the market information it has obtained about counterparty risks. It shall provide any additional information obtained in the course of business liaising and cooperation necessary for evaluating the counterparties.

3. The Treasury Department shall notify the Risk Management Department if and when contacts are made with a new counterparty.

4. The Treasury Department may initiate the definition (setting) of a new counterparty limit or the modification of an existing counterparty limit by the Risk Management Department.

5. The Treasury Department may initiate the conclusion of agreements reducing the counterparty risk and shall cooperate in the process of conclusion of these agreements.

6. The Treasury Department shall coordinate the negotiations related to the collateral agreements and the preparatory process of the contracts with the involvement of the Legal Department and the Risk Management Department.

Legal Department

1. The Legal Department shall participate in drafting the proposals of the ISDA Master Agreements and the related collateral agreements and shall provide for updating the respective agreements with the approved amendments.

2. The Legal Department shall participate in elaborating the dealing principles aimed at reducing counterparty risk and in concluding the respective agreements and contracts.

57. In the course of conclusion of derivatives transactions, from the aspect of counterparty risk and for the selection of potential counterparties, it would be advisable that some minimum requirements or principles relating to the setting of the limits are included in the Risk Management Rules of Procedure in relation with derivatives counterparties in order to regulate the process from a general point of view.[11] For illustration purposes, the following requirements or principles might serve as such examples:

[11] As to the usage of limits when transacting in derivatives in the risk management of government debt, the following guideline is relevant in the Revised Guidelines (under the title of *5.2 Risks arising from the use of derivatives, credit risk, and settlement risk)*:

1. Any and all swap transactions initiated can only be performed with counterparties to which a limit has been assigned prior to the conclusion of a transaction. Individual counterparty limits are set separately for each counterparty, and are registered and monitored by the Risk Management Department.

2. The debt management entity (GDTPD) shall enter into derivatives transactions for hedging (risk management) purposes only (all allowed types of transactions, such as interest swap, FX interest swap, FX-swap, forward, combination of these, etc. shall be enlisted) and only with counterparties with which an ISDA Master Agreement supplemented with a collateral agreement (typically a Credit Support Annex, "CSA") has been concluded in advance and has become effective.

3. The Risk Management Department shall make a proposal regarding the counterparty-specific conditions (minimum transfer amount, frequency of valuation, application of possible thresholds, etc.) of the collateral agreement, taking into account the credit rating and rating expectations of the given counterparty. [12] The list of the currently effective conditions for active counterparties is advisable to be included in the Risk Management Rules of Procedure for internal transparency purposes.

4. Admission of new counterparties can be initiated by the Treasury Department by submitting a request to the Risk Management Department. The Risk Management Department shall make a proposal regarding the extent of the limits based on the provisions of the Risk Management Rules of Procedure.[13]

5. The Risk Management Department can make a proposal regarding the modification or withdrawal of an existing limit at any time.

6. The Risk Management Department shall make its proposal regarding the amount of the counterparty limit primarily on the basis of the rating of the counterparty and other pre-determined factors. However, in the event it obtains any other information that affects the counterparty risk to a considerable extent, it may make a proposal for the modification of the limits based on the respective information as well.

7. If the limit is exceeded in case of downgrading, no new transaction can be concluded with the given counterparty.

8. If the credit rating of the counterparty with which a collateral agreement was concluded is downgraded – regardless of whether limits were exceeded or not – or if any other business information is disclosed that is expected to adversely affect its credit quality, the Risk Management Department – in

"69. **Credit risk should be assessed and managed consistently by debt and cash managers.** If debt managers are responsible for transacting in financial derivatives and investing in liquid assets, and if cash management implies opening short-term lending facilities to financial institutions covered by framework agreements, credit risk should be managed in a consistent way. Conceptually, governments should set exposure limits for individual counterparties that take account of the government's actual and contingent consolidated financial exposures to that counterparty arising from debt and foreign exchange reserves management operations; in practice, the government may achieve this within a structure of delegated responsibilities. Credit ratings from independent credit rating agencies can be used in the evaluation of individual counterparties. Credit risk can also be managed by holding a diversified portfolio across a number of acceptable financial counterparties and also through collateral agreements. Settlement risk should be controlled by having clearly documented settlement procedures and responsibilities and by placing limits, if appropriate, on the size of payments flowing through any one settlement bank […]."

[12] For background, see "Minimum credit quality" under Step 2 **Setting individual counterparty risk limits** in Output No. 2a - Derivatives Counterparty Credit Risk Management.

[13] For background, see "Limits" under Step 2 **Setting individual counterparty risk limits** in Output No. 2a - Derivatives Counterparty Credit Risk Management.

consultation with the Treasury Department and the Legal Department – may initiate the modification of the counterparty-specific conditions of the collateral agreement or, if all else fails, the termination of the already concluded transactions, to the extent allowed by the contract or the underlying ISDA documentation.

9. The Risk Management Department shall keep a register of the open part of the limits (the "headroom") on a continuous basis, which shall also be available to the Treasury Department on a continuous basis.

Reporting Obligations

58. In connection with the above responsibilities and in line with the discussed principles, concrete reporting obligations might be put in place. Examples of such reporting obligations could be:

Treasury Department

1. The Treasury Department shall provide information immediately to the Risk Management Department if the counterparties fail to fulfil their contractual obligations.

   Reporting frequency: as required

2. The Treasury Department shall inform the Risk Management Department without delay if it obtains such market information that may influence the merits of the risk rating/perception of the given counterparty.

   Reporting frequency: as required

3. The Treasury Department shall forward to the Risk Management Department the information on the current market value of the transactions concluded with the given counterparty, sent by the party considered as the calculation agent in the course of the transaction concluded with ISDA-MTM or CSA. Based on its own calculations, it shall countersign the MTM valuation prepared by the Risk Management Department.

   Frequency of report making: in line with valuation frequency

Settlement Department (Back Office)

1. The Settlement Department shall inform the Risk Management Department if any of the transactions have not been fulfilled within the respective deadline.

   Reporting frequency: as required

2. The Settlement Department shall send a written notice to the Risk Management Department if any of the counterparties failed to perform (pay) until the [5th] working day following the settlement date. If a counterparty to which a limit is assigned fails to perform until the [10th] working day following the settlement date according to the written notice of the Settlement Department, the Risk Management Department shall reduce all the limits of the given counterparty to zero.

Reporting frequency: as required

Risk Management Department

1. The Risk Management Department shall notify the Treasury Department in the event of any change to the counterparty rating and/or any change to the existing counterparty limit.

   Frequency of report making: ad hoc

1.4.2.2. Regulation of Setting of Limits

59. In the course of determination and setting of the amounts of the counterparty limits for derivatives operations, the general principles of limits (as described under Section 1.4.2.1. above) shall be applicable. For prudent risk management purposes, it is essential to have an exhaustive list of the specific types of derivatives to be used for hedging purposes, so that the restrictions on the types of derivatives allowed to be concluded, in line with the given risk management policy, will be spelled out either in the Risk Management Rules of Procedure, or in a higher level regulation (ideally, the highest level could be secondary legislation, such as the proposed Draft Order, in order to provide both flexibility and transparency). Based on the meetings of the February 27-28, 2017 mission to Bucharest, interest rate swaps and cross-currency swaps are the relevant derivatives instruments to be used by Romania's MoPF to hedge financial risks in relation to public debt management operations. Thus, when setting up the system of limits it is advisable to use that breakdown of derivatives instruments.

60. When determining the system of limits for derivatives operations, it would be advisable to add the following specific principles to the general ones referred above:

1. Taking into account that ratings issued by credit rating agencies are still the major indicators for financial markets, it is vital to enter into FX market transactions only with such counterparties which themselves – or their direct or majority owner, or their Credit Support Provider (guarantor/surety provider) – have a rating from at least two major international credit rating agencies (i.e. Standard & Poor's Group, Moody's Group, Fitch Ratings Group).[14] The reflection point of this principle is the Downgrade Additional Termination Event (ATE) in the ISDA Master Agreement as analysed under Guideline No. 4. under Section II. above. If a Credit Support Provider is involved, the rating of such Credit Support Provider shall be applied in terms of the limits.

2. In addition to the principle outlined above, limit amounts could be attached to the ratings provided by the three major international credit rating agencies, in such a manner that in all cases the worst of the existing ratings shall be used.

3. In accordance with general practice in the financial markets, it is advisable to explicitly specify that only counterparties with investment grade credit ratings (in other words at least "BBB-") can receive a counterparty limit. Therefore, no new transaction can be initiated with a counterparty whose prevailing credit rating does not reach the "BBB-" with stable outlook level. Limits could be scaled gradually starting from this limit-level upwards to "AAA". Furthermore, several other credit factors might serve as additional parameters to be taken into account in the process of working out the limit amounts.[15]

4. The limits set for the transactions to be secured by collateral agreements are to be handled as aggregated limits, meaning that these limits are to be applied in terms of the total portfolio/exposure of the given counterparty regarding the respective transactions.

5. If an early termination event – as stipulated under the ISDA Master Agreement concluded with a given counterparty – takes place as to the given counterparty (such as a downgrade), the Risk Management

[14] Due to the fact that local Primary Dealers are not always rated by the international credit rating agencies, a reasoned exemption might be made, provided that they are monitored closely and strictly enough to handle the higher counterparty risk emanating from this exemption.

[15] For background, see "Minimum credit quality" under Step 2 **Setting individual counterparty risk limits** in Output No. 2a - Derivatives Counterparty Credit Risk Management.

Department should be authorized to make a proposal to either maintain or terminate the swap transactions concluded with that counterparty, within the framework allowed under the collateral agreement. When making such proposal, the exposure vis-á-vis that counterparty must be taken into account as well.

6. In accordance with the description above under Guideline No. 4. in Section II., downgrade clauses tend to be mutually applicable. Therefore, it should be regulated that if a termination event has arisen and prevailing due to the downgrading of the sovereign counterparty, then entering into new transactions under the given ISDA Master Agreement is advisable to be restricted or even prohibited.

7. When the system of the rating-driven limits is constructed, limit amounts of partners having specific credit ratings are to be allocated in accordance with the prevailing risk management policy/framework, so that the volume of individual transactions that is allowed to be concluded with a given counterparty of that particular credit rating is maximised. Another approach might be that the selection method for a given transaction is to be concluded and quotes shall be sought in ways that prevent excess concentration risk, based on prior exposure-based restrictions.

Reporting Obligations

61. From the above-described principles and responsibilities relating to the limits, emanate specific reporting obligations of the Risk Management Department. For example:

Risk Management Department

1. The Risk Management Department shall prepare a full derivatives risk report covering the whole derivatives portfolio and a break-down by counterparty.[16]

   Frequency of report: weekly/monthly – in accordance with the volume of the derivatives operations

2. The Risk Management Department shall prepare a summary report about the transactions concluded during the target period, restricted with limits. The summary shall contain the following information: type, nominal value, direction of the transaction, name of the dealer, monthly aggregated net position, as well as the related position and transactional limits.

   Frequency of report: weekly/monthly – in accordance with the volume of the derivatives operations

3. The Risk Management Department shall prepare an extraordinary report, if it discovers that a limit has been violated. It shall send the notice on exceeding the limit to the competent units.

   Frequency of report: ad hoc

4. If a new limit is provided, a limit is changed or a limit is withdrawn, the Risk Management Department shall notify the Treasury Department thereof, without delay, in writing.

   Frequency of report: ad hoc

[16] For background, see “Monitoring risk” under Step 4 **Internal processes** in Output No. 2a - Derivatives Counterparty Credit Risk Management.

1.4.2.3. Regulation of Monitoring of Counterparties

62. The role of credit ratings in the course of selection of potential counterparties and setting the limits for derivatives operations has been deeply emphasized earlier in this material. In an internal regulation, since controls for the initial approval and ongoing review of trading counterparties should cover nearly the same risk elements, for the sake of consistency it is reasonable to tackle the ongoing monitoring of the derivatives counterparties together with the same rules applicable to their selection process. The general purpose of this ongoing monitoring is to ensure that efficient and critical counterparty risk analysis is built into the risk management processes. The key role player for this analysis should be the Risk Management Department and its controls is advisable to be based on the counterparty's rating and the structure of the limits allocated for the derivatives operations. The responsibilities and reporting routines for the ongoing monitoring of counterparties are described under the previous two sections.

Annex 1 – Some Considerations for Romania

Following are some steps Romania may wish to consider taking in negotiating ISDA Master Agreements.

It should be noted that the MoPF's legal department should play coordinating and leadership role in this process, even if outside legal counsel has been retained to assist in drafting and negotiating ISDA documentation. At the very least, the MoPF's legal department must be a key partner from the beginning.

(a) **<u>First: Prepare template (model) legal documentation, i.e. template ISDA Schedule and CSA.</u>**
   a. Ensure that negotiations with any counterparty are on the basis of your (Romania's) template Schedule and CSA.
   b. The above implies that you have a template that reflects choices made by Romania in the Master Agreement Schedule and Paragraph 13 of the CSA. In order to do so, you need to:
      i. Build up internal legal capacity and knowledge of ISDA framework.
      ii. Work with outside legal counsel to prepare template ISDA Master Agreement.
      iii. Understand the changing regulatory environment for non-centrally cleared derivatives and impact on counterparty(-ies).
   c. Decide what is Non-negotiable and what is Negotiable. This requires cooperation with:
      i. MoPF staff which have been assigned to perform the credit function (most likely staff in the Middle Office)
      ii. The Back Office
      iii. Outside legal counsel
   d. Understand what can change on the basis of risk profile of the counterparty(-ies) or legal opinions.
   e. Sign the Schedule to the ISDA Master Agreement and the CSA at the same time: if not, the counterparty might not be willing to return to the negotiating table.
   f. If applicable, currently or in the future, coordinate with the National Bank of Romania to align standards.
   g. Examples of what can be important:
      i. Allow multi-branching or not with respect to the counterparty. Questions and issues to consider:
         1. Is there capacity in the Back Office to deal with this?
         2. If multi-branching is acceptable in principle, which branches are acceptable from a legal perspective (also see below)?
         3. Check both the jurisdiction of incorporation and the jurisdiction of the branches (for "ring-fencing" of entities)
      ii. Applicable law for the CSA: NY Law or English Law?
         1. The choice should depend on whether Romania wants or needs to create a "security right" (NY) or a "transfer of title" (English).
         2. It will depend on the insolvency law of the counterparty and law of location of collateral (*lex situs*).
         3. As noted earlier (see section 1.2. of this report), the "transfer of title" type under English Law is the most common and would be advisable to use.
      iii. Automatic Early Termination (AET) or not?
         1. This will depend on the insolvency law of the commercial counterparty.

2. Automatic Early Termination may entail risks.

iv. What Additional Termination Events (ATE) to include?
   1. A rating downgrade, discussed, earlier is the most obvious one.
   2. Whether or not to include other ATE will depend on the risk tolerance/limits set by the credit unit or credit staff, most likely in the Middle Office, of MoPF's Treasury and Public Debt General Directorate.

v. Who will be the Calculation Agent?
   1. Should be decided in coordination with the Back Office.

vi. What collateral will Romania accept and be willing to provide?
   1. Should be determined in cooperation with the credit unit and the Back Office.

vii. Confirmations
   1. Who prepares them? Romania or the counterparty?
   2. What legal form will they take?
      a. Fax / scan / signatures?

(b) <u>Second: Conduct legal due diligence regarding the counterparty(-ies).</u>

a. Know Your Counterparty: Make sure you have the correct and full legal name of your counterparty.

b. Legal jurisdiction: determine and examine the legal jurisdiction in which the counterparty is incorporated.
   i. The jurisdiction of incorporation determines the relevant insolvency law
   ii. Insolvency law determines the enforceability of close-out netting
   iii. Insolvency law determines "automatic stays", validity of Early Termination clauses, and determines potential avoidance powers of the insolvency trustee and / or Resolution Authority
   iv. Insolvency law determines whether and when one can enforce the security rights over the collateral upon insolvency
   v. Insolvency law contains the conflict of laws pointing to the law governing the validity and enforceability of the collateral (*lex situs*)
   vi. Insolvency law and *lex situs* affect the validity of substitution and validity of re-use of collateral

c. Legal form of the counterparty: determine and examine the legal form of the counterparty (bank, dealer, "other" financial institution, insurance company, or corporation?)
   i. The legal form of the counterparty determines the insolvency regime.
   ii. The insolvency regime determines what was listed just above.

d. Find out what transactions your dealers (traders) are envisaging. This will determine whether the ISDA Opinions conclusions are relevant.

e. Review ISDA Netting and Collateral Opinions to which all members have access electronically. If there are questions remaining, contact outside counsel for confirmation of ISDA Opinions.

f. ISDA Legal Opinions:
   i. Netting Opinions: a legal counsel considers whether the close-out netting provisions contained in the ISDA Master Agreement would be enforceable against a range of types of entities organized or incorporated in the jurisdiction of the legal counsel's practice.
   ii. Collateral Opinions: a legal counsel considers whether the provisions contained in ISDA's credit support documents would be enforceable against a

range of types of entities organized or incorporated in the jurisdiction of the legal counsel's practice.

(c) <u>Third: Negotiate Schedule and CSA with counterparty (may adjust template legal documentation on the basis of legal research and credit review per counterparty)</u>

a. Know Your Counterparty:
    i. Ensure that the agreement contains and refers to the correct legal counterparty with its full and correct name.
    ii. Check authority of counterparty to sign – see Part 3 of the Schedule (Agreement to Deliver Documents)
b. Important legal decisions to make depending on the counterparty selected and the legal advice obtained:
    i. Conclusion of legal due diligence might force you to amend your template. For example:
        1. Insurance company might require different termination clauses;
        2. US bankruptcy subject entity might require different Reps & Warranties;
        3. Nature of entity might require adherence to different ISDA Protocols.
    ii. Close cooperation with the credit unit (in Middle Office) and the Back Office is advised on the following issues:
        1. Credit unit (in Middle Office):
            a. Additional Termination Events (ATE)
            b. Thresholds
            c. Re-use of Collateral
            d. Nature of Eligible Collateral
        2. Back Office:
            a. Eligible Collateral
            b. Timing of mark-to-market calculations
            c. Timing of delivery of collateral
            d. Coordination with Custodian

Annex 2 – Review of key differences between the 1992 and 2002 ISDA Master Agreements

There are two versions of the ISDA Master Agreement used by market participants that undertake derivatives transactions. The 1992 and the 2002 versions. On January 9, 2003 ISDA published the 2002 version of the ISDA Agreement following review of certain aspects of the 1992 Agreement.

Both versions are still widely used. It seems that the 2002 Agreement is more readily used and accepted by derivatives dealers (banks and other financial institutions), as the main changes to the 1992 Agreement were proposed mainly by the banking community, while derivatives users seem equally comfortable using the 1992 Agreement. Following is a review of some key differences between the 1992 and 2002 Agreements.

Events of Default – Bankruptcy. Under Section 5(a)(vii) of the 1992 version no grace period applies where a party commences formal bankruptcy or insolvency proceedings, unless the proceedings are commenced by a third party, in which case there is a 30-day grace period and no Event of Default is triggered if the proceedings are dismissed during that period. In the 2002 Agreement, Section 5(a)(vii)(A) a grace period does not apply where the insolvency proceedings are instituted by a regulator, supervisor or any similar official. Meanwhile, Section 5(a)(vii)(B) reduces the grace period from 30 to 15 days, where the grace period continues to apply. In either case, it is the non-defaulting party which may terminate in the event of bankruptcy, or termination may be automatic if elected in the Schedule.

Termination Events – Illegality and Force Majeure. The 1992 version of the ISDA Agreement contains an illegality Termination Event in Section 5(b)(i) which allows a party to terminate if it becomes unlawful to perform any of its obligations under certain circumstances. However, it does not contain a Force Majeure Event as a Termination Event. The 2002 Agreement introduces the latter in section 5(b)(ii) of the 2002 version. Force Majeure refers to a situation whereby due to the occurrence of an event of force majeure or act of state, a party is prevented to make or receive payment or delivery of an obligation under the derivatives transaction. Nonetheless, both for Illegality and Force Majeure a Waiting Period applies, meaning that either of the two may become a Termination Event only after the expiration of the Waiting Period. Once Illegality or Force Majeure becomes a Termination Event, either party may terminate, with certain exceptions.

Termination Event – Credit Event Upon Merger. As mentioned in section in section 1.2.3. Guideline No. 3 of this report, Credit Event Upon Merger does not typically apply to sovereigns, as transformation of sovereigns is not so common, but it does apply to commercial counterparties. The 1992 Agreement discusses Credit Event Upon Merger as a Termination Event in Section 5(b)(iv). Under Section 5(b)(v), the 2002 Agreement expanded the Credit Upon Merger definition to: (i) include changes of control transactions and substantial changes in capital structure which lead to a weakening of the creditworthiness of the counterparty; and (ii) to provide that parties must take into account any applicable Credit Support Documents in determining whether or not the creditworthiness of any successor entity following the merger is materially weaker. The non-affected party is the one that has the right to terminate.

Close-out Amount. The 2002 version of the ISDA Agreement replaced the Market Quotation and Loss measure with a single valuation measure known as the Close-out Amount. Under the 1992 version, if transactions are terminated following an Event of Default or a Termination, an Early Termination Amount is calculated based on the Market Quotation or Loss Measure, depending on which of the two the parties had selected in their ISDA Schedule. The meaning of Close-out Amount is defined at length in Section 14 of the 2002 ISDA Agreement. In a nutshell, it refers to "the economic equivalent of the material terms of the terminated transactions." The Close-out Amount is determined by a Determining Party, which must act in good faith and use commercially reasonable procedures in order to obtain a commercially reasonable result.

Set-off Clause. Section 6(f) of the 2002 ISDA Agreement introduced a Set-off Clause to enable the non-defaulting or non-affected party to the transaction to set off any Early Termination Amount against amounts owed to or by the defaulting or affected party, regardless whether these are related or not to the ISDA Agreement. The 1992 version does not include such clause. The Set-off Clause is similar to the bilateral set-off clause often included by two parties in the ISDA Schedule.

Notices. Section 12(a) of the 1992 Agreement does not allow Section 5 or 6 notices (related to Events of Default and Termination Events; and Early Termination, respectively) to be to be given by fax. The 2002 Agreement allows this, and it also allows the right to give notices by e-mail, except for Section 5 and 6 notices. Notices given by e-mail are deemed to be effective on the date the e-mail is delivered.

Annex 3

UNIUNEA EUROPEANĂ

POCA
Programul Operațional Capacitate Administrativă
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Instrumente Structurale
2014-2020

Agenda
Advisory Services Agreement on Establishment of a Framework for the Use of Derivatives and the Execution of Swap Transactions in Romania (P156803)
World Bank Mission to Bucharest
Oct. 17-20, 2016

Monday October 17

1. **9:00 to 9:30 – Introduction and Objectives of the Workshop** (with translation)(John)

2. **9:30 to 10:30 – General Principles of a Risk Management Framework** (with translation)(John)
   a. Q&A

3. **10:30 to 10:45 –** ***Break***

4. **10:45 to 1:00 – Derivatives Instruments** (with translation)(John)
   a. Overview of Derivatives;
   b. Types of Instruments;
   c. Key Considerations in Using Derivatives;
   d. Q&A

5. **1:00 to 2:00 –** ***Break / Lunch***

6. **2:00 to 3:30 – General Introduction to the (2002) ISDA MA and CSA** (with translation)(Bart)
   a. Composition / Structure of ISDA MA and CSA;
   b. Purpose of ISDA MA & CSA (credit risk reduction);
   c. Main legal issues related to ISDA MA and CSA (credit risk replaced by legal risk);
   d. Recent evolutions that IBRD is aware of;

7. **3:30 to 4:00 –** ***Break***

8. **4:00to 5:00 – General Introduction to the (2002) ISDA MA and CSA** (with translation)(Bart) CONTINUED
   a. Q&A

25 YEARS WORLD BANK GROUP ROMANIA

Tuesday October 18

1. **9:00 to 9:30 – Recap of Previous Day** (with translation)(John)

2. **9:30 to 10:30 – Preparing Negotiations with Commercial Counterparties** (with translation)(Bart)
    a. Selection of counterparty – credit / legal considerations;
    b. Legal Due Diligence;
    c. ISDA MA documentation approach;
    d. Important clauses (general overview);
    e. Confirmations (general)
    f. Q&A

3. **10:30 to 10:45 –** *Break*

4. **10:45 to 11:30 – Preparing Negotiations with Commercial Counterparties** (with translation)(Bart)
    CONTINUED

5. **11:30 to 12:30 – Dodd Frank & EMIR / ISDA Protocols** (with translation)(Bart)
    a. General background;
    b. Impact on MoF?
    c. Q&A

6. **12:30 to 2:00 –** *Break / Lunch*

7. **2:00 to 3:30 – Discussion of certain Sections of the ISDA MA and CSA** (no translation)(Bart)
    a. TO BE COMPLETED

8. **3:30 to 3:45 –** *Break*

9. **3:45 to 4:45 – Discussion of certain Sections of the ISDA MA and CSA** (no translation)(Bart)
    CONTINUED

10. **4:45 to 5:00 – General Q&A on ISDA MA and CSA** (with translation)(team)

<u>Wednesday October 19</u>

1. **9:00 to 9:30 – Recap of Previous Day** (with translation)(John/Bart)

2. **9:30 to 10:30 – IBRD Hedging Instruments** (with translation)(John)
    a. Overview of IBRD Hedging Instruments for Clients;
    b. Interest Rate Instruments (Swaps, Collars, Caps / *Ad hoc* and Automatic Rate Fixing);
    c. Currency Instruments (*Ad hoc*, Automatic, Back-to-back, Major and Local);
    d. Q&A

3. **10:30 to 10:45** – *Break*

4. **10:45 to 11:45 –IBRD Financial Products** (with translation)(Gaukhar)
    a. IBRD Hedging Instruments for Clients – context for using ISDA MDA;
    b. IBRD Schedule to ISDA MDA – Risk Management;
    c. IBRD Schedule to ISDA MDA – overview of selected clauses.

5. **[11:45 to 12:00** – *Break*]

6. **12:00 to 1:00 – ISDA MDA with IBRD** (with translation)(Gaukhar) *cont'd.*
    a. IBRD Schedule to ISDA MDA – overview of selected clauses (cont'd)
    b. Differences between IBRD MDA Schedules with Sovereigns and Commercial Counterparts
    c. Process and Timeline
    d. Q&A

7. **1:00 to 2:00 –** *Break / Lunch*

8. **2:00 to 2:30 – Review of Romania's IBRD Portfolio and Hedging Opportunities** (with translation)(John)

9. **2:30 to 3:30 – Introduction to Developing a General Legal Framework** (with translation)(John)
    a. Main Issues;
    b. Examples from other countries;
    c. Romania's experience;
    d. Q&A

9. **3:30 to 3:45 –** *Break*

10. **3:45 to 4:15 – Introduction to Developing a General Legal Framework** (with translation)(John) CONTINUED

11. **4:15 to 5:00 – General Q&A** (with translation) (team)

<u>Thursday October 20</u>

1. [As needed] Follow-up (one-on-one / smaller team) meeting(s) with client counterparts on ISDA MA and CSA (time/venue/translation TBD)(Bart)

2. [As needed] Follow-up (one-on-one / smaller team) meeting(s) with client counterparts on ISDA MA with IBRD (time/venue/translation TBD)(Gaukhar)

3. Follow-up meetings with client counterparts on: (i) Guidelines on the Development of a General Legal Framework; and Guidelines on Internal Procedures for the Negotiation of ISDA Master Agreements and Related Confirmations (time/venue/translation TBD)(John/team)

4. **1:00 to 2:00** – *Break / Lunch*

5. **2:00 to 4:00 – Wrap-up Presentation** (with translation) (team)

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Agenda
Advisory Services Agreement on Establishment of a Framework for the Use of Derivatives and the Execution of Swap Transactions in Romania (P156803)
World Bank Mission to Bucharest
Feb. 27 – 28, 2017

Legal Component – Follow-Up Mission

Objectives:

The mission objectives are to (i) deliver to select Ministry of Public Finance staff and other relevant stakeholders presentations related to establishing guidelines on the development of a general legal framework to use derivatives, and developing guidelines on internal procedures for the negotiation of ISDA Master Agreements and related Confirmations, as well as to share Hungary's experience in the above; and (ii) have meetings with MoPF staff and other relevant stakeholders to discuss Romania's existing legal framework and MoPF procedures and gather information needed to subsequently produce the two written deliverables (the guidelines).

Mission Team:

John Balafoutis, Lead Financial Officer, Financial Advisory and Banking, World Bank Treasury
Dr. Szita Zsolt LLM, international expert from Hungary's Government Debt Management Agency (AKK)

Monday – February 27

1. **9:30 to 9:45 – Introduction and Objectives of the Mission (John Balafoutis)**

2. **9:45 to 11:00 – Background on Best Practices for Legal Framework (Dr. Szita Zsolt)**
    a. General background on best practices for legal framework
    b. EU best practices
    c. Hungary as an example
        - DMO versus MoF department set-up
    d. Q&A / discussion

3. **11:00 to 11:15 – *Break***

4. **11:15 to 12:45 – Hungarian General Legal Framework and Derivatives Contractual Practices (Dr. Szita Zsolt)**
    a. Legal framework of public debt management in Hungary
        - Description of legal framework and history of public debt management in Hungary
        - Hungary's ÁKK Rt. (Government Debt Management Agency Ltd.)

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   b. Main features of swaps
   c. Counterparty eligibility criteria
   d. Credit risk mitigation description
   e. ISDA & CSA negotiations
      - Hungary's experience
   f. Q&A / discussion

5. **12:45 to 1:45 – *Break / Lunch***

6. **1:45 to 3:15 – Derivatives Contractual Practices (cont'd) (Dr. Szita Zsolt)**
   a. ISDA & CSA negotiations (cont'd)
      - Hungary's experience
   b. The swap execution process
   c. Establishing a general schedule for planning derivatives operations:
      - Step 1: Planning, controlling and structuring all the aspects of the activity (i.e. legal, settlement, accounting, etc.)
      - Step 2: Establishment of the legal framework in the legislation
      - Step 3: Establishment of the internal regulation
      - Step 4: Preparation and chrystallisation of the draft contractual documentation (templates for MA, CSA)
      - Step 5: Selection of the first round of potential counterparties
      - Step 6: Contractual negotiations
      - Step 7: Go live
   d. Q&A / discussion

7. **3:15 to 3:30 – *Break***

8. **3:30 to 5:00 – Meeting(s) (TBD) (Balafoutis/(Dr. Szita)**
      - **or, continue previous session/discussions as needed.**

<u>**Tuesday – February 28**</u>

1. **9:00 to 12:30 – Meeting(s) (TBD) (Balafoutis/(Dr. Szita)**

2. **12:30 to 1:30 – *Break / Lunch***

3. **1:30 to 3:00 – Meeting(s) (TBD) (Balafoutis/(Dr. Szita)**

4. **3:30 to 4:30 – Wrap-up presentation / Q&A (Balafoutis/(Dr. Szita)**

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