IASB/FASB: Joint netting education

Background note

February 2010

1. **Meaning of netting**

"Netting" is a loose non-legal term to describe mainly three separate processes:

- set-off
- close-out netting
- settlement netting

The amounts involved in netting world-wide are extremely large. Netting is not just a feature of financial markets but applies in all commercial situations where parties owe each other money or have trading contracts between them.

- **Set-off**

Set-off is the discharge of reciprocal debts. It is a form of payment. Thus, a bank sets off a loan owed to it by a depositor against a deposit owed by the bank. The bank pays its deposit liability with its asset, the loan owed to it.

- **Close-out netting**

Close-out netting is the cancellation of a series of open unperformed trading contracts between two parties, e.g. for the sale of foreign exchange, on the default of the counterparty and the set-off of resulting losses either way.

Close-out netting requires three steps on a counterparty default: cancellation of the unperformed contracts, calculation of the losses to each party resulting from the premature termination (as well as unpaid outstandings that had accrued due for payment prior to cancellation), and then set-off of the losses either way on each contract, so as to produce a single net balance owing one way or another. Cancel, calculate, set-off.

There are other methods of how you arrive at the net balance, but the functional result is the same.

Close-out netting applies to unperformed trading contracts e.g. for the sale of securities or foreign exchange or commodities or for the exchange of interest swap payments. Set-off applies to ordinary debts, such as loans and deposits. The main difference is that in the case of a debt, you set off the full amount of the debt, e.g. 100, whilst in the case of a sale contract you have to work out the damages to each party (which are usually the difference between the contract price and the market price). It is only these damages amounts which are set-off, not the full nominal amount of, say, the price payable.

Generally speaking, close-out netting is available at the option of the non-defaulting party. That party may decide not to trigger the cancellation procedures if the outcome, in financial terms, would be detrimental to it. At the same time, however, it may be entitled to suspend the performance of its own obligations whilst the relevant default event applies to the defaulting counterparty.

Examples

1. If A agrees in a trading contract to sell a share to B for 100, and B defaults when the market price is 90, B owes 10 to A because that is A's loss. If A owes B a loss to B of 10 on another contract, the two 10s are set off so that A's exposure is zero.

   Typically, in the case of these trading contracts, other amounts may also be payable which are eligible for the overall set-off, e.g. margin deposits and unpaid amounts owing by one party in respect of deliveries which have already been made by the other party.

   The position can be intriguing where a non-defaulting party is out of the money and so decides not to terminate on the insolvency of the other party.

2. If A owes a deposit of 100 to B and B owes a loan of 100 to A, then, if B becomes bankrupt, A sets off the loan and the deposit so that A's exposure is zero.

Two-way payments Most master agreements provide that the solvent party must pay the bankrupt's losses ("two-way payments"). But, apart from contract to do so, in many jurisdictions this is not a legal requirement under bankruptcy law – the solvent party can keep its gains ("walk away").

If the non-defaulting party can walk away with its gains, then strictly, insolvency set-off is not needed because the non-defaulting party is compensated for its losses by the gains it can walk away with.

Nevertheless, master agreements almost invariably provide for two-way payments, partly because the parties like to be treated equally, partly because some bankruptcy laws might treat the forfeiture of gains which the insolvent would otherwise receive as being unlawful and partly because some

regulators require two-way payments (because they suspect that there may be bankruptcy problems or because they want to augment the debtor's estate, especially if they have insured deposits).

- **Settlement netting**

Settlement netting, sometimes called payment netting, is the advance set-off by contract of fungible equivalent claims under unperformed contracts for the delivery of money or assets where the mutual deliveries fall due for delivery on the *same day*. Thus, settlement netting applies to deliveries due on the same date and only if deliverable in the same currency or same asset. See section 2 of the ISDA Master Agreement.

Thus, if one party must on the same day deliver foreign exchange of $100 for yen and the other must deliver foreign exchange of $101 for euro, the parties can agree that only $1 is payable on the day in relation to the two dollar amounts. The effect is to reduce exposures if deliveries cannot be synchronised.

The law of set-off does not apply because the amounts concerned are deliveries. For example, you cannot set-off coffee against coffee.

Provided that close-out netting is available under the legal system, there are usually few legal problems about settlement netting. In practice, this type of netting is of considerable importance in order to reduce Herstatt risk, i.e. one party pays but does not receive. Settlement netting is at the heart of the netting achieved by CLS Bank which settles a large part of the world's wholesale foreign exchange market.

2. International reception of set-off and netting on insolvency

The question of the availability of netting arises primarily on insolvency which is when it really matters. Most countries allow netting prior to the insolvency of a party, but this is irrelevant because, if parties can pay, the remedies are not needed.

The international position on set-off and close out netting is extremely disharmonious. See the attached maps which are indicative only and have not been updated since 2007 (since when there have been quite a few developments).

The disharmony results from disagreement as to whether it is better to protect bankrupt debtors or to protect creditors or markets. Those who favour creditor protection argue that it is better to protect creditors of the debtor because of the extremely large amounts involved which overall probably exceed world GDP by several multiples on a daily basis. For example, in the case of Lehmans, there were around one million trades outstanding. It is thought that flows on the foreign exchange market

are 20 to 30 times world GDP and that systems of netting can reduce exposures by 95% which in turn, it is said, reduces the risk of systemic cascades. Those who favour debtor protection argue that netting depletes the assets of the bankrupt debtor and gives certain creditors a super priority. The choice therefore is between protecting markets and protecting debtors.

The result of this dialectic is that some countries do not permit set-off on insolvency because set-off enables the creditor to be paid ahead of other creditor and depletes the bankrupt's estate.

Some jurisdictions do not permit the termination of contracts (which is essential to close-out netting) by reason of an insolvency because they think that the maintenance of a bankrupt's contracts is desirable for a rescue and because the termination may remove an asset of a contract if the contract is in the money from the bankrupt's point of view.

Some jurisdictions do not permit either set-off or contract termination and therefore are debtor-friendly on this issue.

Other jurisdictions allow all these things and are therefore creditor-friendly on these issues.

The collision of policies on these issues has led to the development of protective statutes which allow set-off and netting only in financial markets. These carve-out statutes may only insulate certain types of financial contracts, or only contracts between certain financial parties, or only if the contract is a specified market contract. There are between 40 and 50 countries which have these statutes. See the attached map (which does not reflect additions since 2007). The EU has various protective provisions, such as the settlement finality directive, the financial collateral directive, and a directive applying to the reorganisation and winding up of credit institutions.

These carve-outs statutes are usually extremely intricate: a recent private review of the statutes ran to about 800 pages of almost indecipherable detail.

3. Master agreements

For technical reasons, it is desirable that there should be a master agreement applying to all contracts which allows the innocent party to terminate on bankruptcy events of default and to set-off. In some jurisdictions, these master agreements are not strictly necessary for set-off or close-out netting. The main advantages of master agreements (apart from the compelling need for uniformity of terms so that the documentation can be put in place) include

- there are clear termination rights on specified events of default

- the master agreement can improve the methods of valuing losses either way

- the master agreement can provide for two-way payments

- the master agreement can set out a contract for set-off. A contract for set-off can be important for set-off against intervenors (see below) and is necessary in a few jurisdictions for the efficacy of netting under a financial markets carve-out statute, e.g. Belgium, or for set-off itself, e.g. Guernsey.

4. **Single agreements and netting by novation**

The concepts of all contracts being a *single agreement* and of netting by novation were originally attempts to circumvent prohibitions in insolvency laws which prevented set-off or contract terminations or both. In the case of *netting by novation*, it was specified that, as each new contract was entered into between the parties, all the previous contracts and the new contract were deemed to be renewed ("novated") so as to form one melded single agreement between the parties.

The theory was that, if a party was bankrupt and there was only one single agreement, the bankrupt could not choose the best bits of that one deal and leave the worst, take the cherry but not the pip.

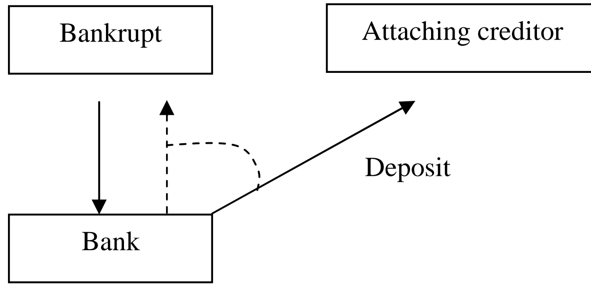
Since all the contracts were obviously different contracts and not a single melded contract, reliance on these contractual techniques has fallen away: they were too suspect for safety in most jurisdictions. The single agreement concept remains a feature of most master agreements, but netting by novation seems to have disappeared.

A similar comment applies to clauses providing that automatic termination and netting are *deemed* to take place automatically *immediately prior* to the commencement of a bankruptcy. Another suspiciously facile attempt to get round mandatory bankruptcy laws.

But in a few countries these clauses do work.

5. **Intervenors**

To be safe, netting must be available not only against a bankrupt counterparty, but also against a third party who takes over the claims owned by the bankrupt. Thus if the bankrupt is owed a deposit by a bank to which the bankrupt owes a loan, and a creditor of the bankrupt attaches the deposit (takes it over pursuant to a court execution judgment) the bank must be able to set off against the *attaching* creditor who has taken over the deposit. There are several other classes of these intervenors, eg. assignees of the deposit, undisclosed principals of agents.

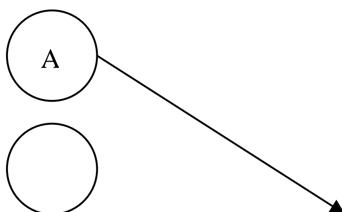


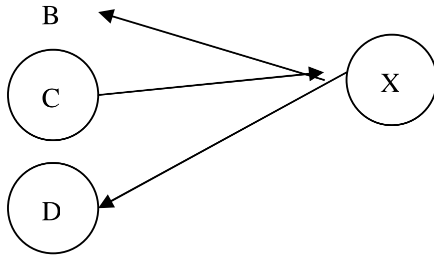
6. **Central counterparties**

On an insolvency, the various forms of netting apply usually only if the transactions are mutual, i.e. there are only two debtor-creditors, each of whom is personally liable for what it owes and each of whom is the owner of the claim owed to it. If you do not have this mutuality, then the effect of set-off is that one person's property is expropriated to pay another person's debt.

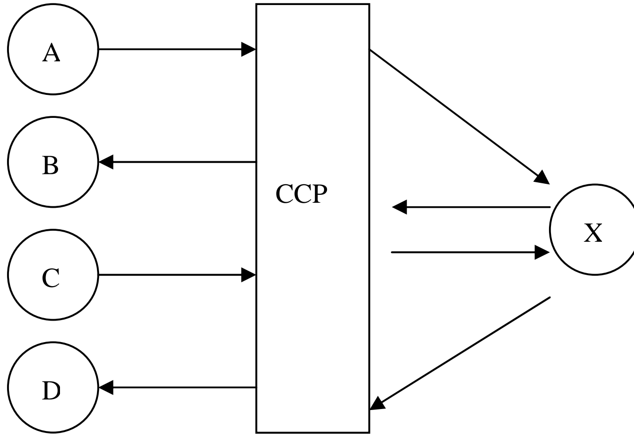
Central counterparties are a method of achieving the required mutuality where, say, 20 or 30 different dealers all contract with a single counterparty X who becomes bankrupt. If that were to happen, all the 20 or 30 solvent counterparites could not net all the separate losses in relation to X because the contracts would not be mutual.

A central counterparty operates as follows: all the dealers in the market agree with each other and the central counterparty that, when they report their trades with each other to the central counterparty and the trades are accepted by the central counterparty, the effect is that a trade between A and X is converted into a two trades (1) one between A and the central counterparty and (2) the other a mirror onward trade between the central counterparty and X. The result is that A, B, C, D, and the other dealers all have contracts with the central counterparty which are mirrored by all those onward contracts between the central counterparty and X. Hence when X becomes bankrupt, all the contracts are mutual *between X and the central counterparty* which can then cancel them and set-off the losses either way. The use of a central counterparty in this way can result in a massive reduction in exposures, e.g. 95%. The main problem is the concentration of risk on the central counterparty.





No set-off – no mutuality. If A wanted to set-off against the claim which A owes to X, it would have to use B's claim and so take away B's property to pay A's claim owed to X. If B is also insolvent, this is an unlawful forfeiture of B's property after the commencement of B's liquidation – the famous *British Eagle* case law principle.



Set-off between CCP and X: mutuality.

The above central counterparty procedure is perfectly legitimate and is nothing to do with the evasive concepts of single agreement and netting by novation under a master agreement.

7. Collateral

A party may be required to pledge or charge collateral to secure its obligations to the other. This is called margin. The validity of collateral worldwide is complex: If the "collateral" is a cash deposit placed with the counterparty bank, then the solvent party just sets off against this deposit – no realisation of collateral is involved. Insolvency set-off must be available in the jurisdiction concerned.

It is sometimes possible for the party depositing the cash deposit to charge back the benefit of the deposit to the deposit bank but these are exceptional transactions.

The position where the parties use repos or outright transfers of assets as a substitute for pledges is intricate internationally because some jurisdictions recharacterise these security substitutes as pledges in law.

8. Conflicts of laws

As a general rule, jurisdictions apply their own netting laws to insolvencies taking place within their own jurisdiction so that you can get complicated conflict of laws problems if, say, a deposit is owed to an insolvent branch in one country but a loan is owed by an insolvent branch in another country, each with different laws. EU insolvency measures generally apply the law of the claim owing to the insolvent in the case of set-off but this seems an exceptional provision.

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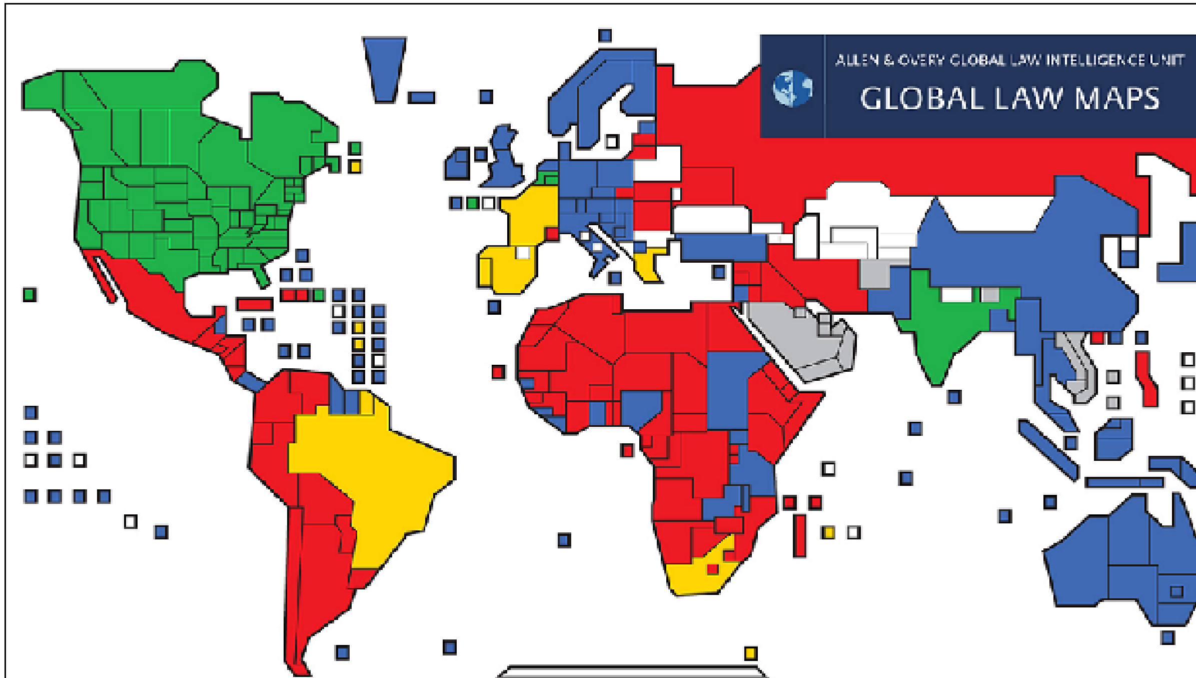
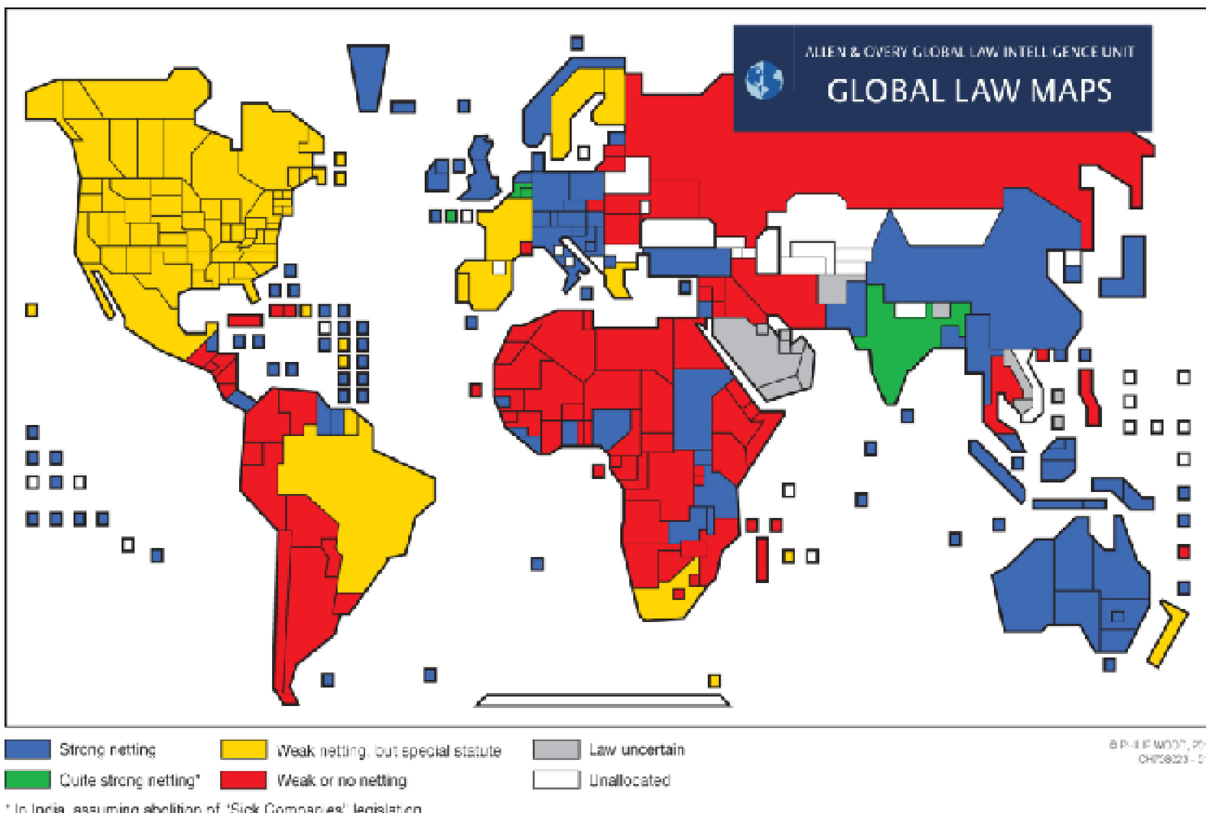
Map: Insolvency set-off



Map: Close-out netting on insolvency



Map: Special netting statutes