Quiet Reformation

Enforceability of close-out netting is the single most important legal requirement for safe and efficient derivatives markets. ***Habib Motani****, consultant at Clifford Chance and former head of its global derivatives practice, explores ISDA's ongoing work to promote netting certainty in emerging markets*

Over the past 10 years, ISDA and the derivatives market have focused a great deal of attention on the implementation of post-crisis reforms, including mandatory clearing, margin requirements and capital regulations, as well as the operational opportunities created by technology.

It is easy to forget that, from the outset of ISDA's existence, substantial effort was required in promoting law reforms – particularly those that enable the recognition of close-out netting. This underpins much of the risk and regulatory capital management that has today become second nature to financial institutions around the world. It is also easy not to appreciate that this law reform work continues today, especially in emerging markets, and remains an important part of ISDA's mission. Countries in which ISDA has recently undertaken this work include Croatia, Russia and Ukraine.

Governments in all jurisdictions naturally aspire to achieve economic growth and stability and, while many things contribute to achieving this, access to competitive funding and liquidity is critical. This is helped by having a robust banking sector, with sound local banks and non-local financial institutions actively participating in providing liquidity.

Effective close-out netting helps facilitate this in several ways. Most importantly, by allowing each pair of counterparties to compress their various obligations into a single payment due by one to the other, netting mitigates credit risk and means a default is less likely to be harmful to the health of the overall market.

Netting benefits

Statistics published by the Bank for International Settlements (BIS) show that close-out netting significantly reduces the risk of outstanding derivatives transactions. According to the BIS, gross credit exposure, a measure that adjusts the market values of outstanding over-the-counter derivatives transactions for legally enforceable netting agreements, was $3.2 trillion at the end of June 2020, just 21% of the gross market value.

Mitigating the credit risk faced by local banks helps reduce their regulatory capital usage, unlocking capacity to serve local customers. Effective close-out netting also attracts foreign banks by facilitating their dealings with local counterparties, helping to increase liquidity and competition. Likewise, exporters that face foreign exchange, interest rate and/or commodity risks as a result of their business are more able to access hedge providers in the international market to manage their risks cost-effectively.

Global standard-setters have recognised close-out netting as risk reducing, both when it comes to setting regulatory capital requirements and developing effective resolution regimes (for example, the Financial Stability Board's *Key Attributes of Effective Resolution Regimes for Financial Institutions*). This has encouraged increasing numbers of regulators in emerging markets to investigate and consider reforms for their jurisdictions.

The ISDA Master Agreement carries several risk mitigation mechanisms – in particular, its so-called three pillars. These are: the single agreement concept (Section 1 (c)); the condition precedent, which makes each party's obligations to perform conditional on no event of default having occurred in relation to the other party (Section 2 (a) (iii)); and the close-out netting provision (Section 6). Prior to the insolvency of a defaulting party, there is often confidence in the effectiveness of these provisions. After insolvency, the picture can be very different.

Many systems of insolvency law take the approach of freezing the insolvent firm's assets and liabilities at the start of the process and applying insolvency procedures to those assets and liabilities as they were at that point in time. The start of insolvency is often set as the time of initiation of insolvency proceedings. As a result, actions taken after that point can cause difficulties. For example, if the initiation of insolvency proceedings is itself the event of default that leads to the delivery of a close-out notice, the notice may be regarded as having been given after the start of insolvency.

As well as the freezing of assets and liabilities at the start of insolvency proceedings, the insolvency laws of many jurisdictions contain clawback rules, suspect period rules and zero-hour rules – all of which have the potential to affect payments and deliveries made under transactions governed by an ISDA Master Agreement in the period leading up to insolvency.

In some cases, insolvency authorities

may view the close-out process as deviating from their insolvency distribution rules. That's because the close-out process is seen as potentially giving an advantage to the non-defaulting counterparty over other creditors of the insolvent entity. An important part of ISDA's work is to explain the risk management and financial stability benefits of running derivatives books on a net basis, as it reduces overall risk in the system.

Jurisdiction engagement

The starting point for ISDA's law reform work is to identify jurisdictions of interest. This is very much driven by ISDA member feedback. ISDA will then ascertain the current legal position in such a jurisdiction through discussions with members and informal contacts with local banks and law firms. In some cases, a local law firm will provide ISDA with a short summary of the current legal framework. ISDA will then attempt to engage with local policy-makers and regulatory authorities, as well as any relevant local trade associations.

Where there are concerns over the enforceability of close-out netting, an important goal for ISDA is to identify the potential for legislative change. A key tool in these discussions is ISDA's Model Netting Act (MNA). As ISDA's guide to the Model Netting Act explains, the MNA is a model for netting legislation and a guide for policy-makers and educators on the basic principles that should underlie a comprehensive statutory regime for close-out netting.

The MNA was originally published in 1996 and was updated in 2002, 2006 and 2018. The 2018 edition reflects recent developments in financial markets, including the adoption of financial resolution regimes, the introduction of mandatory margin requirements and the continued growth of Islamic finance derivatives. The MNA reflects the *Principles on the Operation of Close-Out Netting Provisions*, published in 2013 by the International Institute for the Unification of Private Law (UNIDROIT) – in fact, the eight core UNIDROIT netting principles are reproduced in the appendix to ISDA's guide to the MNA.

The legislative changes outlined in the MNA include the recognition of close-out netting, of the single agreement concept and of the limitation on a non-defaulting party's obligations to the net amount obligation, supporting the three pillars of the ISDA Master Agreement. The insolvency-related provisions in the MNA also address the potential application of preference and suspect period rules. In addition, the MNA includes a provision for the recognition of the governing law of a netting agreement to ensure the agreement is construed in accordance with its contractually selected governing law.

The most recent edition of the MNA also addresses the collateralisation and resolution powers given to resolution authorities. In the latter case, the MNA proposes that resolution regulations should be framed to respect close-out netting, and resolution authorities should apply their resolution powers after giving effect to the relevant netting.

The provisions on collateralisation have been included as a result of regulatory reforms mandating the use of margin. Variation margin is frequently taken on a title transfer basis, meaning the collateral enforcement mechanism being relied on is close-out netting that takes the value of collateral into account. The definition of netting agreement in the MNA therefore expressly incudes collateral arrangements relating to or forming part of the netting agreement. Collateral arrangements are also defined to include pledge-type arrangements, and collateral arrangements themselves are included as qualified financial contracts covered by the legislation.

Although recent attention in financial markets has largely focused on the implementation of regulatory reforms and the operational aspects of derivatives trading and processing, ISDA has not lost sight of the fundamental importance of the enforceability of netting and the protection of derivatives arrangements from challenge on the basis of insolvency and other general laws. ISDA's ongoing promotion of new laws in markets where legislation is desirable for these purposes may get less public attention, but it is a vital part of the work that ISDA undertakes. IQ

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Further Reading

- *What are the Benefits of Close-out Netting?* bit.ly/3sQWmLp
- *2018 ISDA Model Netting Act and Guide*: bit.ly/3iD0BFZ
- Status of netting legislation: bit.ly/2Y5AsWM
- ISDA opinions overview: bit.ly/3oaIAAO