FINANCIAL RISK HEDGING MECHANISMS

Regulation of Swaps and Derivatives

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INTRODUCTION

The ASC in its discussion paper titled 'Derivatives Traded on Over-the-Counter Markets' identifies two primary objects which regulation of the market is intended to achieve - first, client or investor protection and secondly, the orderly conduct of markets.[1] Under the second heading it lists specific concerns including the management of systemic risk in the derivatives market as a whole and the prudential soundness of market participants.

I shall provide brief comment on the current position in Australia concerning three discrete topics which are discussed at varying lengths in Schuyler Henderson's paper and which are relevant to the current debate. They are:

(a) close out netting;

(b) the limitations on powers of statutory authorities to enter into swaps; and

(c) the appropriate standards to be applied to dealers to achieve a satisfactory level of investor protection.

NETTING

The current debate underlines the importance for risk reduction of close out netting on insolvency of a counterparty. Netting reduces the danger of systemic risk by potentially reducing the exposure of solvent party to its insolvent counterparty. It involves the solvent party terminating all unperformed contracts, determining whether those contracts were in profit or loss and setting off all profits and losses to arrive at one net amount owing either by or to the defaulting party. The effectiveness of netting under Australian law will come under further scrutiny following the release a fortnight ago by the Basle Committee on Banking Supervision of the third report on netting which I will mention briefly later.[2]

Insolvency Law Reform

We are all aware of the reforms to the insolvency laws to take effect shortly and I would like to review briefly their effect on netting.

The first point to note is that the insolvency set off rules, currently set forth in section 86 of the *Bankruptcy Act*, will be written into the *Corporations Law* direct but without any substantive change to the existing provisions which govern what claims are eligible for set off on insolvency of a company. So in this respect there is little to report by way of change to the law.

The most radical change to the insolvency laws will be the introduction of the new insolvency procedure for appointment of an administrator. One of the most critical aspects of the new regime is the freeze on creditor enforcement rights set out in Division 6 of Part 5.3A - for instance the mortgagee whose security over the mortgagor's property is limited to less than the whole, or substantially the whole, of the mortgagor's property is prevented from enforcing its security during the moratorium period except with the administrator's written consent or with the leave of the court. Whilst the policy of the legislation is to increase the prospects of rehabilitating a company under administration by staying enforcement actions by creditors, those prohibitions do not apply to the exercise of a set off by a creditor where there are liquidated claims between it and the company so that the creditor is not required to go to court to establish the quantum of the claims which are eligible for set off. Set off as a self help remedy lies outside the restrictions imposed on creditors under the new procedure. In addition, a creditor is not prevented by any of the statutory prohibitions from relying on the appointment of an administrator to found a right to terminate open contracts with its counterparty.

The insolvency set off rules do not apply to the administration of a company so that the solvent counterparty will be enforcing its contractual right of set off, if at all, on the appointment of an administrator. On insolvency, those contractual rights are displaced by the mutual credits, mutual debts provisions which I mentioned will be incorporated in the companies legislation and the solvent counterparty cannot benefit from any contractual provision which confers greater rights than the statutory provisions.

Save as discussed below, the fact that during administration the counterparty will be able to rely on its contractual rights of set off will probably not in practice provide the solvent counterparty with any additional advantage above the rights it would enjoy on insolvency of its counterparty. It is only in rare cases that a contractual right of set off will permit a set off where the insolvency set off rules will not. One relevant difference in relation to administration is that the creditor will not be concerned about cherry picking because the administrator, unlike a liquidator, does not enjoy any statutory right to disclaim unprofitable contracts[3] and thereby selectively perform profitable contracts and disclaim unprofitable ones preventing the creditor terminating all transactions. This is not to suggest that cherry picking is necessarily an obstacle to netting on insolvency.

The next point concerns close out of contracts with a bank governed by the provisions of the *Banking Act*. Section 16(1) of that Act contains a provision which applies to a bank which has become unable to meet its obligations or suspends payment and provides that the bank's assets in Australia shall be available to meet the bank's deposit liabilities in Australia in priority to all other liabilities of the bank. There is now a corresponding provision in section 11F applicable to foreign banks operating through an Australian branch. There has been discussion whether section 16(1) might interfere with the ability of a solvent counterparty to net on insolvency of a bank counterparty because it requires the bank's Australian assets to be applied to satisfy its deposit liabilities prior to payment of other classes of creditors including those creditors which are also indebted to the bank but which, except for section 16(1), would be able to satisfy their obligation to the bank by setting off claims they have against the bank.

It has generally been accepted by practitioners that the *Banking Act* does not prejudice rights of set off against a bank. It seems to me that when the section, at least in section 16(1), speaks of 'assets' of a bank it must mean those assets which would be available to unsecured creditors on an insolvent liquidation of a bank and accordingly requires account to be taken of any right of set off available to any such creditor. It is apparent that this is the only sensible approach when one considers what would happen to interbank exposures on insolvency of one bank if section 16 did not permit set offs.

If set offs were not allowed, it would presumably mean (assuming a full two way payment system applies for calculation of the net termination amount) that the solvent bank (Bank A) would be forced to pay to the insolvent bank (Bank B) the gross amount of B's claim against A for each transaction where B was in the money because each claim would be an asset of B. The payment in gross made by A to B would be applied first to pay the depositors of Bank B at the expense of the depositors of Bank A. If the consequence of A losing the right which it believed it had to net out its exposure with B is that A cannot meet its obligations (ie the domino effect), the result is that A's depositors will not have the benefit of A's claims against B until B's depositors are paid in full. But of course if A has also become unable to meets its obligations, section 16(1) must also be applied to it and, if set-offs cannot be exercised, the position is reversed so that B must pay A's claim in gross. The only solution to avoid a Mexican stand-off where neither claim is paid to either A or B is to recognise the net position. This example may have a very real practical application if both banks are involved in the clearing system and may have very large gross exposures to each other but a small net exposure.

Moreover, I think it must be the case that the 'assets' of the bank in the context in which we are speaking will be the bundle of contractual rights which it enjoys under the documentation it has signed up with its counterparty to regulate its dealings including any right of set off. In my view it is not even necessary, although it does no harm, that the master agreement refer to all of the contracts, which may include quite disparate types of swaps and derivatives, as forming a single contract so that it is one contract and one asset for the purposes of the statute.

All of that is by way of introduction to the point I want to make about section 16 and the administration procedure. To the extent that it is possible that an administrator can be appointed prior to the bank becoming insolvent or suspending payment, section 16(1) will have no application so it need not even be considered at the time netting occurs. The administration procedure is both a preventative and a curative measure. Whilst one basis on which the directors or the liquidator can appoint, or apply for the appointment of an administrator, is insolvency of the company they can also do so if they are of the opinion the company is likely to become insolvent. In that case section 16(1) appears to have no application. It is unfortunate that such an important section is not properly integrated with the insolvency laws (that is why it has caused so much discussion in the first place) but it would only appear to have relevance where the bank is being liquidated because what it is really sorting out is priorities.[4]

Brief mention should also be made of section 553E of the *Corporations Law* which replaces section 553(2) of the *Corporations Law*. The old section had provided that on a winding up the bankruptcy rules regarding the respective rights of secured and unsecured creditors and debts provable and the valuation of annuities and future and contingent liabilities applied to the company in liquidation. The new section is phrased more narrowly and provides that only the bankruptcy rules regarding debts provable are to apply to a company in liquidation.

It had been suggested that the old section incorporated into the law of company liquidation section 301 of the *Bankruptcy Act*. That section provides, amongst other things, that a provision in a contract for sale of property that the contract is to terminate if the purchaser becomes a bankrupt is void. If applicable to companies, the provision could affect the ability to close out deliverable foreign exchange contracts and other forward sale contracts. In the case of FX contracts it would depend on whether the reciprocal exchange obligations could be characterised as a sale of property. In my view there was no compelling argument to suggest that the old section was incorporated into company law. That was evidenced by the fact that the legislature attempted to introduce into the insolvency reforms a section 301 equivalent which appeared in the first draft of the bill but was removed as a result of lobbying by the industry. In any event, section 301 cannot be characterised as providing for rules regarding debts provable which are the only *Bankruptcy Act* provisions which will be incorporated in the *Corporations Law* when the reforms become effective.

Finally, the amendments include provision for the treatment of foreign currency claims against the insolvent. A provable debt expressed in a foreign currency is to be converted into Australian currency at the rate agreed between the creditor and insolvent, or if no rate is agreed, at the CBA carded on demand rate. For the purposes of the ISDA document I think the Termination Currency selected in respect of an Australian counterparty to determine the termination payment can still be a foreign currency but if the net amount is owing by the insolvent that foreign currency amount will be converted into Australian dollars to put the counterparty on an even footing with the other creditors proving in the liquidation.

The insolvency reforms have continued to recognise the privileged status of the creditor with a set off right and by so doing have no adverse affect on netting. In some minor respects the law has been clarified.

The Corrigan Report

The Basle Committee is cautious in its support for netting as an effective means for a counterparty to reduce its exposure to an insolvent counterparty citing as the primary reason the lack of decided cases on the subject in the G-10 countries. One can only speculate whether residual uncertainty concerning the legal basis of netting in one or more of the relevant jurisdictions may also have played a part in the Committee's approach.

One major advance from the November 1990 report on netting issued by the BIS is the inclusion of proposed amendments to the 1988 Basle Accord on international convergence of capital measurement to recognise bilateral netting. Recognition of netting will depend on certain conditions being satisfied including the provision of comprehensive legal opinions confirming that the bank will have a net, not a gross, exposure on insolvency of its counterparty. For present purposes, I would like to draw attention to a couple of important points in the report.

First, the Committee disapproves of what it describes as 'walkaway clauses' in contracts or master agreements and states that contracts containing these clauses will not be eligible for netting for capital adequacy purposes. A 'walkaway' clause is a termination payment clause which denies the defaulting party the right to any payment on close-out of all transactions or which limits the amount of the payment to be made to the defaulting party. The Committee, without providing specific reasons, is obviously concerned that such a clause may not be legally enforceable against a defaulter or its insolvency representative. It is relevant to note that the report specifically identifies one of the methods for calculating loss in the 1992 ISDA Master Agreement as a walkaway clause (referred to in section 6(e) of the 1992 ISDA Cross Border Master Agreement as the 'First Method'). This provides a compelling reason for bank counterparties to embrace the full two-way payment method in their swap documentation if they have not already done so. Secondly, the Committee sounds a note of caution to national regulators in relation to cross-product netting but is clearly not opposed to it in principle.

REGULATION OF THE POWERS OF STATUTORY AUTHORITIES

One way that the legislatures throughout Australia are able to exercise some control on the growth of and access to the swap and derivative markets is by limiting participants' capacity to enter into these derivative transactions. This method of regulating participation in the financial markets is not available in respect of a corporation which is governed by the provisions of the *Corporations Law* and which has both the legal capacity and powers of a natural person and nor, need I say it, is it available in respect of individuals. However, ultra vires is still a real issue for participants dealing with statutory authorities or other non-*Corporations Law* corporations which include incidentally all of those financial institutions which are governed by the AFIC legislation. The Commonwealth and State legislatures around Australia have been cautious in allowing most statutory bodies unfettered access to the markets no doubt concerned to avoid the political embarrassment which would be caused by a public authority finding itself in a similar position to Hammersmith and Fulham Borough Council through unwise and inappropriate use of financial instruments.

The significance of Hammersmith and Fulham in Australia is not so much the actual legal decision, which is irrelevant in Australia turning as it did on the specific issue whether swap transactions were incidental to an English local authority's borrowing function having regard to the provisions and limitations of the UK *Local Government Act*, but the impression left on the minds of not only regulators but more importantly government that swaps and other derivatives if not properly used by the consumer can have disastrous consequences for it.

This 'paternalistic' attitude of government to protection of the consumer more from its own lack of experience or expertise or the siren call of speculation (than from the wiles of unscrupulous dealers) should not be underestimated when considering the likely outcome of any government deliberations on the subject of regulation. The borough council's problems were caused by its own risk mismanagement and not by sharp practice of others. It may explain in part the reluctance of governments to confer unlimited powers on many statutory authorities to transact swaps and other derivatives.

Fortunately, there have been amendments to the enabling statutes of a number of statutory authorities in recent years which have clarified the powers of those authorities. But the most comprehensive amendments which combine wide contractual powers with safe harbour provisions to preserve dealings with third parties to place, in effect, the authority on an equal footing with *Corporations Law* corporations have been to enabling statutes of authorities whose officers should be sophisticated in use of these instruments, for instance the various state treasury corporations. Moreover, in relation to these kind of authorities, the ability to operate in the financial markets like any other financial institution, and therefore to implement risk hedging strategies, is integral to its statutory function of providing financial services to the public sector so the statutory amendments may be regarded as an absolute necessity. However, in a large number of cases the empowering legislation provides that the authority is required to exercise its powers in performance of its statutory functions or purposes or more specifically for, say, hedging purposes. A power which has been conferred expressly on an authority but subject to the requirement it be exercised in furtherance of the authority's functions, if not so exercised, may give rise to an ultra vires transaction. Therefore the validity of transactions with these authorities will depend on the proper construction of its enabling statute to identify the relevant statutory functions and on whether in fact the power has been exercised for that function. That means that a counterparty cannot be completely certain that the transaction is within power. If an authority has power to swap for hedging purposes, its counterparty to an interest rate swap may obtain evidence that the notional principal amount of the swap matches the principal amount borrowed or raised by the authority under a particular financing and require the authority to represent that it has entered the swap for permitted statutory purposes. But in the absence of provision in the enabling statute protecting the dealing with the third party, the counterparty will not be protected if in fact the authority was not hedging that borrowing. In addition, it should not be assumed that it will always be readily apparent whether the authority has engaged in hedging or speculation.

If protection of and certainty in dealings in the financial markets is a primary policy objective (as it should be) there is a strong case for conferring comprehensive powers on all statutory authorities to swap or enter any other derivative contract without reference to the authority's functions. This would remove completely one troublesome area of legal risk. Regulation is, or should only be, a means to an end and if, in some instances, regulation creates problems of its own there needs to be a compelling competing policy objective to justify preservation of the regulation. The competing policy objective in this case is the protection of public funds (the taxpayer's money) through financially disadvantageous dealing by a public authority. But as these markets become more familiar to participants and better understood this justification will become increasingly difficult to sustain because it proceeds on the assumption that the use of derivatives is 'inherently dangerous' or a form of gambling (which is not the case). If authorities or corporations cannot be trusted to protect taxpayers' or shareholders'/investors' funds perhaps it is better they be given no, rather than limited, powers to engage in risk hedging or management and rely on some other public sector organisation which does have clear powers to carry out those functions on its behalf.

INVESTOR PROTECTION

There appears to be almost unanimous agreement between all sides in the current debate concerning regulation that the existing regulatory framework is unsatisfactory in some respects, particularly because of the uncertainty created by the wide definition of a 'futures contract' in Chapter 8 of the *Corporations Law*. There is disagreement about what changes ought to be made to the law. The existing framework is structured around statutory definitions which are intended to establish defining characteristics of different instruments. The mechanics for transacting an instrument - whether it must be exchange traded - will then depend on whether it fits the statutory definition of, say, a futures contract or not.

To compensate for the broad reach of the 'futures contract' definition, the legislative draftsman excluded from the definition various types of contract entered into by a bank or merchant bank. But there are grey areas and there has been little case law to settle the statutory principles. What case law there has been is at first instance and has been the subject of some criticism. That is indicative of an inherent problem in the existing statutory approach to constructing the regulatory framework. The problem is that when a matter comes to court not all of the institutions with a real interest in the outcome of the case can intervene in the proceedings to make submissions to the court on matters directly relevant to the points in issue and to draw to the court's attention the wider ramifications for all financial markets of interpreting a section a particular way and deciding a particular instrument must be exchange traded. For instance in both the **Carragreen Currency Corporation Case**[5] and the **Shoreline Currencies Case**[6] the dispute was between the company and the Corporate Affairs Commission. No other industry association intervened in either case to draw to the court's attention the relationship, from its perspective, between the exchange traded and the derivative markets or the policy objectives of the statute. It is a fair assumption that the kinds of criticism of the effects of the judgments which have been made subsequent to the decision were not debated in court. It is unsatisfactory to rely on the courts to resolve the scope of the extremely complicated statutory definitions if their rules are not wide enough to enable all interested parties to intervene in the proceedings.

It would be far simpler if the legislative restrictions which affect matters such as formal validity of contracts could be based as far as possible on characterisation of the participants - whether they are sophisticated investors or consumers. Regulation based on the characteristics of the contracting party is preferable to a system based on identification of the key characteristics of the contracts because, as the speaker relevantly notes, derivative contracts mimic transactions in the physical markets thereby complicating the issue of characterisation. It makes sense for regulations intended to promote investor protection to focus on the characteristics of the investor.

A licensing system for dealers may help to exclude the sharp, incompetent and financially unsound as dealers. A licensing system already exists in relation to the authorisation by the Reserve Bank of dealers to trade foreign currencies under the *Banking (Foreign Exchange) Regulations*. The two basic criteria applied by the Reserve Bank are first, that the applicant must satisfy a minimum shareholders' funds requirement and secondly, that the applicant must demonstrate sufficient expertise in dealing in foreign exchange. The first criteria relating to creditworthiness may be unnecessary for those dealers which are already subject to prudential requirements of an existing regulator such as the Reserve Bank of Australia. The second criteria recognises that special skills and experience are necessary for a dealer to conduct FX operations. The same probably applies to a treasury operation dealing in swaps and other derivatives.

Assuming there are investors in the market who need protection, (a matter disputed by industry participants who maintain that end users are mainly large and sophisticated corporates) should the legislation spell out in detail the form such protection should take? It would be wrong to assume that there is not already some protection under common law for so-called retail investors. Leaving aside any contractual arrangements between the dealer and its customer and any available statutory claim, for instance based on section 52 of the *Trade Practices Act*, there is a possibility that a dealer which recommends its customer have recourse to the over-the-counter market may owe a duty of care to the customer and be liable to the customer for economic loss suffered by it due to the dealer's negligent advice or, where no advice is given, the dealer's failure to give advice or warn the customer in connection with the outcome of any dealings by the customer. Existence of a duty will depend on all the circumstances surrounding the relationship between dealer and customer such as the degree of reliance that the customer places on the expertise or experience of the dealer. The relevant common law principles are set out by the High Court in its decision in **San Sebastian Pty Ltd v Minister Administering the Environmental Planning and Assessment Act**,[7] in relation to negligent misstatement and in **Rogers v Whitaker**,[8] in relation to liability for failure to warn. Neither case concerned advice given, or which should have been given, by a financial institution but there have been numerous cases before other courts, mainly concerning foreign currency loans, where the principles have been applied to banks.

If the court finds there is a special relationship, it will need to determine the standard of care required of the dealer to discharge its duty to the customer. The standard will vary from case to case depending on the circumstances. This flexible response to protection of the investor on a case by case basis will be lost if specific detailed rules relating to disclosure requirements are written into the law. It is notable that the submission made by the Sydney Futures Exchange in response to the ASC Discussion Paper, whilst generally advocating more regulation of the over-the-counter markets, advocates a lessening of regulation for exchange trading, citing as one example the statute mandated disclosures imposed on brokers in relation to professional clients.

FOOTNOTES

1. See page 5 of the ASC Discussion Paper.

2. The report is titled 'The Supervisory Recognition of Netting for Capital Adequacy Purposes'. The separate report titled 'The Supervisory Treatment of Market Risks' issued at the same time is not discussed here.

3. The liquidator's rights to disclaim onerous property is set forth in section 568 of the *Corporations Law*.

4. If, following netting by the counterparty, the bank is liquidated within the preference period the effect of section 16(1) may become relevant if any recovery made by the counterparty by exercise of a set-off is challenged under the antecedent transaction provisions.

5. (1987) 7 NSWLR 705.

6. (1986) 10 ACLR 847.

7. (1986) 162 CLR 340.

8. (1992) 109 ALR 625.