COUNTERPARTY RISK AND NETTING OF EXPOSURES IN FOREIGN EXCHANGE, MONEY AND SECURITIES MARKETS

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This actually is a rather complicated subject. It reminds me a little bit of the chap who fell out of a fourth floor window during a brawl and kicked up a terrific fuss when he landed. The police rushed out and said "what's happening, what's happening?" and he replied "I don't know, I just got here myself!"

The subject is difficult because you cannot see the asset we are dealing with. Debts are intangible-invisible-untouchable, totally odourless, not harmful to the ozone, you cannot jump in a debt and race it down the motorway, you cannot cuddle a debt in a taxi, you cannot see it. But nevertheless, the debts (not that I would ever get the chance to cuddle anything in a taxi!) - nevertheless, debts do have personalities. They live and die, they have a life. And when you get two debts owed reciprocally, you get the effect of a mortgage. So the subject we are discussing is very similar to the law of mortgages.

To give you an example - if one counterparty in a market owes \$100,000,000 and is owed \$100,000,000, then if he can set those two off on the insolvency of the counterparty he is secured - the effect is he has an exposure of zero. But if he is wrong on that exposure, then he has an exposure of \$100,000,000, not zero. Exposures of that size would be regarded as fairly small in some markets, for example foreign exchange markets. If one counterparty gets the law wrong, and it is very ticklish law, it is highly technical and difficult, then he might go down, taking with him his counterparties and possibly taking down those institutions which provide credit to the market - what the BIS calls the systemic failure, which brings about rolling domino insolvencies.

I am going to deal mainly with foreign exchange, but what I say will apply equally to commodities markets, futures markets (which is just like an ordinary sale of goods issue) and to financial markets like futures and options, which often involve debt claims for differences; it also applies to securities markets which are just the future sale of securities.

The objects of netting are three-fold.

The first is to deal with the settlement risk or the delivery risk.

The second is called market netting - there are many names for it - replacement cost. If you have two contracts with a counterparty for securities, commodities, foreign exchange, and a counterparty becomes insolvent while the contracts are still open - in other words the delivery date had not arrived - and one contract showing a profit of 5 and the other a loss of 5, if you can cancel those two contracts and net out the profits and the losses, pluses and gains, the exposure is zero.

Thirdly, if you can reduce those amounts, these vast sums of money to fairly small amounts, the saving in transaction costs and paperwork is absolutely enormous. The fact of the matter is the clearing systems for cheques and payments, securities, would completely collapse if it wasn't for netting - whether or not the netting works on insolvency.

The object of netting then will be reduce capital adequacy requirements, improve the balance sheets, and lessen the requirements for margin and generally reduce expenses.

So the question is, does it work?

Now so far as settlement netting is concerned, when the second contract is entered into so as to result in a netting of both currency deliveries, it is essential to ensure that it must not be preferential. Now the BIS thought after a survey of the world's laws, that that would be preferential. I do not understand why this is so, because to me, provided it is for full value, I do not see the improvement in position.

In any event, in Australia and in England, motive would be required - preferential motive would be required to have that netting set aside. Usually the object of a counterparty is not to improve your position, but simply to do a deal.

The second requirement relates to the netting of the open contracts on insolvency, and this is where the trouble starts. There are two requirements for it to work. First of all it must be possible for one party to rescind the contracts. He must be able to cancel them. And secondly, he must be able to set off the resulting losses and gains. Remember, there is a gain on one side of 5, a loss on the other side of 5 - exposure is therefore zero; but if you cannot do that, then it is an exposure of 5.

Let us consider rescission first - that is the cancellation of open contracts on the insolvency of a counterparty. This has given rise to discussion about whether a liquidator can "cherry pick". Cherry picking is the selective performance of contracts profitable to the insolvency state and the cancellation of those not profitable. If the liquidator can perform some contracts and cancel others then one cannot net off the 5 and 5 and exposure is 5 and not zero. The position in England and here is that contracts for unascertained assets like grain, and say oil in a tank, provided they are not identified, can be cancelled on insolvency of the counterparty. They are not assets of the estate. There is plenty of case law to justify that proposition. There is no freeze on the rescission of executory contracts. There is not even a freeze in the case of rehabilitation proceedings. Executory contracts can be cancelled, and there is a good reason for that because when you are dealing with an insolvent estate it makes no sense to keep the main executory contract alive which is a sale of goods contract. Why? Because goods are perishable and because the market is very volatile.

In other countries the position is completely different. In the pro-debtor group of central European states - France, Spain, Belgium, Luxemburg - there are statutory stays on the cancellation of executory contracts on insolvency, therefore, the liquidator can cherry pick. In the United States there is also a statutory stay except where you are dealing with a bank.

So you see when one is dealing internationally there is a problem because dealers cannot sit with Dicey's *Conflict of Laws* beside them when doing deals. One is faced with this huge disparity of international approaches.

The solutions we are using to get round this stay on rescission are four-fold. The first is to treat a whole series of contracts - foreign exchange, securities, commodities, swaps - as one legal unit. We say "these are indivisible, they are linked, they are just all part of one transaction", by contract. It is a well established proposition that a liquidator who takes one part of a transaction must take the whole transaction. You cannot take the benefit without the burden, you cannot have the cream without the crust - provided it is just one pie. Does it work? We do not know.

The second technique is to cancel all of the contracts automatically by contract just before the liquidation petition, the point at which the freeze operates. Does it work? We do not know. and certainly I have not come across any law on the subject anywhere.

The third technique is to have an exclusive jurisdiction clause, so that if you are operating from Australia which is very sympathetic to netting, then you will try and bring the foreign liquidator home into this jurisdiction so that he would be subject hopefully to your insolvency laws. Do derogation clauses work? Sometimes they do, sometimes they do not, it depends where you are. Also of course if you yourself have a claim against the liquidator in the foreign forum, then to the extent you have got more at home than you should have got, normally most jurisdictions will require you to equalise in the home proof. Right, that's so much for rescission.

The second requirement I said was set-off. Set-off rather reminds me of the parrot, the magician's parrot on the Titanic who is a marvel at making things disappear, and when they were out in the ocean sitting on their log, the parrot looked round and squawked: "OK clever boy, what have you done with the ship?" Set-off, as I said, makes debts disappear.

Now there again, for this to work, you have to be able to set the debts off against each other. Unfortunately again, we come to this huge disparity of international attitudes as to whether you can have set-off on insolvency. Some states say you can on grounds of fairness. Other states say the effect of a set-off is a payment, which it is, so one creditor offends the fundamental notion of pari passu payments.

In this area we again find that there is more or less the same grouping of states but with some differences. States, for example, which allow set-off are England and its environs - Jersey, Guernsey, Ireland, Scotland - Germany, Austria, Switzerland, Italy (since 1942), Sweden, Norway, Finland, Netherlands. In your region Thailand, Japan, Korea, Singapore, Hong Kong, China (but very hesitant at the moment), probably not the Philippines, but I have not looked into it. The no states are again the Napoleonic group - France, Belgium, Luxemburg, Spain - Greece, Portugal, South Africa, Bahrain, Egypt, Kuwait, the whole of Latin America except Panama. Uncertain states are those with no bankruptcy law like Russia, Saudi Arabia and the UAE. So there you are you see again life is impossible so long as we have this mosaic of jurisdictions with completely different solutions.

There is another risk which I will turn to now, what I call the intervener risk. In many markets brokers act as agents on behalf of their clients. Sometimes they act as undisclosed, they do not identify their clients, in which case they are still an agent or sometimes they pretend they are acting as principal in which case the principal can come out from behind the arrows and take over the claim. Now wherever you have brokers acting as agents, as known agents, netting is impossible, it cannot be done. Because if client No. 2 goes "bust" and you try and set off that claim, you are using client 2's money to pay client 1's debt. It is not mutual. So any market which operates otherwise than on a principal to principal basis is doomed.

Let me turn to a claim owed to the counterparty when it is taken over by an assignee. The rules here are rather different. In our jurisdictions, in the common law jurisdictions, provided both claims are incurred before you hear about the intervener, both claims are incurred and provided there is a contractual right of set-off, there has to be a contractual right of set-off (I cannot go into it, it is too technical), but there has to be a contractual right of set-off in practice.

Now in the case of markets, if the counterparty sometimes acts as principal, sometimes as agent, and you do not care one way or the other, then you may be fixed with knowledge that he is acting as an agent, in which event the moment you get that notice and if you incur claims after that there is no set-off. There is a very low threshold of notice so far as organised markets are concerned in England.

The next risk to be borne in mind is the moratorium risk. Many corporate rehabilitations result in the postponement of claims by voting. So if you owe a claim which has matured, the price, or a Forex claim to a counterparty, and he owes you a claim which has been postponed by the "surprise" moratorium, then you have to pay the counterparty. The debt has become due - but he does not have to pay you, and there is no set off, because the other claim is not due. Generally speaking, in most jurisdictions, one does not get caught like that without being able to accelerate beforehand. Normally the moratorium is preceded by some sort of notice of a creditor's meeting or notice of a petition, but not invariably. I am unable to go into jurisdictions - but generally speaking the position is better than it is on freezes on rescission of executory contracts.

There are a series of other risks, for example contracting post-petition, the contract may be vulnerable. One has to make sure that damages calculations satisfy the normal rules about liquidation of damages, that Hornbook law - I do not need to tell you about that - and of course there is the problem everywhere about whether the margin is preferential. It is not preferential if it secures new money of equivalent value, of equivalent consideration, usually. Is a fluctuation in values or a set of new contracts which increases an exposure thereby attracting margin - do either of these "represent" new money? I do not know.

The use of clearing houses may have a significant impact on issues of set off. The decision in *British Eagle International Air Lines v Compagnie Nationale Air France* ([1975] 1 WLR 758) is very important in assessing how one sets up the clearing house arrangements. If A goes bust, if A is a bank, a clearing bank for instance, then X and Y cannot set off their profits and losses - if X has got a profit Y has got a loss - because they are not mutual there is no set off. The world's payment systems are very vulnerable to that because they try and do that set-off non-mutually. The world's payment systems are inherently weak because they are not mutual and you will not obtain a mutual set-off.

What is now being done, particularly in relation to foreign exchange, and has been done in relation to commodity clearances for many many years now, is to put a clearing house in the middle. As principal the clearing house acts as principal - it is creditor and debtor, it buys and sells as principal. You either get the contracts to the clearing house by novation or you make the dealers agents of the clearing house, or you just establish the privity by the articles of association of the clearing house, there are many methods. The effect of that is that if A goes down then A and the clearing house are in a mutual position. In a European foreign exchange clearing house, it has been calculated that something like $100,000,000 will go through this clearing house every minute and the reduction of exposure is 96% - 96% by that very simple little technique.

In every town, certainly in the City of London, there are a lot of legal aunties around. I do not blame them, I am probably a bit of a legal auntie myself about some things. Because the risks are so big and because one always has that feeling - I can reason it out, I can make sense of it, barking dogs do not bite, I know the proverb, you know the proverb, but does the dog know the proverb? Are the courts going to honour what seems to me to be common sense - there is always that niggling doubt. And it was as a result of that that in 1989 Parliament passed legislation which sanctioned netting on insolvency. It does this by a lot of very complicated sections, but there is only one section which matters: it says that the default rules of investment exchanges and clearing houses - it only applies to these recognised clearing houses and investment exchanges - will be enforceable. Basically it just overrides insolvency law. The reason for that was that it was felt there were a lot of doubts and the Bank of England said "to hell with the lawyers, let us just have some legislation which makes it absolutely clear".

Now we did not really need this, except on the edges. But if you now introduce new insolvency legislation in this country, it is absolutely essential that you bear this in mind. The operation of financial market requires the ability to net. That means there must be no stay on executory contracts and the set-off must be preserved. Now in the case of New Zealand, if New Zealand banks wish to participate in these clearing houses which have been set up in New York, Tokyo, London, there could be a penalty against them, because the other banks who are guaranteeing these clearing houses are going to say "well, we cannot net against you therefore we run a bigger risk so far as you are concerned - deals with you are concerned". And so that will attract a cost.

I very much hope that in your legislation, if you do bring it in, this will be borne in mind. I would like to see the laws around the world operate on the same basic rules.

Mr Chairman, I am reminded of the after-dinner speaker who said that he had brought along two speeches. He did not know which one to give. He had a short one and there were cheers and he had a long one and there were groans, and he decided to give them both and there was an appalled silence. The short one was "thank you" - the long one was "thank you very much".