CAPITAL MARKETS - RISK MANAGEMENT PRODUCTS (PRACTICALITIES, DEVELOPMENTS AND PROBLEMS)

CURRENT ISSUES

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INTRODUCTION

Without doubt the biggest current "legal" issues confronting the risk management products markets are:

- standardisation of documents, and
- netting.

I shall be explaining today:

- the increasing trend towards the ISDA Master Agreement for documenting all types of risk management products (these include interest rate and currency swaps, interest rate options, FRAs, forward bills, currency options, foreign exchange contracts, bond options, equity indexed options and commodity swaps)
- why parties want to net
- two issues in the netting debate being:
  - the right to terminate if a winding up order is made
  - s16 of the Banking Act versus s86 of the Bankruptcy Act.

STANDARDISATION OF DOCUMENTS

Traditionally a number of factors have militated against getting master agreements signed for the various types of risk management products.

(a) There have been many "standard" documents produced for various products. For example:

  - for swaps there was AIRS followed by ISDA
  - for currency options - the London Interbank Currency Options Market ("LICOM") terms

- for FRAs - the "ABAFRA" terms have been under development for some time

- individual banks have developed their own documents for corporate counterparties.

The variety of documents has made it difficult for operations personnel to come to grips with and finalise documents with counterparties.

(b) In the interbank market participants often take the attitude that the counterparty will not default therefore they do not really need a master agreement.

(c) In the corporate market it is a buyer's market and the corporate says "if you want to send me a complicated 20 page document, don't bother because I'll go down the road".

(d) The documents can be complex and there is a natural tendency to put them in the too hard basket.

However, there is a growing trend to "get houses in order". This is being driven by an increasing concern about credit exposures to counterparties and in particular a desire to be able to net.

The most important trend in relation to documentation is that more and more banks worldwide are moving to document as many products as possible both in the interbank and corporate markets under the ISDA Master Agreement. The International Swap Dealers Association, Inc (as its name suggests) started life in 1985 as an association of interest rate and currency exchange dealers. The 1987 master agreement published by ISDA uses terminology which at first glance would suggest that the document is restricted in its use to interest rate and currency swaps.

However, it was soon recognised that it could be used as a master agreement for various other types of risk management products. This led in 1989 to the publication by ISDA of an addendum relating to caps, collars and floors which was followed in 1990 by an addendum relating to options (principally currency options).

The Australian swaps market did not originally use the ISDA Master Agreement. Instead in 1986 the AIRS terms were developed and signed by most Australian counterparties. AIRS was used for most domestic $A interest rate swaps almost exclusively until about 1990. In 1990 AFMA published the first version of its Guide to using the ISDA Master Agreement under Australian law. At that time the guide was limited to interest rate and currency exchange agreements.

In 1991 an updated version of the Australian ISDA Guide was published. The range of products covered was expanded to also include interest rate caps, collars and floors, swaptions, bond options and currency options. A number of those products had not previously had any market standard wording.

There will be a further version of the Australian ISDA Guide published in about September 1992 which again will contain some significant updates and changes. The most important of these are:

- ISDA is about to republish its master agreement. There are many aspects of the document which will be updated. Some of these are:

- It will now be called the ISDA "Master Agreement" (ie the term "Interest Rate and Currency Exchange" will be deleted from its title and "Swap Transaction" will now be referred to as "Transaction"). This is a change to reflect that the master agreement will be used for many transactions other than interest rate and currency swaps.

- It will have wording reflecting that some products involve deliveries of commodities in difference to payments of amounts.

- The termination provisions have been significantly rewritten. The document will now contain an option for the parties to agree on using either the limited two way payments (where the defaulting party does not receive full value for terminated contracts profitable from its perspective) or the full two way payments (where the defaulting party does receive such full value) method of calculating amounts payable on early termination.

- The additional tax events recommended by ISDA in 1988 will now be incorporated in the master agreement. This picks up the situation where a party receives a payment subject to a withholding in difference to a party obliged to gross up in respect of a payment due to be made by it.

- The time when parties are legally bound to transactions will be clarified.

All this will mean that parties will need to review their existing master agreements with counterparties and decide whether to update to the new master agreement. ISDA recognises that this may involve some counterparties in significant administration in updating their master agreements with counterparties. However, the choice was to forever leave the master agreement in its current form or to update it to reflect market changes and concerns which have arisen over the last five years. On balance, I think it is a good development for the document to be updated but parties need to realise that resources will need to be devoted to updating existing master agreements.

- An FRA addendum will be included.

- A Forward Bill addendum will be included.

- An FX addendum will be included. This will probably be the most significant development. Traditionally, FX contracts in the interbank market have not been subject to any master agreement and the FX markets have traditionally been separate from the swap markets. The move to have FX documented even in the interbank market under a master agreement is driven by netting.

NETTING

Many banks have been actively reviewing for some years how they can manage and control, by entering into netting arrangements, risk arising in relation to risk management products.

In early 1991 these efforts were focused into a committee called "The Australian Netting Working Group" which comprises members of Australian Bankers' Association, Australian Merchant Bankers' Association, Australian Financial Markets Association, Australian Treasury Operations Association, Foreign Exchange Market Consultative

Group, a selection of other licensed banks who are not members of ABA and the legal firm Mallesons Stephen Jaques.

The aim of the group was to facilitate the adoption of netting in Australia.

It is important to recognise that there are two main benefits which can flow from netting:

(a) it reduces credit limit usage;

(b) it will achieve savings in capital adequacy requirements once the RBA adopts netting for capital adequacy purposes.

The first is relevant to any entity which trades with another subject to credit limits. The second is relevant only to those institutions subject to the RBA's prudential capital requirements.

Importantly it is not necessary for the RBA to have first accepted netting for capital adequacy purposes before a party can start netting for credit purposes. Indeed the RBA has made it clear that it will not alter its capital adequacy rules until it is satisfied that a large number of banks are netting for credit purposes.

It is therefore important for all banks to actively review their policy on netting for credit purposes.

To assist banks in this process the Netting Working Group has produced a guide for implementing netting. It contains a step-by-step recommended procedure as well as a complete copy of the Submission made to the RBA by the Netting Working Group in October 1991.

This submission recommends the adoption of the netting approach known as netting by close out using a master netting agreement for credit risk assessment purposes of treasury risk management products. (By close out, I mean having the right to terminate all contracts on default and calculate damages by reference to the replacement values of the terminated transactions). A suggested method by which risk adjusted assets could be calculated for capital adequacy purposes using the netting technique is contained in the submission.

The RBA has not yet responded formally to the submission. It is hoped that there will be a response within the next few months particularly once the BIS releases its long awaited report on how to assess risk on a net basis.

Obviously, the critical question which must be asked when someone propounds the adoption of netting is - Does it work legally?

I think it is fair to say that there is overwhelming agreement among most lawyers on the fundamental issues surrounding netting such as the effect of s86 of the Bankruptcy Act. Today, I do not propose to comment on all the issues surrounding netting which arise in the context of risk management contracts. Instead, I am going to concentrate on two issues only being:

- the right to terminate if a winding up order is made, and
- s16 of the Banking Act versus s86 of the Bankruptcy Act.

Right to terminate if a winding up order is made

Generally the argument which is put on the right to terminate on the winding up of the counterparty is as follows:

(a) if you have a contractual right to terminate on the winding up and calculate a replacement value, then this would be enforceable;

(b) if the replacement value is not an Australian dollar amount, you can ensure that a s86 set-off will be available by having a contractual right to convert the foreign currency obligation into Australian dollars. You would therefore pass the commensurability test.

These conclusions have been based on the following principles:

- Section 301 of the Bankruptcy Act (which makes void a provisions in certain types of contracts with individuals which permit their termination on bankruptcy) does not apply to corporations.

- The common law principle enunciated in **Ex parte Mackay** ((1873) LR 8 CL App 643) does not apply, namely that a court will not give effect to a contract which provides that if one party becomes bankrupt, the other party (ie the solvent party) is then to get some additional advantage which prevents the property of the bankrupt being distributed under the bankruptcy laws. This is because the solvent party is still bound by the laws of set-off and by terminating, the solvent party cannot remove any of the insolvent party's property from the liquidation which would otherwise be available for distribution.

It is appropriate to make some observations about both of those principles.

- Section 301 Bankruptcy Act.

  The Corporate Law Reform Bill contains a proposed s564A which would effectively incorporate s301 of the Bankruptcy Act into the Corporations Law. This could seriously impact on the efficacy of master netting agreements which permit termination of contracts on a winding up. It appears from the Explanatory Memorandum of the Bill that s564A was not intended to cover risk management contracts and it is to be hoped that this will be rectified in the final version of the legislation. The Law Council will be making a submission to the Attorney-General's Department to this effect.

- Common law principle.

  It is possible to mount an argument as follows (this argument is more fully expounded in a paper on set-off by Rory Derham in the November 1991 *Journal of Business Law*).

  — Certain obligations under risk management contracts can be classified as obligations to deliver commodities, eg the obligation to deliver foreign currency under an FX contract.

  — An obligation to deliver a commodity is not capable of being the subject of a s86 set-off. There are two reasons for this:

(a) the perceived difficulty in producing a balance on the account when one of the demands is not a money claim;

(b) the wording of s86 which says that the 'sum' due from one party shall be set-off against the 'sum' due from the other.

— Accordingly, in the absence of a netting agreement there may be a doubt whether foreign currency obligations under an FX contract can be the subject of a s86 set-off.

— Does a netting agreement help? There are a number of cases from which a principle can be formulated that a contract will be void if it provides for something to occur upon the occurrence of a liquidation which would result in preferential treatment for the creditor as against the general body of creditors.

— A netting agreement which allows you to convert an obligation to deliver a commodity into a money obligation in order to obtain the benefit of a set-off could infringe this principle.

— The infringement could occur as follows. Assume there was no netting agreement and the insolvent had entered into a number of contracts with a particular counterparty. At the time of winding up some were profitable for it and others were not. In such circumstances it would be less advantageous for the solvent party if the liquidator were to disclaim the unprofitable contracts and obtain an order for specific performance of the profitable contracts. This is because the solvent party would be obliged to give full value to the insolvent for the profitable contracts while being entitled only to a dividend in the insolvent's estate for the damages to which it was entitled in respect of the disclaimed contracts.

However, a netting agreement usually adopts one of the following approaches:

(a) the solvent party would be entitled to terminate all contracts and prove for the sum of damages due to it on profitable contracts and not give value to the insolvent for unprofitable contracts (the so called limited two way payments approach); or

(b) the solvent party would be entitled to terminate all contracts and set-off the values of profitable contracts against the values of unprofitable contracts (the so called full two way payments approach).

In either of these cases the solvent party would be in a better position than if it was forced to perform contracts profitable to the insolvent.

Accordingly, it could be concluded that the termination under the netting agreement is unenforceable because the contract provides for something to occur upon the occurrence of a liquidation which would result in a different distribution in the liquidation in comparison to what would have been the case if the change had not occurred.

Although there are a number of aspects of this argument which can be challenged (eg that foreign currency obligations should be viewed as obligations to deliver commodities - or, at least, non monetary obligations - and whether a court is likely to order specific performance) there is enough authority to support the argument to warrant closing off the risk that the argument could be successful.

Solution. The suggested solution is to have all contracts documented as part of a single contract with an express provision under which the parties agree either:

(a) that the right to seek specific performance is negated unless all obligations under the contract are to be performed; or

(b) that each obligation of each party to pay an amount in respect of a transaction is subject to the condition precedent that no event of default (one of which would be the making of a winding up order) has occurred in respect of the other party.

Two things would flow from this approach:

(a) because all transactions would form part of a single contract a liquidator would be obliged to disclaim all transactions (including those which were profitable for the insolvent); and

(b) the arguably objectionable element of the netting agreement would not apply because, since a liquidator would not be able to seek specific performance of profitable contracts, the insolvent would not be able to improve its position by keeping those contracts on foot.

On one view this approach would mean that the solvent party would not need a contractual right to terminate on insolvency because it would simply give a 28 day notice to the liquidator asking whether the liquidator proposed to disclaim the contract. If the liquidator disclaims, the solvent party would have a damages claim against the liquidator for profitable contracts from the solvent party's perspective. However, interestingly, the liquidator would not have any common law or statutory claim against the solvent for those parts of the contract which were profitable for the insolvent.

For this reason, subject to the provisions I have suggested be included in the netting agreement, a contractual right for the solvent party to terminate on a winding up order being made also should be included and should be enforceable.

It should be included because it will give the solvent party the right to terminate immediately the winding up order is made and not have to wait for the liquidator to make a decision whether to disclaim. The market could move adversely in the interim.

It should be enforceable because the solvent is not being put in any better position. Because no part of the contract is specifically enforceable, the liquidator cannot "cherry pick". If the liquidator chose not to disclaim, the act of terminating by the solvent will result in the liquidator receiving the net mark to market position of all transactions. The only other way this could be achieved would be by the liquidator performing all transactions both profitable and unprofitable.

If the liquidator cannot obtain specific performance, a netting agreement which contractually gives full value to the insolvent for contracts profitable to it actually improves the position of the insolvent because it would not otherwise be able to get value for contracts profitable to it. Therefore a netting agreement which gives such value to the insolvent should not be voidable by the liquidator.

In the context of the ISDA Master Agreement this potential problem is already largely covered. This is because s2(a)(iii) of the ISDA Master Agreement provides that each obligation of each party to pay an amount in respect of a transaction is subject to the condition precedent that no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing. It is difficult to see how a court could order specific performance of particular obligations of the solvent party in the light of such a clause.

However, it is thought desirable to make amendments to the ISDA Master Agreement to make it even clearer that all transactions form part of a single contract.

Once the 1992 version of the ISDA Master Agreement is published I shall be issuing a supplement to the guide for implementing netting which will incorporate this conclusion. I am waiting for the new version to be published because there are amendments being made which otherwise will impact on the recommendations for amending the ISDA Master Agreement which are contained in the guide for implementing netting. Overall my recommendation for those wanting to adopt netting for credit purposes using the ISDA Master Agreement is to wait for this supplement which should issue within the next month or so.

Section 16 of the Banking Act versus Section 86 of the Bankruptcy Act

Sections 16(1) and (2) of the Banking Act are as follows:

> "16(1) In the event of a bank becoming unable to meet its obligations or suspending payment, the assets of the bank in Australia shall be available to meet that bank's deposit liabilities in Australia in priority to all other liabilities of the bank.
>
> (2) Unless otherwise authorised by the Reserve Bank, a bank shall hold assets (other than goodwill) in Australia of a value of not less than the total amount of its deposit liabilities in Australia."

The fundamental issue is whether "assets" in s16(1) mean the assets of the bank before s86 is applied or the "assets" remaining after s86 is applied.

If the former and assuming there is no netting agreement, the argument is that the solvent party would be obliged under s16 to hand over the mark to market values of all transactions profitable to the bank without being entitled to set-off under s86 the mark to market values of all transactions unprofitable to the bank. The solvent party would be left to prove for the values of transactions unprofitable to the bank.

In saying this I have made an assumption that the "asset" in the risk management contract context is the mark to market value of the contract. Herein lies a problem. What if the contracts are not terminated on insolvency of the bank? What then is the asset? Is it the bank's right to receive a cash flow on its side of the swap? In other words would this mean that the solvent party would be obliged to meet its obligations under the swap but the bank would not be so obliged? Surely not, but expressing the problem in those terms does highlight the deficiencies of s16 when an "asset" is part of a bundle of rights and obligations. I shall come back to this point later, but for the moment I am going to assume that the mark to market value of each transaction profitable to the bank is an "asset" and the mark to market value of each transaction unprofitable to the bank is a "liability".

If you read s16(1) in isolation from s16(2) you can mount a very strong argument that "assets" in s16(1) is referring to net assets after the application of s86. This is because there is a very similar phrase used in s501 of the Corporations Law which says the "property of a company shall, on its winding up, be applied in satisfaction of its liabilities equally". Section 501 must be read in conjunction with s553 of the Corporations Law which imports s86 of the Bankruptcy Act with the result that it is clear that the words "property of a company" in s501 means that property existing after the application of the set-off rules in s86.

The argument then runs that there is no inconsistency between s16 and s86. Section 16 is dealing with priorities in the distribution of assets in the context of an insolvency administration. Section 86 is dealing with what constitutes assets. Therefore "assets" in s16(1) should mean assets remaining after the application of the set-off rules in s86.

However, the issue is complicated by s16(2). Section 16(2) imposes an obligation on a bank always to be holding assets (other than goodwill) in Australia of a value of not less than the total amount of its deposit liabilities in Australia.

The argument can be made that "assets" in s16(1) must have the same meaning as "assets" in s16(2) otherwise there would be no point in including s16(2) in the legislation. The argument goes therefore that because "assets" in s16(2) must be measured pre-insolvency without the application of set-off rules, similarly assets in s16(1) must be so measured.

This would mean that a solvent party could not set-off the mark to market values of profitable and unprofitable contracts in a bank's insolvency and only be obliged to pay over the net amount. This is said to be consistent with the fundamental purpose of s16 being to maximise use of the insolvent bank's assets to meet deposit liabilities.

If this argument is correct there are some interesting aspects to it:

(a) if it was the legislature's intention to override s86 which is a fundamental principle of bankruptcy law it could have been expected that this intention would have been expressly stated;

(b) a court might have to selectively apply s86. For instance, what would be the position if a bank had breached s16(2) and a depositor with the bank also had a loan from the bank? The depositor could recover all its money through a set-off but if it could not set-off, it would recover less than 100 cents in the dollar. Would the court grant it a set-off right?

(c) it seems fair to say that "assets" which comprise part of a bundle of rights and obligations were not in the contemplation of the drafter of s16. This is clear when one examines Form D in the Banking Act which lists as assets things such as coin and bullion, Australian notes, cash with the Reserve Bank, Australian public securities, loans to authorised dealers, bank premises etc. These are all items which have a clear independent value. The final item on the list is "all other assets". Risk management contracts will fall into this category. But how do you value them?

Interestingly, the current practice of the Reserve Bank is that the value of risk management contracts is not taken into account in the s16(2) calculation. However, it could be expected that if a bank became unable to meet its obligations, the Reserve Bank or the liquidator would seek to apply the proceeds of such assets in meeting deposit liabilities. This gives force to the argument that a different meaning of "assets" can apply as between s16(1) and s16(2).

(d) a bank could comply with s16 and actually be less prudent overall. Here is a very simple example and I realise that it ignores the capital adequacy guidelines and it ignores the Reserve Bank's practice of not taking risk management contracts into account for s16(2) purposes. However, the example still illustrates what I believe to be a valid point. Assume the only assets and liabilities of a bank were:

1) A deposit of $1m.

2) An in the money FX contract having a mark to market value of $1,100,000.

3) Ten out of the money FX contracts having an aggregate mark to market liability of $10m.

If the overall net position of the FX contracts was applied, clearly the bank would be in breach of s16(2). But if only the asset in 2) is compared with the liability in 1), the bank would not be in breach. It seems curious that an interpretation of s16(2) could be supported which allowed a bank to be less prudent than if the net position was used for s16(2) purposes. I realise that there is a counter argument to this being that s16(2) is not concerned with non-deposit liabilities - it is only concerned with ensuring that depositors are repaid. But it still seems a curious result.

My conclusion is that there are some unsatisfactory aspects of s16 when one seeks to apply it in the context of risk management contracts in the absence of a netting agreement.

It would be helpful if s16 were amended to make it clear that in both s16(1) and s16(2) "assets" means assets which would remain after the application of statutory set-off rules.

But in the absence of such an amendment I consider that the better view is that any potential difficulties with s16 can be avoided by an appropriately worded netting agreement. If all the transactions form part of a single contract such that the "value" of the contract if there is a default at any point in time both before and after insolvency is the overall net mark to market position, it is difficult to see how a court could go behind the terms of the contract and rewrite it so that each transaction had its own value for the purposes of s16. True it is that each transaction has its own consideration and that it is possible to argue that each constitutes a separate asset. However, if the parties expressly agree that performance of one obligation is dependent on performance by the other party of all obligations under all of the transactions or that it is a condition precedent to performance of an obligation that no Event of Default has occurred in respect of the other party, then it is difficult to see how a court could properly override the expressed intention in order to allow s16 to operate.