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

QUESTIONS AND ANSWERS

Question - Tony Rumble (Macquarie Bank, Sydney):

Two questions for Philip Wood. First, Tony Shea took some time in the *International Financial Law Review* to comment on a paper that you had written and I just wondered if you could respond to his points and secondly, the Bank of International Settlement has preferred multilateral netting by novation and substitution, and I just wonder if you could comment on that?

Response - Philip Wood:

So far as Tony Shea's article was concerned, he disagreed with something I had said about the nature of foreign exchange contracts. It was an executory contract to exchange money. It didn't give rise to reciprocal debts. And that has a number of very important legal consequences. I subsequently wrote a letter to the IFLR in which I went through his points and I think he conceded defeat - I think so. There was just a misunderstanding, I don't think one burns people at the stake for that sort of thing and it is rather a subtle point. But I think he has withdrawn really what his position was and actually we agreed on the one fundamentally important point that in England there ought to be no problem subject to certain caveats about preferences and so on. There ought to be no problem about netting and the same in Australia.

Your second point is about novation netting. The DIS report was very much influenced by the Fed and I think it has become clear in the discussions over the past couple of days that the policies in the United States are very different from the policies in England. And the techniques used to make netting work are very much directed against those jurisdictions where it doesn't work - you know, which stay executory contracts, which stay set-offs and so on, and subject to the various exceptions which David has pointed out.

One of the important techniques which they thought would get round various problems on delivery netting was when contracts were entered into you treated existing contracts and the new contracts as just being one big consolidated contract. The object of that is that the liquidator or the trustee in bankruptcy would not be able to take one bit of the contract and not other bits. It is an attempt to create this connexity, this linking so that the liquidator can't have the benefit without the burden. Whether it works or not is very much I suppose up for grabs. But that is a matter of foreign law. That is the origin.

I actually think that there are serious dangers involved in this contract consolidation process, which is to do with the fact that if you have got existing contracts and then you consolidate them again, you discharge the existing contracts and you bring them into a new contract, you are bringing existing contracts into red periods against build ups of set-offs and that sort of thing. And I think that is dangerous.

Question - Rory Derham (National Australia Bank, Melbourne):

First of all could I just ask a question. You mentioned that in England you have got these amendments which allow setting off provided you go through a clearance system - I presume by that you mean the FX Net System. What percentage of foreign exchange contracts go through that sort of system and what sort of percentage are dealt with outside of the system?

I would also make a comment on another one. I think you mentioned on the preference point in Australia that there is no problem because there is no intention to prefer. In fact in Australia we look only at the effect of the transaction, we don't look at intention to prefer. I think that is the High Court in *Richards'* case. If you accept that, then we have got a problem with settlement netting, the reason being of course that if you settle and at the time you have notice of insolvency at the other bank, it may be a preference if you work on the assumption that the obligation to deliver foreign currency is an obligation to deliver a product and not a debt, because of the *Washington Diamond Mining* case. If you can't have a set-off in the liquidation, a settlement prior to a liquidation would be a preference. So it seems to me we do have a problem in Australia on settlement netting that you don't have in England. If you would comment on that and also on the first question please.

Response - Philip Wood:

Well, it has been a great pleasure to meet you Rory. Rory Derham, as you know, has written an excellent book on set-off. I am sure Rory Derham and I could spend many hours discussing these problems. Yes, thank you very much for the correction on the preferential points. I must say I find this a particularly difficult question because obviously if you are compensating contracts and the price is netted out on insolvency by a set-off then there is an improvement in position. But if the netting takes place prior to that - I must say I find it very difficult to see how the insolvent's position is improved. You see because the netting is equal and opposite on both sides.

> [**Rory Derham:** In my view when you set off, you stay with a set-off. Two countervailing deals, Australian dollars and US dollars - you can set the two Australian dollars off

against each other, but you couldn't set the two US dollars off against each other provided that the obligation is an obligation to deliver the product and subject also to the comment or your view that the contract would be terminated automatically on insolvency in any event. I think that was a view you expressed in the *International Financial Law Review*. Subject to those provisos which are we would have to say uncertain I suppose, then there are doubts in Australia as to whether settlement would be a preference or not. If on the other hand it is not a product (it is a monetary obligation if it is not a product) if the obligation to deliver the foreign exchange contract would be terminated automatically on insolvency so that you do then have a monetary obligation that could be set off, once again it would not be a preference because it would be set-off in any event. But if those two views are not correct and I think we would have to accept that there are at least doubts as to whether they are correct, then you come into the problem.]

Philip Wood: Well anyway it is certainly going to be something which we in London with these clearing houses are going to have to make up our minds about. Because if it doesn't work, then Australian banks are going to be in a worse position than other banks. Don't you have any comments on that David?

Response - David Huggin:

I will recommend to you that when you are considering revision of your insolvency laws that you might take a look at what we did in the United States in 1982 and 1984 which are the amendments I mentioned in my talk, because this is something that the financial community and the Federal Reserve and the Treasury were very much concerned about in terms of stability of the markets, and a convincing argument was made to the Congress to provide I think very useful amendments. Now it does not cure all of the problems, but certainly it has gone a long way toward helping out in areas of uncertainty such as the preference fraudulent conveyance set-off areas and for these special types of contracts. I would commend to you these are fairly straightforward amendments to our *Bankruptcy Code* that are reasonably intelligible - for once.

Question - John Radcliffe (Westpac Banking Corporation, London):

Reverting to Rory Derham's first question. You didn't answer it Philip. Is FX Net one of the new monetary exchanges or investment exchanges? I hadn't thought it was.

Response - Philip Wood:

No, it is not. FX Net is a private operated scheme, I think led by Chemical, and it is a bilateral operation. It is not multilateral. It doesn't have a clearing house in the middle, therefore you don't get this massive neutralisation of set-offs which you would get in a proper clearing house.

Question - John Chandler (Chairman):

I was just going to ask one question if I can use my prerogative and that is to ask Philip to comment on the situation of a contract being void - and I am thinking particularly of the situation in the United Kingdom with local authorities and statutory authorities in the light of the *Hammersmith* case.

Response - Philip Wood:

Well, the *Hammersmith* case, which is sort of on its way to the House of Lords I think, is a bit of a side-show in the law. It was a case about ultra vires, but it would have been interesting if it had involved a commercial corporation. But it involved a local authority - a very special beast - and when you are dealing with administrative organisations, governmental organisations, you can expect a different set of policies, a different set of rules, to apply. I must say I don't tend to follow it all that closely, because once you have swatted up what one court has said then it is reversed in the next court, and I am sure it will be reversed when we actually get to the House of Lords. I very much hope that a sensible view will prevail. At the moment the position is very much in ferment, nobody quite knows what to do because there is considerable doubt about what the effect is as far as tracing recoveries, restitution and so on, where you have a void contract. I find it impossible to work it out.

Comment - John Chandler (Chairman):

Ladies and gentlemen we have run out of time and I am sure you would like to join with me in thanking our speakers for the immense amount of work they must have put into their papers, which were very stimulating and very capably delivered.