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

INTEREST RATE AND CURRENCY SWAP AGREEMENTS FOREIGN EXCHANGE CONTRACT: AND OTHER SECURITY CONTRACTS - COUNTERPARTY RISKS

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Since this is my last appearance before you I want to again thank you for inviting me and having me participate in these interesting and stimulating sessions. I should have mentioned yesterday that copies of my remarks are available at the Melbourne office of Sullivan & Cromwell - if any of you would like to call they would be glad to furnish you with copies or give me your card and I will see that you get one.

I would like to begin this morning with a discussion of counterparty risk and the enforceability of netting arrangements in swap agreements. Interest rate and currency swaps are clearly financial instruments of major importance to international financial transactions. It has been estimated that there are interest rate and currency swaps outstanding which exceed a notional principal amount of a trillion dollars. And while these originated as transactions between financial institutions to exchange cash flows, today there is an active dealer market in swaps and derivative market products, and quotes are made and transactions confirmed by telephone and facsimile.

As this market has grown it has become essential to standardise swap documentation. The International Swap Dealers Association or "ISDA" has developed standard forms for interest rate and currency swap agreements which have to a large extent accomplished this standardisation, even though individual credit terms, pricing and collateral are negotiated.

One key feature of these standard agreements is the use of a master ISDA agreement with confirmations providing for particular terms of individual transactions. In addition the master ISDA agreement provides that the parties can agree that when payment dates on two or more swaps coincide, payments on the same day in the same currency will be netted - similar to the slide that we saw just a moment ago with respect to foreign exchange transactions.

The obligation of each party to make payments under the swap agreement is subject to the condition that the other party not be in default. If he is in default, the non-defaulting party can terminate the swap, that swap agreement, and any other swaps. And in the event of such an early termination, there is a lump sum termination payment that is calculated under the terms of the agreement. If the lump sum termination amount is positive in favour of the non-defaulting party, then a payment is due, otherwise no payment is due.

Typically of course, one of the events of default in these agreements is the filing of a bankruptcy petition or the insolvency of one of the parties. And for purposes of the United States *Bankruptcy Code*, there has been a great deal of discussion about whether or not these netting and termination provision really work.

You will recall that one of the powerful tools of the trustee of the debtor in possession in a Chapter 11 case is the power to assume or reject executory contracts. This power can be very useful in effecting a reorganisation, since it permits the assumption of contracts which are favourable and the rejection of unfavourable contracts. If the debtor assumes a contract under the *Bankruptcy Code* it must do three things: (i) it must cure or provide for the cure of all defaults; (ii) it must provide compensation for any third party that suffers a loss as a result of the debtor's default; and (iii) it must provide adequate assurance of future performance. The obligation to cure defaults however, does not include a default relating to insolvency or the commencement of a bankruptcy case or other financial condition type defaults in the agreement. And if a contract is rejected by the trustee or the debtor, the counterparty had a claim for damages against the estate, but this is usually just an unsecured claim.

Now there is no definition in the *Bankruptcy Code* of an executory contract, although it is generally assumed that a contract is executory if performance remains due to some extent on both sides. While the debtor can generally assume and require performance of all executory contracts, ie, swap agreements which are favourable to the debtor resulting in payments in the debtor's favour, the Code does not permit the debtor to assume contracts which are contracts to make a loan or extend other debt financing or financial accommodations to a debtor. It has been argued that swap contracts fall within the financial accommodations provisions of the Code, but unfortunately there is little judicial authority, and no judicial authority with respect to swaps in particular, that is very helpful in determining what financial accommodations really means for purposes of the *Bankruptcy Code*. And we have to assume that bankruptcy courts will read such terms narrowly.

If a swap contract is an executory contract, and I think we have to assume for this purpose that it probably is, and if each transaction under a master agreement is considered to be a

separate contract, then the counterparty is subject to the risk of cherry picking by the debtor - affirmation of the favourable contracts and rejection of the unfavourable ones.

This problem is exacerbated by the fact that there is no specified time under the *Bankruptcy Code* within which the debtor must decide to assume or reject. On the other hand, damages, in the event of a rejection, are calculated at the date of filing of the petition. Under a section of the Code the debtor may assume or reject an executory contract at any time prior to confirmation of the plan, and this could be several months or even years after the filing of the petition. If the counterparty tries to mitigate his loss by hedging a contract as of the date the petition is filed, on the assumption that this is an underwater contract and will not be assumed by the debtor, he may find that 60 or 90 days or even several months later when the market value of the contract has changed, that the debtor decides to assume the contract.

The second problem relates to the automatic stay. In addition to the executory contract provisions, Chapter 11 provides for an automatic stay of all action upon the filing of a Bankruptcy petition. The stay against all action to collect or recover a claim is read expansively by the courts even to the point of including the mere making of a demand. A violation of the automatic stay can result in the recovery of actual and punitive damages, and the automatic stay will prevent a counterparty from terminating a swap contract after the filing of a petition. It will also prevent any set-off or other action against the debtor or his property including against any margin or other collateral accounts.

A third problem relates to preferences and fraudulent conveyances. You will recall that payments made by a debtor on account of an antecedent debt within 90 days of filing or one year in the case of insiders, can be recovered as a preferential payment. In the case of swap contracts the debtor in the Chapter 11 proceeding within the 90 day period prior to bankruptcy, may argue, successfully, that payments made to a counterparty can be recovered leaving the counterparty in the position of having only a claim for the recovered amount. In addition, the debtor may argue that the consideration received in the case of an unprofitable or underwater contract is less than reasonably equivalent value in exchange for the debtor's payments to the counterparty and therefore a fraudulent transfer.

In late 1988 the United States Senate passed a Bill which would have amended the *Bankruptcy Code* in several respects to solve many of these problems confronting swap counterparties. This legislation would have amended the automatic stay provisions to permit a swap counterparty to set-off any mutual debt including any obligations under other swap contracts whether or not they arose under a master agreement. It specifically recognised the concept of a master agreement and netting of contracts within that agreement. This provision would have resolved a lot of the

legal uncertainty surrounding the netting provisions. It would also have made clear that absent fraud or other wrongdoing, payments or other transfers made by a swap participant prior to bankruptcy would not be recoverable as preferences or as fraudulent conveyances. And finally, it would have added a new section to the *Bankruptcy Code* which would specifically permit termination of a swap contract upon the filing of a petition so long as there was a contractual right in the swap agreement to so terminate despite the provisions of the Code which would have prohibited this.

Now, unfortunately, the Senate Bill although it passed the Senate did not pass the House and it died in the House Judiciary Committee. I am happy to report, however, that the Bill has been reintroduced in the Senate just this Spring, it was approved by the Senate Judiciary Committee in March and indications are that it will pass the Senate and the question is whether the House will act favourably. I believe they will and that we will have legislation that will cure many of these problems with respect to swap agreements, hopefully by the end of the year.

On June 25, 1990 the President signed into law an amendment to the *Bankruptcy Code* which would permit termination of swap agreements and the exercise of set-off rights similar to the bill introduced in 1988 and discussed above.

Now I would like to turn to some of the *Bankruptcy Code* provision relating to other types of securities and commodities contracts.

In 1982 the *Bankruptcy Code* was amended to permit a stockbroker, a financial institution or a securities clearing agency to liquidate securities contracts, so long as the liquidating party had a contractual right to do so in his contract. This right to liquidate securities contracts is available regardless of the fact that under the executory contract doctrine one cannot terminate or liquidate a contract solely because of the filing of a bankruptcy petition or the insolvency of the debtor. Furthermore, the 1982 amendment provided that the automatic stay would not prevent liquidation or termination and it provided that these extraordinary remedies could be exercised only with respect to what comes within the definition of securities contracts. These specifically include any contract for the purchase or loan of a security or any option relating to foreign currencies entered into on a national securities exchange. The remedy however, is available, the remedy of termination and netting is available only for financial institutions, securities dealers or securities clearing agencies since the rationale for these exceptions from the general rule prohibiting such action is that the prompt liquidation of an insolvent's position preserves the stability and integrity of the securities and commodities markets.

It was not entirely clear that this amendment covered securities repurchase agreements and reverse repos, so the Code was again amended in 1984 to provide specifically for repos. This provides

essentially the same liquidation and termination rights for any party falling within the definition of a repo participant. A repo participant is simply any person who has outstanding a repurchase agreement at any time within 90 days prior to bankruptcy. Interestingly, the scope of beneficiaries of this liquidation and termination provision is not limited to brokers, dealers, financial institutions and clearing agencies as is the case for securities contracts.

And finally, in 1982 further amendments were made to the *Bankruptcy Code* which provided relief for a commodity broker or a commodity forward contract merchant for a liquidation of commodities contracts. As with securities contracts, the commodities contract must specify the right of the liquidating party to liquidate and the benefit of these provisions is available only for those who come within defined terms - commodity broker or commodity forward contract merchant. Now one of the problems that we have faced is whether a bank engaging in the purchase and sale of foreign currency for future delivery falls within the definition of a forward contract merchant. Although there is no authority that deals with this, a bank which engages regularly in purchasing and selling foreign exchange for future delivery should be deemed to be a forward contract merchant, in my view. In order to benefit from these provisions however, the forward contract merchant must deal in contracts which have a maturity or more than two days - that is, they cannot be a spot contracts.

Now to add to the complexity of this legislation overlay on swap contracts, repos, securities contracts and commodities contracts, we have a particular difficulty in the United States in that financial institutions such as banks, savings and loan associations, insurance companies, and certain other types of financial institutions are not subject to the *Bankruptcy Code*. We have national banks, state chartered banks, savings and loans, various other credit unions, and private banks, and they are all subject to an array of different insolvency laws, unfortunately. And this has resulted in a great deal of confusion and uncertainty with respect to rights against these parties who enter into these types of financial contracts.

Fortunately until the recent wave of insolvencies resulting from the thrift crisis, there have not been too many occasions for these issues to be raised, at least in the bank context, because until this recent crisis at least, in most cases of bank failures the Federal Deposit Insurance Corporation has negotiated a sale of a failed financial institution to another institution and depositors and other creditors, including parties to financial instrument dealings, have not suffered losses. Prior to August of last year, insolvent commercial banks were under the jurisdiction of the FDIC which acted as a receiver in the case of an insured bank, and in the case of thrift institutions the FSLIC or the Federal Savings and Loan Insurance Corporation was the insurer and receiver of insolvent thrift institutions.

However, after the FSLIC insurance fund effectively became insolvent in 1988-89, Congress passed and the President signed into law on August 9, 1989, an extremely complex and confusing piece of legislation which has a wonderful title "The Financial Institutions Reform Recovery and Enforcement Act of 1989" - otherwise known as FIRREA. FIRREA abolished the FSLIC and it also abolished the Federal Home Loan Bank Board which had regulated thrift institutions. It did a number of other things including creation of the Resolution Trust Company which is charged with the responsibility of liquidating all of these insolvent thrifts, the price tag for which continues go up.

FIRREA put the jurisdiction for all the thrift insurance fund with the FDIC. Today the receivership powers with respect to all insured financial institutions, those that have the benefit of federal deposit insurance which constitutes clearly the majority of banks in the United States, are now housed with the FDIC.

FIRREA also added some very interesting and useful insolvency provisions to the law relating to insolvency of these insured institutions. The receiver of an insolvent insured institution is permitted to repudiate burdensome contracts if the receiver determines that repudiation will promote the orderly administration of the institution's affairs. This is sort of like an executory contract concept or rescission of executory contracts, but it does not use the term executory contracts, it talks about burdensome contracts - whatever that means.

Such repudiation must be within a reasonable period following appointment of a receiver. And in the case of a repudiation a damaged party is entitled to direct compensatory damages determined as of either the date of appointment of the receiver or in the case of certain qualified financial contracts, the date of repudiation by the receiver. Qualified financial contracts include securities and commodities contracts as well as swaps contracts and repos. With respect to these qualified financial contracts a counterparty may exercise right of liquidation, set-off or termination if the contract by its terms so permits. The statute specifically states that set-off or netting is permitted among contracts including any master agreement.

The provisions are, however, subject to the overriding power of the FDIC to transfer the assets of an insolvent institution to a solvent bank, including the qualified financial contracts. That is the one question I think that we have about this provision, is exactly how it will work in the case of transfers of assets of insolvent institutions to solvent institutions where the FDIC is given the power to effectively prevent the netting of contracts. And how that will work and what the effect of that will be on the ability of a counterparty to quickly liquidate a position is somewhat unknown.

Now just to summarise these very confusing and complicated provisions with respect to termination and liquidations - the right of a counterparty to terminate or liquidate a swap

agreement, a securities contract or a commodities contract will be determined by the insolvency law that is applicable to the defaulting party. As to those parties who are subject to the *Bankruptcy Code*, a right to terminate will be available to specified classes of counterparties, in the case of securities contracts, repo agreements and commodities agreements, if the relevant agreement so provides. In the case of swap contracts there is no such right to terminate and liquidate, although hopefully we will have legislation by the end of this year that will permit that.

Finally, in the case of defaulting parties which are banks or thrift institutions which are insured by the FDIC, FIRREA now provides a statutory right, assuming the contract permits it, to terminate, liquidate and set-off with respect to all qualified financial contracts including repos, swaps, foreign exchange contracts and securities contracts.

I would like to mention one other aspect of the problems that we deal with in these types of contracts - it may not seem particularly obvious - and that is the recent efforts by the US regulatory agency that deals with commodities trading (which is the Commodity Futures Trading Commission) to assert jurisdiction over various hybrid instruments and the concern that that has caused particularly with respect to swaps. The *Commodity Exchange Act* provides a comprehensive regulation of trading in commodities futures contracts. Jurisdiction over the regulation of the commodities market rests with the CFTC, the Commodities Futures Trading Commission. The *Commodities Exchange Act* prohibits the trading of commodities futures contracts except on a federally designated commodities exchange. That is, off exchange trading of commodities futures contracts is prohibited. Unlike securities trading, there is no over-the-counter market in commodities futures contracts. Accordingly if interest rate and currency swaps are deemed to be commodities futures contracts, the existing practice of writing and dealing in swaps would be illegal.

The statutory definition of commodities in the *Commodities Exchange Act* is extremely broad. It includes all goods and articles except onions, and I have never been able to figure out why it excludes onions - but it does. All goods and articles and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in. Neither the Act nor the regulations define futures contracts or commodity options. But the breadth of this definition of a commodity which excludes onions, but includes intangibles, raises questions as to whether swaps are covered by the Act.

There are certain exemptions in the Act, for example for forward contracts, that is contracts in which there is a sale for deferred shipment or delivery. This exclusion is normally thought of as being available for privately negotiated transactions between parties who are capable of taking delivery as opposed to futures contracts which are usually hedges or

speculative contracts where there is seldom delivery of the actual commodity.

In addition, there is a statutory exemption for certain types of financial instruments such as futures and options on foreign exchange and futures on US government securities. However, these exemptions have generally been read narrowly by the courts and the CFTC, and would not be available for swaps. Another exemption is available for so-called trade options, that is options that are offered by a person to a producer, processor or commercial user of a commodity. Participants in swap transactions that have option features have relied on this exemption from the statute, but the language is not altogether clear and the CFTC has taken the position that the trade options exception is not available for transactions of a speculative nature, only for hedging, so that it would not be available for speculative swap contracts. And how one defines which swap contracts are speculative and which ones are for hedging may not be such an easy task.

Even more uncertainty was created in December of 1987 when the CFTC issued a notice or proposed rule making which discussed a wide variety of hybrid or related instruments including swaps. And this so-called advance notice asserted CFTC jurisdiction in a number of areas which many believe were beyond their statutory authority and created a great deal of uncertainty in the market place and also a little bit of fun because the SEC called the advance notice "unnecessarily expansive covering a vast array of innovative instruments that do not require and would not benefit from regulation that is mandatory under the Commodities Act".

After reviewing the comments it received and some of the heat that it received from the SEC regarding this proposal the CFTC retreated and in July of last year issued a policy statement that expressed the view that "at this time", leaving open the possibility that things may change in the future, "most swap transactions, although possessing elements of futures or options contracts, are not appropriately regulated under the Commodities Act". The policy statement went on to establish a safe harbour for swap transactions.

Eligibility for this safe harbour requires that a swap meet five criteria. First that the swap must be negotiated by parties as to its material terms based on individual credit determinations and documented by not fully standardised documentation. A master agreement including the ISDA standard forms can be used, but it is required that the essential credit terms, collateral security etc. be individually tailored. This requirement is intended to preclude of the safe harbour for swaps which are fungible and therefore readily traded. Secondly, in contrast to futures contracts which may be terminated by off-set or the establishment of an opposite position through the mechanism of a commodities clearing organisation which is the way the CFTC works, a qualifying swap must not be terminable absent a default without the consent of the counterparty unless individual termination

terms are negotiated in advance. Third, swaps cannot be supported by a market to market margin and variation settlement system designed to eliminate individual credit risk, nor can they be supported by a clearing organisation. Again this requirement does not preclude individually negotiated collateral and margin arrangements. Fourth, a swap must be entered into in conjunction with a counterparty's line of business - nobody knows exactly what that means, but the CFTC takes the view that that is intended to prohibit the participation of individuals in the swap market. And finally the fifth criterion prohibits the marketing of swaps to the public.

Generally the CFTC's policy statement was greeted with a sigh of relief by swap market participants since the requirements of the safe harbour are generally not difficult to meet. The CFTC has also used criteria established in the Act and supported by court decisions in distinguishing futures contracts from contracts for forward delivery.

The controversy, however, may not be over as the SEC and CFTC continue to debate their jurisdiction and support has been growing in the United States to combine the CFTC and the SEC under the jurisdiction of the SEC and thus eliminate the CFTC. In many ways that may be a good thing because I think some of these issues regarding these so-called hybrid instruments, swaps and other types of securities and commodities contracts which are financial in nature, would be dealt with in a much more intelligent way by the SEC than by the CFTC. Thank you.