

Close-out Netting

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1. An introductory example

Suppose that Bank A has entered into a large number of transactions with Bank B. On a gross basis, Bank A is expecting to receive £1.45 billion from Bank B in respect of in-the-money transactions and to pay £1.475 billion to Bank B in respect of out-of-the-money transactions.

Bank B discovers that it has crippling exposures to third parties as a result of unauthorised trading. Insolvency proceedings are commenced promptly in respect of Bank B and it is not expected that there will be any significant distribution for Bank B's creditors.

Bank A now faces at least two possibilities. The first is that the gross amounts of £1.45 billion and £1.475 billion will be netted against each other to produce a single net amount of £25 million which Bank A owes to Bank B. This would leave Bank A broadly in the same economic position it would have been in had Bank B remained solvent.

The second possibility is that Bank A will have to pay £1.475 billion in full to Bank B (or to Bank B's representative in insolvency) and claim as an unsecured creditor to recover £1.45 million in Bank B's insolvency. The insolvency of Bank B will have converted Bank A's net liability of £25 million into a gross exposure of £1.475 billion, which will be reduced (if at all) by whatever distribution Bank A ultimately receives in Bank B's insolvency as an unsecured creditor for £1.45 million.

The second possibility may have other undesirable consequences. What if the gross exposure of £1.475 billion were to make Bank A insolvent? A domino effect might ensue, in which the insolvency of one institution (Bank B) might lead to insolvencies of other financial institutions (including Bank A).

Thus the first possibility, in which Bank A owes a single net amount of £25 million, is good for the security of financial markets generally.

Bank A, being a bank, will be subject to minimum capital requirements which require it to maintain capital in respect of its exposures. Bank A would be permitted to account for its position with respect to Bank B as a £25 million net liability only if it were sure that such netting would be effective in Bank B's insolvency.

Therefore, Bank A would have known in advance which of the above two possibilities applied and would have been accounting for its exposures accordingly. If it had been accounting for its exposure to Bank B on a gross basis, this would have increased its minimum capital requirement. Such an increase would have represented a significant additional cost for Bank A.

Thus the first possibility, in which Bank A owes a single net amount of £25

million, reduces cost and improves efficiency in the financial markets generally, by reducing minimum capital requirements.

For completeness, we should mention a third possibility: that Bank A will not have to pay anything to Bank B, not even £25 million.

2. **What is close-out netting?**

Close-out netting is a process by which, following an event of default or termination event:

- open transactions between two parties are terminated;
- each terminating transaction is valued; and
- all the termination values, together with any unpaid amounts, are reduced to a single net amount owed by one party to the other.

In the example above, the successful application of close-out netting to the open transactions between Bank A and Bank B should yield a single net amount of £25 million payable by Bank A to Bank B. The benefits of close-out netting are demonstrated by the example:

- Credit risk between counterparties is reduced.
- This reduces systemic risk.
- The minimum capital requirements of banks and other regulated financial institutions are reduced.
- This reduces cost and improves efficiency in the financial markets generally.

3. **The use of master agreements**

How do markets and market participants achieve close-out netting?

A popular method is for market participants to enter into bilateral master agreements with their counterparties. Each master agreement governs a category (or a number of categories) of transactions between the two parties and subjects each of those transactions to close-out netting provisions which are set out in the master agreement.

The detailed implementation of the close-out netting may vary depending upon the form of the master agreement, but the basic idea is the same: to reduce gross exposures across the relevant category (or categories) of transactions to a single net exposure.

Master agreements commonly used include:

- International Swaps and Derivatives Association (ISDA) Master Agreements (for derivatives and possibly other transactions), published by the ISDA;
- the Global Master Repurchase Agreement (for repos), published by The Bond Market Association and the International Capital Market Association; and
- the Global Master Securities Lending Agreement (for stock loans), published by the International Securities Lenders Association.

These master agreements deal with other matters besides close-out netting. However, their close-out netting provisions are of the utmost importance and go to the heart of the master agreement's purpose.

This chapter focuses on the close-out netting provisions of the ISDA Master Agreements.

4. Netting opinions

The example above noted that banks and other regulated financial institutions, when calculating their minimum capital requirements, are permitted to account for exposures on a net basis only if they are sure that close-out netting will be legally effective in an insolvency.

How is the requisite level of legal certainty achieved? The regulator will often require the financial institution to obtain a legal opinion confirming that close-out netting will be effective in an insolvency. If more than one legal system is relevant (eg, because the counterparties are from different countries), legal opinions may be required for each relevant legal system.

It would be inefficient if each financial institution had to obtain its own legal opinions. Therefore, the organisation which publishes the master agreement will also maintain a collection of up-to-date netting opinions for a number of different legal systems.

A financial institution is permitted to rely on these netting opinions by becoming a member of the organisation and paying subscription fees, part of which are allocated by the organisation to paying the cost of maintaining the collection of netting opinions. This reduces the overall compliance cost for market participants and promotes consistency of approach.