Close-out netting: Impact on risk management and systemic risk*

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* Views expressed are those of the author and not necessarily those of the BIS

Close-out netting as risk management tool

Widely used risk management and risk mitigation **tool**

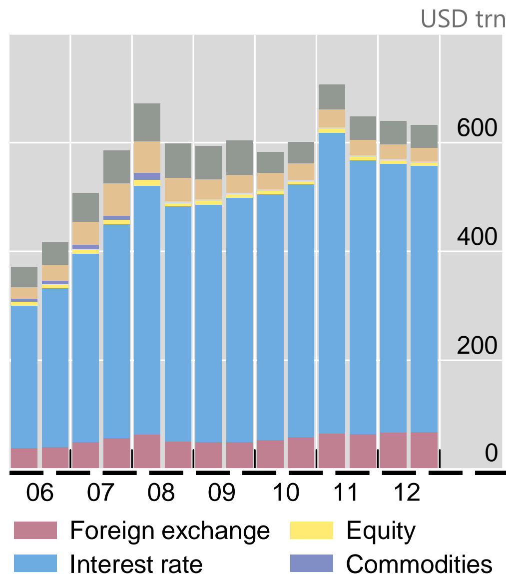
•**Pros** (if netting is valid and enforceable):

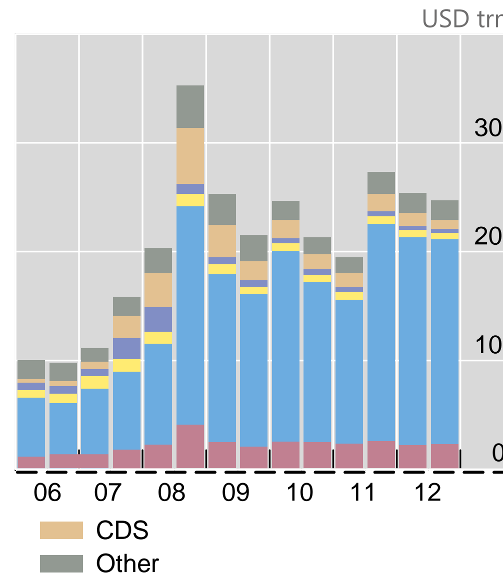
- Reduction of exposures and counterparty risk
- Enhanced risk/exposure management
- Enhanced market liqudity
- Prevention of contagion
- (Reduction of capital requirements and cost of capital)

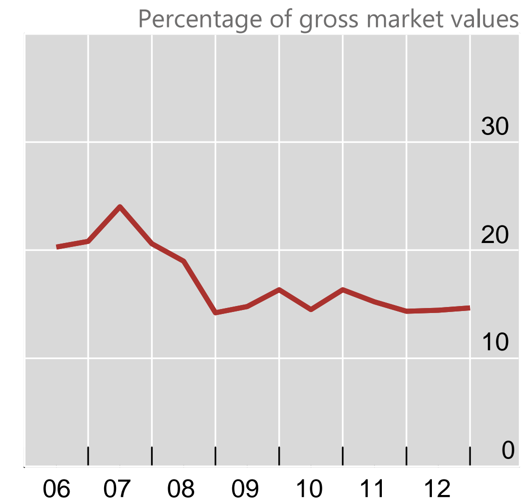
•**Cons:**

- Preferential treatment of financial institutions in an insolvency situation - Unequal treatment of creditors?
- Pre-empting liquidators’ choices/primacy of insolvency law
- Limiting resolution measures?

Netting benefits







Source: BIS OTC derivatives statistics.

The gross market value of all OTC derivatives contracts, ie the cost of replacing the contracts at current market prices, equalled $24.7 trillion at end-2012 (Graph 1, middle panel). Gross credit exposure, which deducts from the gross market values the amounts that reflect legally enforceable bilateral netting agreements, equalled $3.6 trillion. This was equivalent to 14.7% of market values, about the same percentage as at end-June 2012 (Graph 1, right-hand panel)

Systemic implications

- **Number of** (standardised) netting **arrangements**
- **Interconnectedness** of market participants
- **Complexity** (business, structural or operational)
- **Global activities** (cross-jurisdictional) of market participants

⇒ **Not:** the existence of close-out netting per se

Lehman case:

- Sudden fragmentation across jurisdictional lines of a previously tightly integrated enterprise
- Risk positions were disaggregated
- Counterparty terminations were effected at once in huge numbers and could not be monitored or managed effectively real-time
- Lack of documentation maintenance and planning for default by counterparties led to wrong or too late exercise of close-out

Potential for systemic risk (I)

- If ***netting*** is (or will become) ***unenforceable***
  - market participants would need to assume ***gross exposure***, not net exposure, as the relevant measure of counterparty risk
  - high demand for additional collateral and capital, potentially resulting in ***shortfalls of collateral and liquidity***
  - ***difficulties to manage risk*** due to the inability of market participants to adjust market risk positions or hedge portfolios against major market movement or other macroeconomic shocks
  - ***banks deleveraging risk***, potentially leading to asset contractions and extended periods of weak economic activity
  - market participants would lose the ability to engage in offsetting trades to reduce counterparty exposure to troubled entity, increasing ***likelihood of early termination*** of transactions

Potential for systemic risk (II)

- If ***netting arrangements*** are found to be ***invalid*** *or* ***unenforceable*** *in particular in a market wide stress situation*
  - ⇒ ***Uncovered exposures***
  - ⇒ ***Possible contagion*** through counterparty channel (default of a counterparty leads to losses or other impairments at other market participants)

- In case of a ***simultaneous exercise of close-out netting*** by a high number of market participants upon the default of systemically important financial institution
  - ⇒ ***Standardisation*** and ***number of arrangements*** may amplify market strains through large scale asset liquidation
  - ⇒ Forced liquidation (***fire sales***) of assets could cause distortions in market liquidity or prices (amplified by leverage/margin calls), leading to ***system-wide shocks***

Short-term stays

- Following the 2008 events, policy makers turned their attention to procedures for the resolution of failed systemically important financial institutions (first banks, then non-banks)
- Introduction of short periods in which authorities would have the opportunity to transfer the ***entire book*** of transactions (a "netting set") to a solvent entity (***no cherry-picking***)
- To support this, regulators have sought to ***delay for short periods*** (24 or 48 hours, in order to minimise market risk) the ability to terminate contracts in order to allow for an orderly transfer of the netting set to a solvent entity. If the transfer is not successful, termination can go ahead

⇒ ***No general challenge*** *of the concept of close-out netting and its safeguards*

Netting and resolution

FSB Key Attribute 4 *Set-off, netting, collateralisation, segregation of client assets*

•Contractual netting should be ***clear, transparent and enforceable***

•It should ***not hamper the effective implementation*** of resolution measures

•Entry into resolution should not trigger close-out netting, ***provided the substantive obligations under the contract continue to be performed***

•The ***resolution authority should have the power to stay temporarily termination rights*** where they arise by reason only of entry into resolution or in connection with the exercise of any resolution powers. The stay should:

(i) be strictly limited in time (for a period not exceeding ***2 business days***);

(ii) be subject to ***adequate safeguards*** that protect the integrity of financial contracts and provide certainty to counterparties; and

(iii) not affect the exercise of early termination rights of a counterparty against the firm being resolved in the case of ***any other event of default***

⇒***Acknowledged by Principle 8 of the 2013 UNIDROIT Principles***

Insolvency treatment of close-out netting

- On-going debate on whether there should be a wider abolition of the safe harbour treatment (automatic exemption from stays) , in particular regarding ***securities financing transactions (repo/securities lending)***
- Since the financial crisis, a number of ***academics*** have argued that the 'safe harbour' status of repos may in fact increase systemic risk, because it may ***in their view***:
  (i) increase the 'money-likeness' of repos and result in a rapid growth in cheap and potentially ***unstable short-term funding***;
  (ii) facilitate the ***fire sales*** of collateral upon default; and
  (iii) reduce ***creditors' incentives to monitor the credit quality*** of repo counterparties

Insolvency treatment of close-out netting

- ***Alternative proposals*** include e.g. that:
  - repos backed by risky or illiquid collateral should either not be exempt from automatic stay or be exempt from automatic stay but ***subject to a tax***, which could be varied as a macro-prudential tool; or
  - in the event of default, lenders of such repos should be able to sell collateral only to a '***Repo Resolution Authority (RRA)***' at market prices minus pre-defined haircuts specified by asset class by the RRA
- The FSB considered the proposals made and concluded that "*while theoretically viable in addressing some financial stability issues, [they] can involve substantial practical difficulties, particularly the need for fundamental changes in insolvency laws, and therefore should not be prioritized for further work at this stage*"
- Consequently, the FSB recommends that ***changes to the insolvency regime should not be pursued*** at this point in time