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

UNCITRAL COLLOQUIUM
Vienna, Austria, 16-17 December 2013

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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 liquidity
  - 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

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:
  1. increase the ‘money-likeness’ of repos and result in a rapid growth in cheap and potentially unstable short-term funding;
  2. facilitate the fire sales of collateral upon default; and
  3. 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