



FINANCIAL CONTRACTS AND NETTING

UNCITRAL *Insolvency Legislative Guide's* Recommendations

Prof. Riz Mokal
Chair of Law and Legal Theory
University College London

Vienna, 17 December 2013

Contents

- 1. UNCITRAL's *Guide* and International Financial Architecture**
- 1. Financial Contract Immunities from Bankruptcy Rules**
- 2. Systemic Risk**
- 3. Who is Affected?**

Distinctive Role in Financial Architecture

1. UNCITRAL *Insolvency* *Legislative Guide*

Financial Stability Board

- FSB recognises “Compendium of Standards” that are “internationally accepted as **important for sound, stable and well functioning financial systems**”
- “The international community attaches much importance to the adoption and implementation of these standards because of their **beneficial effects on the stability of financial systems** both at national level and globally.”
- FSB-recognised Insolvency and Creditor/Debtor Regimes (‘ICR’) Standard consists of **World Bank’s *Principles for Effective Insolvency Systems* together with the Recommendations of the Guide**
- No other body has ICR standard-setting role

Source: Financial Stability Board, *About the Compendium of Standards*

IMF and World Bank

- “Standards and codes are benchmarks of good practices. The IMF and the World Bank have recognized international standards in 12 policy areas related to their work. In **assessing countries' observance of these standards, and helping them to implement reforms where needed**, the IMF and World Bank aim to increase economic and financial stability by strengthening domestic economic and financial institutions.”
- Again, the **Bank's Principles together with the Guide's Recommendations** constitute the recognised standard
- No other recognised ICR standard-setting body

Source: IMF, *Standards and Codes: The Role of the IMF* (19 September 2013)

UNCITRAL *Guide* (2005) vs. Unidroit *Netting Principles* (2013)

2. FINANCIAL CONTRACT IMMUNITIES IN BANKRUPTCY

UNCITRAL *Guide* vs. Unidroit *Principles*

Issue	<i>Guide</i>	<i>Principles</i>
Parties	All parties (pp. 6, 158 and 159 and Recommendation 106)	Excludes natural person acting primarily for personal, family or household purposes (Principle 2)
Immune contracts	No limitation as to who may be party to immune contract	At least one party must be public authority or “ qualifying financial market participant ” (Principle 4(1)(a); state may extend scope)
Stay	None on close-out netting and none on enforcement of seizure and disposal rights (pp. 158-9, Recommendations 101 and 103)	Do not preclude stay on seizure and disposal rights
Avoidance	None (pp. 146 and 153, and Recommendation 92)	Permissible on grounds such as knowledge of counterparty’ insolvency when netting arrangement created , and deliberate preference (Principle 7(2))

UNCITRAL *Guide's* Primary Justification for Immunities

3. SYSTEMIC RISK

Immunities Justified to Avoid Systemic Risk

- “The purpose of provisions on netting and set-off in the context of financial transactions on financial markets is to **reduce the potential for systemic risk**”

Source: *Guide*, p. 158, Purpose clause to Recommendations 101-107

Immunities Justified to Avoid Systemic Risk

- “Without the ability to close out, net and set off obligations ... a debtor’s failure to perform its contract...could lead the counterparty to be unable to perform its related financial contracts with other market participants. The insolvency of a significant market participant could result in a series of defaults in back-to-back transactions, potentially causing financial distress to other market participants and, in the worst case, resulting in the financial collapse of other counterparties, including regulated financial institutions. This domino effect is often referred to as **systemic risk**, and is cited as a significant policy reason for permitting participants to close out, net and set off obligations in a way that normally would not be permitted by insolvency law.”

Source: *Guide*, p. 157

Close-out of financial contracts may exacerbate systemic risk

- Unhindered closeout results in **determination of collateral values at fire sale basis**
- This fire-sale valuation would then be used to **establish market prices for similar assets** in contracts with other parties
- This **triggers obligations to post additional collateral**, and may place those other parties in distress

Source: **Basel Committee on Banking Supervision**,
Report and Recommendations of the Cross-border Bank Resolution Group (March 2010)

Close-out of financial contracts may exacerbate systemic risk

- These processes “**will transmit the debtor’s instability far beyond its counterparties**” (‘collateral contagion’)
- This would tend to “**destabilise markets and undermine orderly resolutions of failing institutions**”
- Must be “**requisite powers to override termination clauses and transfer financial contracts to a sound counterparty**”

Source: **Basel Committee on Banking Supervision**,
Report and Recommendations of the Cross-border Bank Resolution Group (March 2010)

Close-out of financial contracts may exacerbate systemic risk

- “Difficulties would also arise with respect to financial institutions that have **non-bank affiliates** that engage in OTC derivatives contracts. As the special resolution regimes applicable to banks would not generally apply, **authorities would not have the ability to transfer those contracts to another financial institution or to a public entity in the interest of maintaining financial stability and preserving the franchise value of the troubled institution.**”

Source: **Basel Committee on Banking Supervision**,
Report and Recommendations of the Cross-border Bank Resolution Group (March 2010)

Power to delay contractual termination

- There should be power to:
 - “temporarily delay immediate operation of contractual early termination clauses in order to complete a transfer of certain financial market contracts to another sound financial institution, a bridge financial institution or other public entity”
 - “fairly facilitate the ability of a defaulting counterparty or its estate to realise the benefit of ‘in-the-money’ derivatives contracts.”

Source: **Basel Committee on Banking Supervision**,
Report and Recommendations of the Cross-border Bank Resolution Group (March 2010)

Financial Institution Resolution

- Temporary stay on early termination rights (FSB Key Attributes, 3.2(x), 4.3 and 4.4)
 - “In the case of a SIFI, the termination of large volumes of financial contracts upon entry into resolution **could result in a disorderly rush for the exits that creates further market instability** and frustrates the implementation of resolution measures aimed at achieving continuity.”
- C.f. Unidroit *Principles*, Principle 8

Financial institutions vs. non-financial enterprises

- If collapse of non-financial enterprise may result in contagion and systemic risk –
 - then does **collateral contagion** also apply, so that brief bankruptcy stay would be useful?
- If collapse of non-financial enterprise does not result in contagion and systemic risk –
 - then how weighty are any remaining justifications for exempting financial contracts from bankruptcy stay?

How should *Guide* reflect new understanding of relationship between closeout netting and systemic risk?

An illustration

4. WHO IS AFFECTED?

“Non-sophisticated” counterparties

Standalone Interest Rate Hedging Product

‘Private’ or ‘Retail’ customers

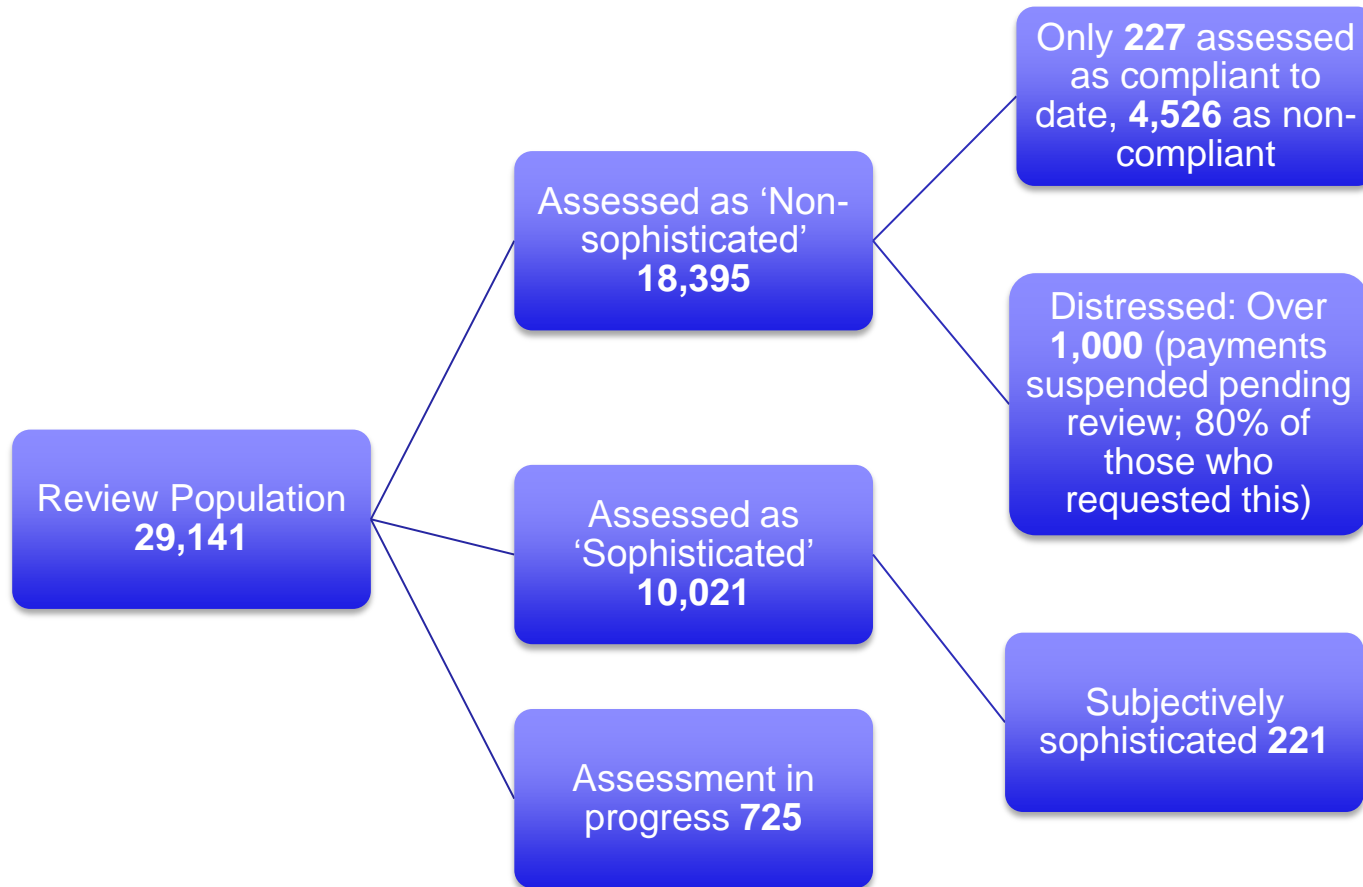
Does not possess “necessary experience and knowledge to understand the service to be provided and the type of product or transaction envisaged, including its complexity and the risks involved” (‘subjectively non-sophisticated’)

Small company or group

Aggregated value of less than £10 million

Source: UK Financial Conduct Authority (November 2013)

“Non-sophisticated” counterparties



Source: UK Financial Conduct Authority (28 November 2013)

	Aug	Sept	Oct	Nov
Joining the review				
Sophistication assessments completed	80%	90%	94%	98%
Customers invited to join review	15,000	16,000	17,500	18,400
Overall customer opt-in rate	50%	65%	70%	76%
Compliance				
Compliance assessments complete (% of customers who have opted in)	8%	12%	25%	34%
Overall rate of non-compliant sales	93%	95%	95%	95%
Redress				
Customers in redress phase	1,950	2,600	4,100	6,100
Redress determinations complete (including compliant and non-compliant sales where no redress is due)	500	950	1,850	3,300
Redress determination letters sent (including compliant and non-compliant sales where no redress is due)	250	500	1,300	2,600
Outcomes				
Offers accepted ('full tear up' and alternative product offers)	10	32	125	547
Redress paid	£0.5m	£2.0m	£15.3m	£81.2m
Outcomes where no redress is due	78	112	253	438

Source: UK Financial Conduct Authority (28 November 2013)

Conclusion