

NETTING IN FINANCIAL MARKETS

PART I

NETTING: AN OVERVIEW

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In modern economies where wealth is almost exclusively materialised in claims, issues concerning netting are of extraordinary importance.¹ Significance of this legal institute is growing not only due to the increasing volume of trades in the financial markets, and thus also claims arisen in the framework of these trades, but also due to the nature of modern financial instruments coming to resemble Lego where by combining various conditioned or unconditioned claims a financial position is taken which is interesting primarily from the aspect of the net resultant financial effect.

In analysing netting in financial market, it seems to be pragmatic to focus only on the netting between the most active operators operating in a standard manner in these markets, such as banks², securities brokers³, asset management companies⁴ and insurance companies⁵.

The basic legal regulation of netting is contained in the Civil Code⁶. As obligations between financial market operators have, as regards the nature of such entities and as regards the nature of trades in financial markets, in principle a commercial-legal character,⁷ the more non-mandatory treatment of the Commercial Code shall also apply to them in such cases. The title itself of Division IX of the Commercial Code "Certain Provisions on the Set-Off of Claims" clearly and unambiguously indicates that

the Commercial Code does not contain a comprehensive regulation on netting in the framework of commercial-legal relations, and from the introductory provisions of the Commercial Code it ensues also that as far as netting is concerned, subsidiary provisions of the Civil Code apply. Therefore, the situation is different than in case of the prescription, which is comprehensively governed by the Commercial Code.

The term netting

As results from the nature of netting and also its position in the Civil Code, netting is one of the methods of discharging claims⁸. In spite of the frequent use of this method of discharging claims, the Civil Code does not define the term netting, it merely describes its functions⁹. Referring to these functions, we can define netting, from the theoretical aspect, as a legal act on the basis of which two mutual, undisputed and non-doubtful off-settable claims between two parties in the amount of the lower of these two claims are discharged, whereas the larger claim remains in existence in the extent in which it has not been set off.

It is necessary to distinguish the economic understanding of netting from its legal definition. From the economic aspect, netting shall be understood the determination of the net positions of one party to the deal in respect of the other parties to this deal. The economic term of netting will thus cover both the calculation of net positions, not having legal effect as regards the existence of the concerned claims, as well as a set of legal acts leading to the state where only one net claim corresponding to the net position will exist. These legal acts may, besides netting in the legal meaning of word, also include other legal acts.

This distinction appears to be essential in implementing certain legal institutes from financial markets relating to netting in the Slovak system of law and in interpreting issues of netting in bankruptcy proceedings.

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¹ See, for example, Du Ferrage, A. C.: "Le rêve familial du global netting à la française. La réforme de l'article L. 431-7 du Code monétaire et financier par la loi NRE." In: *Banques & Droit*. 09-10/2001, no. 79, pgs. 3 – 15.

² Act No 483/2001 Coll. on banks and on amending and supplementing certain acts, as later amended (in this text the whole series, simply "the Act on Banks").

³ Act No 566/2001 Coll. on securities and investment services and on amending and supplementing certain acts, as later amended (in this text the whole series, simply "the Act on Securities").

⁴ Act No 594/2003 Coll. on collective investment and on amending and supplementing certain acts, as later amended (in this text the whole series, simply "the Act on Collective Investment").

⁵ Act No 95/2003 Coll. on insurance industry and on amending and supplementing certain acts, as later amended (in this text the whole series, simply "the Act on the Insurance Industry").

⁶ Articles 580 and 581 of Act No 40/1964 Coll. Civil Code as later amended (in this text the whole series, simply "the Civil Code").

⁷ Article 261 (1), (3)(c) to (e), and (4) of Act No 513/1991 Coll. Commercial Code as later amended (in this text the whole series, simply "the Commercial Code").

⁸ In the Civil Code the institute of netting is regulated in Part Eight (Binding law), Chapter One (General provisions), Section Six (Discharge of Liabilities).

⁹ Article 580 of the Civil Code.



Types of netting

The applicable Slovak law recognises two basic types of netting in the legal meaning, and this netting by a unilateral legal act¹⁰ and contractual netting¹¹. Netting in the economic meaning may, besides netting by a unilateral legal act and by contract, also cover certain specific legal approaches which do not have a long tradition in continental law and have, together with various financial instruments, been imported from the Anglo-Saxon legal environment.

In the common law system, dominant in financial markets, a general term comprising "netting/set-off" does not exist. Instead, several terms have been created for various types of off-setting combined with other legal institutes, which continental law as a rule identifies separately. As it is English-American markets that influence financial customs in global markets, not excluding those of Slovakia, it will be necessary to provide several accompanying notes regarding these terms. In doing so it is impossible to avoid the use of English terms indicating individual types of off-setting/netting in financial markets. Many of them have as yet not found their commonly-used translation in Slovakia and therefore the English expressions will be necessary for their identification.

Among individual types of netting in financial markets, it is suitable to direct attention towards in particular the following terms: (a) payment netting, (b) netting by novation, (c) close-out netting, (d) account netting, (e) legal rights of set-off, (f) clearing. This list of types of netting does not represent any classification by a certain criterion. Thus it may happen that a single legal act can be designated by two of these terms.

Since there is considerable disunity in the terminology used around the world describing netting, the use of individual terms in this article is based primarily on the Angell Report of the Bank for International Settlements¹², which summarised information on netting arrangements from various jurisdictions around the world.

Payment netting. The Angell Report gives payment netting as the first type of netting, where this be termed also position netting, payment netting, netting of payments or bulking of payments and connected with it binding payments netting. Payment netting does not have an influence on the existence of mutual claims. Both parties following an agreement on netting are still bound by individual contracts. In other words, the contracting parties agree on the netting that will take place only through the

net payment on the value date of the mutual claims. Up until that moment, both the claims exist; the individual risks of the counterparties survive up until their netting. The advantage of this type of netting is a reduction in transaction costs connected with the payment of the set-off claims. The Angell Report also lists further advantages of this form of netting, such as lowering the risk of insufficient liquidity or the occurrence of errors. At the same time, the lower liquidity increases payment discipline and the probability that the financial partner will be more willing to provide a credit to the concerned party.

In the case of binding payments netting, both contracting parties undertake to accept the net performance of the other party. In contrast to the non-binding payments netting, in this case the netting always takes place on the value date, because the debtor of the larger of the claims is obliged to pay to the other party the net amount, only. Similarly as in the case of non-binding netting, these obligations are discharged by the net payment on the value date. Both obligations exist up until their value date and on this date the net payment is paid.

The term netting of payments and multilateral payment netting is also used in the ISDA Master Agreement (Master Agreement of International Swaps and Derivatives Association, Inc.), the importance of which is now undoubted in the term financial markets. This framework agreement defines the netting of payments by means of the following rule: If on any date amounts would otherwise be payable in the same currency and in respect of the same Transaction by each party to the other, then, on such date, each party's obligation to make payment of any such amount will be automatically satisfied and discharged and, if the aggregate amount that would otherwise have been payable by one party exceeds the aggregate amount that would otherwise have been payable by the other party, replaced by an obligation upon the party by which the larger aggregate amount would have been payable to pay to the other party the excess of the larger aggregated amount over the smaller aggregate amount.¹³

If the contracting parties have agreed on netting mutual claims under several transactions, the Framework Agreement of ISDA calls such netting "multiple transaction payment netting".

Netting by novation. By the fact that the term defining "payment netting" used by the ISDA employs the term "replacement" of the original obligations by the new ones, it moves us closer to the term netting by novation as defined by the Angell Report.

According to this document, netting by novation offers the option of reducing credit risks by means of discharging mutual obligations and their replacement by a new net obligation. Both contracting parties agree that any

¹⁰ Article 580 of the Civil Code and Articles 358 to 363 of the Commercial Code.

¹¹ Article 581 (3) of the Civil Code and Article 364 of the Commercial Code.

¹² Group of Experts on Payment Systems: Report on Netting Schemes (Angell Report). BIS: Basle, 1989, pg. 33.

¹³ ISDA Master Agreement, 2002, Article 2(c).



time when two mutual obligations payable in the same currency and on the same date arise between them, such obligations shall be replaced by the obligation to pay a net sum. This mechanism requires that at the moment of the two obligations arising between the two contracting parties payable on the same date, both are to be novated and thus a new obligation arises between these two parties¹⁴. In the case of novation, the obligations to be terminated do not need to be mature. This operation may repeat also several times up until the final settlement date agreed in advance. An advantage of netting by novation is that it reduces the counterparty's risks, in contrast to the position netting, and the existence of the net obligation represents an advantage also for the needs of capital adequacy reporting. Its disadvantage lies mainly in the relative complexity of and sensitivity of the novation, and in any possible complications connected with securing the novated obligations.

Netting by novation need not necessarily be of a bilateral nature; it may also be used at a multilateral level through a clearing centre. This technique is then usually called netting by "novation and substitution".

If we remember our definition of netting in its legal and economic meaning, we can see that netting by novation is a netting in the economic sense, even though it has legal consequences.

Account netting. Although it is clearly not possible under Slovak law to classify account netting or current account set-off as a specific type of netting, this type of discharging obligations has its own particular features. First of all, it is necessary to specify the meaning of the term "funds on account". Sometimes the public perceives money deposited on a current account as their money, i.e. as a *depositum regulare*. Nevertheless in fact these persons, should the balance on their account be positive, have merely a claim in respect of the bank and in the case of a negative balance, it is an obligation. Otherwise it would not be possible to explain how it is possible that a current account may have also a negative balance, since "minus" money cannot exist.

In result the system of payments functions so that the debtor gives its bank an order to pay in favour of the account of the creditor's bank. Through acceptance, an obligation arises to the debtor's bank to pay in favour of the creditor's bank and at the same time a claim of the debtor's bank towards the debtor. Subsequently the claim of the debtor's bank towards the debtor, resulting from the payment order, is automatically set off against the debtor's claim towards the bank from the current account, provided its balance is positive.

The French doctrine defends the opinion that in the

case of creating mutual obligations and claims in the framework of a current account it is more precise to speak of the "fusion" of claims/obligations rather than netting. According to this doctrine, only one net claim/obligation exists from the current account. This doctrine speaks of "fusion", since in accepting a payment to the account by the creditor whose account balance is positive it cannot be said that the bank's obligation to perform based on the payment accepted in favour of the creditor is set off against the bank's obligation to fulfil the obligation resulting from the preceding positive balance on the account, because both claims are the creditor's claims towards the bank, and thus are not mutual. According to the French doctrine this case concerns the "fusion" of both claims, giving rise to one final claim from the final balance on the account.

French courts connect with this interpretation serious legal consequences in ensuring obligations. This concerns mainly the case when the bank has its claim from a loan agreement towards a client secured by a right of lien, and recorded on a separate account, and beside this, the client has opened a current account in the bank which is not secured in any way and on which a negative balance is recorded. If the bank re-accounts the payable claim from the loan agreement to the current account having a negative balance, a fusion of the bank's two claims occurs, and thus the claim from the loan agreement is discharged. Thus a new claim from the current account arises. But through the fact that the original claim from the loan agreement was discharged, accessorially together with its discharge security has been also terminated.

The author is not aware of any case law in Slovakia in which this problem would have been dealt with. Nevertheless it is obvious that the bank could defend itself in this case by Article 516 of the Civil Code, which provides for survival of the security in the case of the obligation's novation. A security survives the novation of the original secured obligation, whereas in case of a guarantee, the guarantor maintains all its objections as there was no novation agreement.

As far as Slovak law is concerned, there exists a specific regime in netting claims from deposits by a unilateral legal act. This issue will be discussed below.

Close-out netting. Close-out netting is a contractual mechanism used mainly in master agreements, enabling unilateral termination of a financial operation governed by a master agreement in the case of a bankruptcy or other event stipulated in the agreement, and at the same time the "netting" of their replacement values into a final balance, usually termed the "termination amount".

Simply said, this mechanisms works so that where situations specified in the master agreement occur, the entitled party may terminate all transactions or only those relating to this situation carried out on the basis of the

¹⁴ It is however necessary to clarify its content in advance. This technique is practicably usable only between professional juristic persons having standardised relationships.



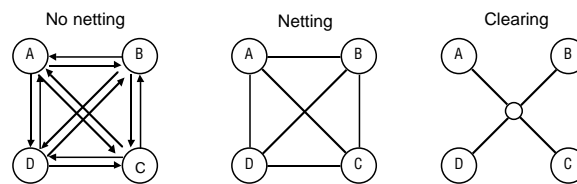
master agreement. The contracting parties instead of terminating the relating, or possible all transactions by a notice of the one party, they may also agree in advance that in the case of a certain specified situation the related, or possibly all, transactions between the parties will be automatically terminated. This termination is deemed to mean the termination of the obligation to fulfil according to the transaction agreements. At the same time, the cost of the replacement of individual positions in such transactions by new ones will be determined, taking account of market prices. The market price set in this manner will then be converted into one currency and the net position established, termed the "early termination amount". The obligation to settle this net position, i.e. the obligation to cover the "early termination amount", will replace the obligations of the contracting parties in the framework of the terminated transactions.

ISDA documentation contains a detailed mechanism for close-out netting, where this latter provides the possibility, to the party in the case of which the situation launching the close-out netting occurred, to set-off this early termination amount also together with other claims between the parties according to the ISDA framework agreement.

To sum this up, in the case of close-out netting it is imprecise to speak of the whole of this institute as netting in the legal meaning. In fact it concerns the replacement of the on-going financial operations by the replacement value, sometimes also termed replacement contract netting.¹⁵ Close-out netting may be considered a type of netting by novation. Therefore some authors speak of close-out netting as "risk compensation"¹⁶.

The Act on Banks classifies agreements on close-out netting under the term "agreements on settlement and other agreements". Translations of the European legislation deal with the term close-out netting as agreements on netting and novation. The new Act on Bankruptcy and Restructuring calls the close-out netting as the "profit and loss settlement arrangement". However, it is questionable whether, at the moment of the exercise of this settlement, it is possible from the accounting point of view to say that any losses arised, and even more problematic to speak of profits. Nevertheless, we will leave this discussion to the accounting experts. Anyway, it would be useful to unify the terminology concerning close-out netting.

Legal Rights of Set-off. The Angell Report designated the term legal rights of set-off as an independent type of



Derivative Credit Risk. Renaissance, 1995, pg. 161

netting. This concerns netting which is not based on a contract, but results directly from law. The Report mentions that this right of set-off is always governed by the national law and is often applied directly from law in the same cases such as close-out netting, i.e. in declaring bankruptcy, liquidation, or another event set by law.

Although in Slovakia there is unilateral set-off which is based directly on law and does not need any specific agreement, it may currently not be applied in the case of bankruptcy. Nevertheless, the situation is to be changed according to the new Act on Bankruptcy and Restructuring, entering into effect on 1 January 2006.

Clearing. In the case of clearing, the key players are the clearing houses. These bring together the claims of several entities, set them off and determine their net value.

The main advantage of clearing is that it substantially reduces the number of payments in the financial markets. Clearing usually forms a part of the payment systems. The clearing, however, gives rise to several important legal issues, which should be solved to the greatest possible extent by rules binding for the clearing system operators and by a law.

The main problems include the insolvency of one of the operators and the definitiveness of transfers and set-offs. In this context the important issue is that of whether the clearing centre is party to the individual claims and obligations, or whether the parties to these claims are directly the participants in the clearing system. If the clearing centre became the holder of individual claims and obligations, the insolvency risk of one of the participants would be indirectly borne by all the participants with long positions.

The clearing in the system of payments is governed by the Act on the System of Payments¹⁷ in Slovakia.

Other expressions used for netting. Besides the above-mentioned types of netting, many other terms determining this action are used. If, for example, claims do not originate in the same transaction, this is an independence set-off, meaning netting of two mutual, but independent claims. Equitable set-off (also called transaction set-off) is the compensation of claims arisen in the

¹⁵ Du Ferrage, A. C.: "Le rêve familial du global netting à la française. La réforme de l'article L. 431-7 du Code monétaire et financier par la loi NRE." In: Banques & Droit. 09-10/2001, no. 79, pg. 4.

¹⁶ Vauplane, H. a Bornet, J. P.: Droit des marchés financiers. Litec: Paris, 1998, pg. 548.

¹⁷ Act No 510/2002 Coll. on the system of payments and on amending and supplementing certain acts, as later amended (hereinafter and in the whole cycle only "the Act on the System of Payments").



framework of the same transaction, or within the framework of a set of interconnected transactions.

On the basis of the legal background for netting, we talk of contractual set-off, which is netting on the basis of a contract, where there would otherwise not be reason for set-off. Judicial set-off is court netting and insolvency set-off is netting carried out in the case of bankruptcy or analogous proceedings.

As is clear from the above, the use of terms for netting and set-off is not settled, and therefore their meaning needs to be interpreted in the context in which they are used.

Conclusion

In this part of a series of articles on netting in financial markets, we have defined some terms and concepts commonly used in these markets in connection with netting. In fact, it is not possible to talk about their implementation in Slovakia without clearly defining what is understood under these terms, and whether it concerns netting in the strictly legal meaning, or a set of legal acts having a similar result. Further articles of this series will deal with netting in Slovakia in the case of solvency, but also insolvency of the parties involved in obligation relations.