Netting and payments finality: proposed changes to the law

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This article outlines the proposed changes to insolvency law, contained in two discussion papers recently released by the Reserve Bank, which deal with the enforceability of netting arrangements and the finality of payments settled on the day that an insolvency commences.

I Introduction

The Reserve Bank recently released two discussion papers, entitled ‘Netting’¹ and ‘Payments finality: proposed changes to insolvency law’.² These papers propose changes to insolvency law to achieve the following two core objectives:

- to ensure that netting arrangements are enforceable on the failure of a counterparty; and

- to prevent payment transactions settled on the same day that an insolvency commences, but prior to the actual time of a court order being made, from being invalidated.

Netting is the process by which reciprocal obligations between parties are set off against each other so that only the difference between the obligations (the “net” amount) is required to be met. It is widely used in financial markets as a means of lowering risk exposures between participants and as such plays an important role in reducing risk in the financial system overall.

However, there is considerable legal uncertainty as to whether some netting arrangements would be upheld in the event that a counterparty were placed in liquidation, bankruptcy or statutory management. This potential lack of enforceability prevents the benefits of netting from being fully realised and leaves participants and ultimately the whole system exposed to high levels of risk.

A significant legal problem also exists in relation to the finality of settled payments. The so-called “zero hour” rule which deems a court ordered insolvency to take effect from the first moment of the day that an order is made can result in payments settled on that day, prior to the time of the order being made, having to be reversed. In respect of the insolvency of a bank or other major financial institution, this could have a potentially destabilising effect on the financial system. In particular, this potential problem would undermine the benefits of Real Time Gross Settlement, the new system for settling inter-bank transactions which is currently being implemented by the Reserve Bank and the banking industry.

The discussion papers propose solutions to these legal problems. The proposals contained in the papers have not yet been submitted to the Government for approval and as such represent the views of the Reserve Bank only. The Bank has invited submissions on the papers, which are due by 30 September 1996.

The purpose of this article is to describe the background to the Reserve Bank’s proposals and outline the key legislative changes proposed. Part II of this article sets out the main policy considerations underlying the proposals. Part III deals with the proposals on netting. It sets out the different forms of netting and their benefits, the legal problems with enforcing netting in an insolvency and the legislative changes proposed to protect netting agreements under insolvency law. Part IV deals with the proposals on payments finality. It outlines the legal problems which could lead to the unwinding of settled payments and the proposed changes to insolvency law designed to address this problem. Part V sets out the limits of what the proposals seek to achieve. And part VI briefly outlines the process for finalising and implementing these changes.

II Background to the proposals

Reduction in systemic risk

In promoting the enforceability of netting and payments finality, the Bank is primarily concerned to reduce the risk of contagion arising from a bank failure - the risk that financial distress in, or the failure of, one institution will lead to financial difficulties for other institutions - and the consequential instability and damage to the financial system which could result. If a netting arrangement proved to be unenforceable in an insolvency, the solvent counterparty would probably face a much greater liability than expected. The solvent counterparty may be required to meet the full amount of its gross obligations, but may be unable to recover the gross obligations owed to it by the failed counterparty, which could in turn cause it financial difficulties.

¹ Reserve Bank of New Zealand (August 1996).
² Reserve Bank of New Zealand (August 1996).
The impact of the "zero hour" rule would similarly increase contagion risk in an insolvency. Solvent counterparties (particularly banks) could potentially suffer large losses on reversed transactions, because they may have to repay funds received from the failed counterparty which they have credited to their customers and are not able to recover.

These measures are being undertaken as part of the Reserve Bank's role in promoting the maintenance of a sound and efficient financial system. In this sense, the measures form part of the Bank's wider work programme on reducing systemic risk including the development of Real Time Gross Settlement, the recently completed review of banking supervision and the development of the associated bank disclosure regime.

Other important considerations

In addition to the concerns related to systemic risk, other considerations were also taken into account in formulating the Bank’s proposals in relation to netting. One of the most important is the need for legal certainty. The prevalence of netting in New Zealand and international financial markets implies that certainty as to the legal status of these contractual arrangements is in itself an important goal. Legal certainty promotes the efficient operation of financial markets and helps create conditions which encourage innovation. In a stable and certain environment, participants in the markets are able to enter into transactions, develop new contractual arrangements and arrange their affairs on the basis of their agreements with confidence. Greater legal certainty would enable participants to treat their risk exposures on a net basis, in reliance on their netting agreements, and hence manage their risks in a more flexible and efficient manner.

Another consideration is that legally effective netting facilitates more efficient use of capital by registered banks through enabling credit exposures to be measured on a net basis, rather than on a gross basis, for capital adequacy purposes. In recent years, the Basle Committee on Banking Supervision has broadened the extent to which netting is recognised under the 1988 Basle Capital Accord. The Accord has been amended so that all forms of bilateral netting may be taken into account, subject to certain conditions, and the development of a framework to take into account multilateral netting under the Accord is currently under way. Due to the uncertainty over the enforceability of netting in New Zealand, recognition under the Reserve Bank's Capital Adequacy Framework is at present limited to bilateral netting by novation of foreign exchange transactions.

Certainty as to the enforceability of netting would enable the Reserve Bank to broaden the recognition of netting under its Capital Adequacy Framework, as is provided for under the Basle Capital Accord. This would benefit New Zealand incorporated banks by, in effect, reducing the amount of capital which they would be required to hold in order to satisfy the capital adequacy requirements. Overseas banks would also benefit as it would enable them to take into account netting in measuring their exposures to New Zealand counterparties for the purpose of capital requirements applied by overseas supervisors. Legal enforceability would also ensure that New Zealand banks are able to participate in international netting schemes. Under minimum requirements set down by the Bank for International Settlements, international netting schemes need to be enforceable in all relevant jurisdictions.

The Bank has also noted the growing recognition in many overseas jurisdictions of the need for a robust legal basis to support payment and settlement mechanisms and lower the potential risks arising from an insolvency. A number of jurisdictions have enacted, or are planning to enact, legislative provisions to safeguard netting arrangements in insolvency. These include Australia, United States, United Kingdom, Canada, Ireland, Germany, France and South Africa.

III Netting

Benefits of netting

Netting is commonly utilised in relation to foreign exchange transactions, swaps and other derivative transactions, and the settlement of payment obligations between financial institutions. It offers significant benefits for financial market participants including:

(a) Lower risk exposures

By reducing the amount of total obligations between counterparties, netting effectively lowers the risk exposure of each counterparty from the gross amount of its entitlements to the net amount. This decreases the amount of credit and liquidity risk faced by each participant. It also decreases the amount of "Herstatt" or settlement risk in respect of transactions involving foreign exchange where the separate legs of the transaction are settled at different times.

(b) Lower business costs

Netting lowers the costs incurred by counterparties by reducing the number and the size of payments required to be made. This leads to savings in transaction costs and
the cost of maintaining liquidity in the relevant currencies required.

**Forms of netting**

There are various rights of set-off available under the law which provide for a debt owed by one party to another to be set off against a debt which the other party owes to the former. Some of these set-off rights can be claimed as defences to an action for the enforcement of a debt. However, most of these set-off rights are not available in an insolvency, apart from the mandatory set-off which applies in the case of a liquidation or bankruptcy (contained in section 310 of the Companies Act 1993 and section 93 of the Insolvency Act 1967).

Netting agreements essentially provide contractual rights of set-off. The main forms of netting are:

(a) **Payments netting**

This is the simplest form of netting. It essentially involves parties agreeing to accept payment of the net amount where they have payments falling due on the same day. The important characteristic of payments netting is that the separate gross payment obligations continue in existence until settlement when the net payment is made. Therefore, parties’ exposures are not reduced to the net amount prior to settlement.

(b) **Netting by novation**

This process operates so that whenever two transactions with matching settlement dates and matching currencies occur they are set off against each other immediately and the separate obligations discharged to that extent. The parties are then liable in respect of the remaining net amount due, which can be regarded as a new obligation that has replaced the previous separate obligations. This process can occur many times up until the settlement date. It is usually facilitated by the keeping of a running account of the amount due between the parties pursuant to a master agreement.

(c) **Close-out netting**

Close-out netting involves the termination or “close-out” of obligations between two parties when an event of default, such as the appointment of a liquidator or statutory manager, occurs. The termination of the contracts may occur automatically or at the option of the non-defaulting party. The amounts owing under the separate contracts are quantified, usually on the basis of the replacement cost of each contract, and then set off against each other to produce a single net sum owing. The standard master agreements for swaps and other derivative transactions provide for close-out netting.

(d) **Multilateral netting**

Multilateral netting is designed to extend the benefits of netting to cover transactions originating from any member of a group of counterparties participating in the netting arrangement rather than just a single counterparty, as in the forms of bilateral netting outlined above. One method of multilateral netting involves a legally interposed central counterparty. In this case, the clearing house or settlement agent involved interposes itself as the central counterparty every time two participants agree on a transaction. The central counterparty maintains a running net position of what is owed between itself and each participant in respect of each value date and currency. Under the other method of multilateral netting, the clearing house or settlement agent does not become a counterparty to transactions. Rather, it functions as message handler, calculator and recorder of value.

Currently, the inter-bank settlement system in New Zealand effectively operates as an informal multilateral netting arrangement. Banks settle their multilateral net positions every morning, in respect of payment instructions processed the previous day, across their settlement accounts with the Reserve Bank. Under the new Real Time Gross Settlement system, there will still be scope for multilateral netting to be utilised among banks prior to submitting transactions into the system for settlement.

**Enforcement problems under insolvency law**

Netting agreements do not generally pose problems while all the counterparties are solvent. However, complications arise under insolvency law in relation to some netting agreements where a counterparty fails. In the case of liquidation or bankruptcy, the mandatory set-off provisions displace other rights of set-off at law. These provisions are of key importance in determining the enforceability of netting agreements in liquidation or bankruptcy.

There are several potential difficulties where a bank or other institution is placed in liquidation under the Companies Act which could prevent a netting agreement from being enforced. If a netting agreement is consistent with the mandatory set-off in section 310, then there is no need to rely on the agreement, as the section in effect achieves the same result. Section 310 provides that mutual credits, mutual debits or other mutual dealings between the

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3 The enforcement difficulties in bankruptcy are essentially similar to those in liquidation and are therefore not separately discussed in this article.
company in liquidation and another person must be brought to account and set against each other so that only the balance may be claimed in the liquidation or is payable to the company.

However, a netting agreement might be inconsistent with the mandatory set-off for a number of reasons. The agreement may apply to transactions which are not eligible for set-off under the provision. For example, it may cover non-mutual dealings. If the counterparties have acted in a different capacity to each other, such as where one has entered into transactions as agent for a client, then there is no mutuality between them. Also, there is an argument that some foreign exchange contracts involve non-money obligations at law, with the result that they cannot be set off under the section 310 because it only applies to money obligations.

Another possibility is that the netting agreement may lead to a different result from the set-off provision by providing for a different calculation method than that which applies under the provision.

If a netting agreement were inconsistent with the mandatory set-off in section 310 the most likely result would be that it would be open to challenge on other grounds. A more remote possibility is that a court could hold the agreement to be void because it attempts to contract out of section 310. Assuming that a netting agreement would not be void on this basis, then its enforceability would depend on whether it can be successfully challenged on one of the grounds outlined below.

(a) Pari passu rule

In some cases it could be argued that a netting agreement is an attempt to contract out of this rule. If so, it would probably be void on the grounds of being contrary to public policy. The pari passu rule is a fundamental principle of insolvency law enshrined in section 313 of the Companies Act. It provides that in a liquidation all of a company's assets remaining after preferential claims have been paid must be distributed equally and rateably by the liquidator among the remaining creditors.4 If the netting occurs before the commencement of liquidation there is no breach of the rule because the obligation to pay the net amount would constitute the entire contract between the parties. However, this might not be the case where the event triggering close-out netting is the appointment of a liquidator or where there is a time gap between the incurring of obligations and their set-off under an agreement. In such a case, the netting agreement could be held to breach the pari passu rule. This will depend on whether the netting is regarded as depriving the company in liquidation of property to which it would otherwise be entitled.

(b) Liquidator's power to disclaim onerous property

A liquidator may seek to "cherry pick" in relation to transactions subject to a netting agreement, i.e. to disclaim transactions where the failed company is "out of the money", but require the counterparty to perform transactions where the failed company is "in the money". Under section 269 of the Companies Act, a liquidator may disclaim onerous property of the company, including unprofitable contracts. The ability of a liquidator to "cherry pick" depends on whether the netting agreement is effective in replacing the separate gross obligations with a single net obligation before the liquidator exercises the right to disclaim. There is a risk that close-out netting and other forms of netting, where there is a time gap between the entering into of obligations and their set-off, might not be effective in preventing a liquidator from disclaiming transactions. The outcome of a liquidator successfully disclaiming transactions in such a case is uncertain. One possibility is that the solvent counterparty may have to perform the transactions which have not been disclaimed fully and claim in the liquidation as an unsecured creditor for the damages arising from the disclalmier of the other transactions.

(c) Prohibition on the enforcement of rights

The prohibition on the enforcement of rights over the property of a company in liquidation, in section 248(1) of the Companies Act, could prevent the termination of outstanding contracts under a close-out netting agreement. If such a termination occurs on the appointment of a liquidator there is a risk that it could be held to have occurred after the commencement of the liquidation. If so the prohibition would only apply if the termination of the contracts constitutes the exercise or enforcement of a right over the property of the company in terms of the section. This would probably be the case where the termination of the contracts took place at the option of the solvent counterparty, rather than automatically.

In the case of a major institution it is possible that an insolvency would be handled through statutory management under the Reserve Bank of New Zealand Act 1989 ("RBNZ Act") (in the case of a registered bank) or the Corporations (Investigation and Management) Act 1989 ("CIM Act") (in the case of other institutions), rather than liquidation. Statutory management enables the impact on the financial system and the wider economy to be taken into account. There appears to be an even greater risk of

4 There is an exception to this in section 313(3) which provides that an agreement by a creditor to accept a lower priority than the creditor would have had under the section is not prevented from having effect by that section.

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netting agreements being unenforceable in statutory management than in liquidation. Furthermore, if a netting agreement were unenforceable in statutory management the impact on the solvent counterparty would be likely to be more serious than would be the case under liquidation. This is because there is no set-off provided for in statutory management. Under liquidation, the solvent counterparty may still be able to rely on the mandatory set-off to reduce its exposure, to some extent, if its netting agreement proved to be unenforceable.

The impediment to netting in statutory management arises because of the moratorium which applies, from the commencement of statutory management, to prevent the enforcement or exercise of a range of rights, claims and powers (section 122 of the RBNZ Act and section 42 of the CIM Act). The moratorium provides that no rights of set-off may be exercised against the entity under management. It would therefore most probably prevent the enforcement of any netting agreement where the netting (the set-off of reciprocal obligations) has not taken place prior to the appointment of a statutory manager. The result of the moratorium preventing an agreement from operating would effectively be to make the solvent counterparty liable for the gross amount of its obligations.

However, a statutory manager appointed under either of the Acts may waive the application of the moratorium. With statutory management under the RBNZ Act, the Reserve Bank has the power to give directions to the statutory manager. There is no equivalent power in the CIM Act. In the case of a registered bank, the Reserve Bank would give consideration to directing a statutory manager to waive the moratorium to enable the enforcement of netting agreements in order to minimise the flow-on effects to other financial institutions. But this decision would be taken on a case by case basis and therefore the power to give directions cannot be relied on as ensuring that netting agreements are enforceable.

Reserve Bank’s proposals

Due to these enforcement problems, the Reserve Bank is satisfied that legislative amendments are needed to provide sufficient certainty for market participants, and the financial system as whole, in respect of netting agreements. Therefore the Bank has proposed amendments to the Companies Act, Insolvency Act, RBNZ Act and CIM Act designed to ensure that netting agreements would be enforceable on the failure of a counterparty. The key legislative amendment put forward by the Bank is a proposed new section 310A of the Companies Act (mirrored by a proposed new section 93A of the Insolvency Act) which would seek to protect netting agreements in a liquidation so that the total obligation or entitlement of the solvent counterparty is limited to the amount determined under the netting agreement. In addition, the Bank has proposed amendments to section 122 of the RBNZ Act and section 42 of the CIM Act which would exempt netting agreements from the moratorium on set-off so that they can be enforced in statutory management.

In seeking to protect netting agreements in insolvency, two main issues arise:

- Should all forms of netting be protected, or only certain forms?
- Should netting agreements be protected in all circumstances, or only where they lead to wider benefits for the financial system?

These are discussed below.

(a) Which forms of netting?

There appears to be no real basis for the law to favour particular forms of netting over others. Such an approach would influence the behaviour of market participants in structuring transactions and netting arrangements in a way which could introduce market inefficiencies. It may also discourage the development of new forms of netting, thereby impeding financial innovation. In the Bank’s view, market participants and other counterparties should be free to structure their netting agreements according to what suits their needs without being unduly influenced by any legal protection accorded to netting.

Therefore the Bank’s proposed protection applies to all contractual forms of bilateral and multilateral netting. The only requirement is that the netting agreement be in writing. This seeks to avoid the difficulties of proof which can arise with oral agreements and the scope for abuse through a creditor falsely claiming the existence of a netting agreement as a means of reducing exposure in an insolvency.

(b) Should protection only apply where there are benefits for the financial system?

The main reasons for proposing these amendments are because of the financial system benefits which would result: primarily the reduction in systemic risk, but also the potential efficiency gains for the financial system. These benefits generally only flow from the netting of wholesale financial transactions, such as foreign exchange and derivatives trading, between institutions which regularly participate in financial markets (ie banks, other large financial institutions and major companies). In contrast, netting involving private individuals and small businesses would not lead to wider systemic benefits because of the
insignificant size of the parties relative to the system, the smaller size of the transactions and also because those types of parties do not typically deal in financial markets on a regular basis.

Nevertheless, for a number of reasons, the Reserve Bank’s proposed amendments for netting are not restricted to situations where systemic benefits would result. The Bank’s proposals would cover netting agreements between any types of counterparties and involving any types of transactions. In the Bank’s view, restricting the protection for netting arrangements would be problematic.

First, it would be difficult to draw a clear and workable dividing line between those netting agreements which should be protected on systemic grounds and those which should not. In many overseas jurisdictions, statutory provisions for netting only apply in respect of particular types of contracts (eg, specified derivative and foreign exchange transactions), particular types of counterparties (eg, banks and large financial institutions) or specified clearing houses or investment exchanges. However, drawing such distinctions is easier in many overseas jurisdictions than in New Zealand because there tend to be clearer dividing lines between different parts of the financial sector, according to the functions performed by different types of institutions. In New Zealand, with the deregulation of the financial sector in the 1980s, the distinctions between different financial institutions have become blurred. Although the supervisory framework under the RBNZ Act only applies to registered banks, protection for netting agreements would clearly need to apply more widely because there are other significant participants in financial markets, in particular large companies. It would be possible to define the institutions covered on another basis, for example, by reference to size (eg, total assets) or volume of financial market activity. But such an approach would be arbitrary and would provide an incentive for institutions at the margins to structure themselves to come within the definition.

Second, to limit the protection in a way that only certain institutions could benefit from it would conflict with the established policy of maintaining a competitively neutral regulatory framework across the financial sector. The statutory provisions for netting could, in effect, confer advantages to some institutions over others.

Third, related to the second point, such protection would result in unfairness to private individuals and small businesses. They would continue to face uncertainty as to the enforceability of any netting agreements they enter into, while banks and other large institutions would be able to rely confidently on their netting agreements. On equity grounds, it seems that small businesses and private individuals should be able to limit their risk exposures and fully avail themselves of the other benefits of netting to the same extent as banks and other large institutions.

An alternative approach would be to restrict the protection to the netting of defined wholesale transactions, such as derivative and foreign exchange transactions. However, market developments would inevitably result in new products which would fall outside the scope of the protection and lead to uncertainty. It would be necessary to update such a definition, at least occasionally.

For the reasons outlined above, in the Bank’s view the protection proposed for netting agreements in an insolvency should apply to all forms of netting, between any types of counterparties and involving any types of transactions.

IV Payments finality

Nature of the problem

Existing insolvency law presents a potential impediment to the achievement of payments finality. Due to the application of the “zero hour” rule, a court ordered liquidation is deemed to commence from the first moment of the day on which a liquidator is appointed, regardless of the actual time at which the court order is made. If a bank, or any other institution issuing and settling payments on a real time basis were placed into liquidation by the court this would result in the reversal of payments settled between the start of the day and the time the order was made, unless validated by the court.

Under statutory management this problem would probably not arise. However, there is a possibility that a court could hold a statutory management to have commenced at the start of the day on which it was declared if the Order in Council declaring it did not specify a time of day. There is also a possibility that, even if an Order in Council specified the time for commencement, this could be challenged and a court could hold that the statutory management commenced at the start of the day.

This potential for the unwinding of transactions under insolvency law would undermine the benefits of Real Time Gross Settlement. Under Real Time Gross Settlement, inter-bank payment obligations will be settled between banks throughout the business day rather than on a deferred basis, as at present. It is expected to offer a number of advantages over the existing system of deferred settlement, including a reduction in inter-bank exposures arising from the payments system, increased ability for banks to monitor and control inter-bank exposures and a greater degree of finality of payment than is currently the case.
The reversal of payments under Real Time Gross Settlement could potentially lead to instability in the financial system. Banks which had received funds from the failed bank could face large losses on reversed transactions because in many cases they may not have the right to recover funds already credited to their customers. This could result in the failure of one bank causing financial difficulties for other banks. In addition, reversal would cause uncertainty as to the status of the customer transactions which underlie inter-bank settlements. Attempting to unwind large numbers of customer transactions could lead to a loss of confidence in the financial system and would probably not be feasible in practical terms. Similar problems would also arise under the existing deferred settlement system for inter-bank payments and under other settlement mechanisms utilised in financial markets, such as the Austraclear delivery versus payment system for the settlement of securities transactions.

**Reserve Bank’s proposals**

To address the problems outlined above, the Reserve Bank has proposed legislative amendments to require that the time of day at which a liquidation, bankruptcy or statutory management commences be specified. In respect of liquidation, the main changes proposed are to amend section 241 of the Companies Act 1993 to provide that liquidation takes effect at the time the liquidator is appointed and to require the shareholder or director resolution or court order appointing the liquidator to record the time it was made. Similar amendments are proposed for the Insolvency Act in relation to bankruptcy.

In respect of statutory management, the principal changes proposed are to amend section 117 of the RBNZ Act and section 38 of the CIM Act to require that the Order in Council declaring statutory management specify the time of commencement and to prohibit the retrospective commencement of statutory management.

These proposed amendments are not restricted to registered banks. The main reasons for this are to avoid according special treatment to banks under the law and to ensure that these problems do not arise with other financial institutions, which may also become significant participants in the financial system in the future. Furthermore, it would seem desirable to remove uncertainty as to the time of commencement of insolvency for all entities.

**V Limits of the proposals**

Although the proposals involve changes to aspects of insolvency law, they do not seek to alter any of the policies underlying insolvency law. The Bank has sought to ensure that the proposals do not go beyond what is necessary to achieve its objectives. The broader issues related to the reform of insolvency law are to be addressed in a fundamental review of insolvency law being conducted by the Ministry of Commerce.

In relation to netting, the proposals do not seek to protect the individual transactions subject to a netting agreement from legal challenge. In particular, a liquidator would still have the ability to challenge a transaction on the grounds that it constitutes a voidable transaction, under-value transaction or transaction for inadequate or excessive consideration under the Companies Act 1993. Similarly, the proposals in relation to payments finality do not seek to prevent transactions settled on the day a liquidation is commenced from being challenged by a liquidator on those grounds.

Neither do the proposals seek to guarantee that netting agreements, underlying transactions and transactions completed on the day that an insolvency commences constitute valid and binding contracts at law. Those matters are properly determined by the general law of contract and contract law statutes which deal with issues such as contractual mistake, fraud and the capacity of contracting parties. The Bank’s proposals are focused solely on addressing the specific problems caused by insolvency law in relation to the enforcement of netting agreements and the finality of payments settled on the day of an insolvency commencing.

**VI Process**

The discussion papers on netting and payments finality have been released to a wide range of interested parties for comment. After considering the responses received, the Reserve Bank plans to present revised recommendations to government later this year, with the aim of having legislation introduced in 1997 if possible.

**References**
