American Bankruptcy Institute Commission to Study the Reform of Chapter 11

Field Hearing – Wednesday, May 15, 2013
Association of the Bar of the City of New York

Justification for the safe harbors for Qualified Financial Contracts

STATEMENT OF EDWARD MURRAY

I am a Consultant to, and former senior partner of, the Derivatives and Structured Finance practice at the international law firm, Allen & Overy. Since 1994 I have been one of the principal external legal advisers to ISDA, the International Swaps & Derivatives Association. I am the Chairman of ISDA's Financial Law Reform Committee and represent ISDA on the UK Treasury's Banking Liaison Panel. I am also a member of the UK Financial Markets Law Committee, currently chaired by the former UK Supreme Court justice, Lord Walker of Gestingthorpe. The views I express today are, however, my personal views and do not necessarily reflect the views of Allen & Overy, ISDA or any other body with which I am associated.

I should also add that, although I have been a New York attorney since 1986, I have practised for most of my career principally as an English solicitor. I am not an expert on US bankruptcy law, but I have been heavily involved over the past twenty years in law reform efforts at national level in various countries and at European and international level to ensure legislative protection post-bankruptcy of close-out netting and financial collateral arrangements. Therefore I offer an international perspective on why it is important for the US financial market to protect the enforceability of close-out netting and financial collateral post-bankruptcy.

In most countries with a developed financial market, close-out netting and financial collateral arrangements are protected by some form of special legislative protection or "safe harbors" for what, in the US, are called Qualified Financial Contracts. There are at least sixty countries around the world with some form of bankruptcy safe harbor for close-out netting or financial collateral or both, including the United States and all 27 member states of the European Union. A number of emerging markets have implemented or are considering implementing such protections in order to strengthen their local financial markets, to increase their appeal to international market participants and to improve their liquidity, efficiency and systemic stability.

Not every country requires bankruptcy safe harbors for financial contracts. In England, for example, close-out netting and financial collateral work robustly on the basis of general principles without the need for special legislative protection, except, quite recently, in relation to new bank resolution powers introduced in the UK in 2009.

The key question for every country is whether the enforceability of close-out netting and any related financial collateral arrangement is legally certain, notwithstanding the opening of bankruptcy proceedings against a party to the arrangement. If it is not, then proportionate and effective legislative protection is necessary to ensure legal certainty.

This is not a question of creating a privilege for certain market players. Any creditor, of whatever nature, should benefit from the enforceability of close-out netting and financial collateral against an insolvent firm. This was the case for many small and medium-sized companies, for example, that were creditors of the various Lehman entities that collapsed in 2008.

So, what is close-out netting?

It is the offsetting of mutual exposures between two financial market counterparties. It is normally effected by a master agreement between the parties governing a set of transactions, for example, all derivative transactions between them, or all securities repurchase (repo) transactions, or all energy trades.

The ISDA Master Agreement is the most widely used form globally and in an English case arising out of the Lehmans bankruptcy was referred to by the judge as "probably the most important standard market agreement used in the financial world".

Close-out netting operates when one party defaults, and involves three steps:

(1) the early termination by the non-defaulting party of all transactions between the parties under the master agreement;

(2) the valuation of the terminated transactions at current market value; and

(3) the determination of a net balance owing between the two parties.

Prior to the introduction of netting safe harbors in the US Bankruptcy Code in 1989, the first and third of these steps were considered uncertain under US bankruptcy law. In some countries, the second step is also potentially problematic – where local insolvency law imposes a mandatory valuation process that does not reflect market reality.

Every important financial and commodity market, whether an organized exchange or operating off-exchange (that is, OTC), works, in effect, on the basis of close-out netting. Close-out netting is the single most important tool for the reduction of credit risk in the financial markets, far more important, in terms of absolute amount of credit risk reduction, than financial collateral arrangements and far more cost-effective, with fewer ancillary risks.

To give you some idea of the power of close-out netting, as of June 30, 2011, the total gross market value of all outstanding OTC derivatives globally was $19.5 trillion, according to the Bank for International Settlements in Basel. After applying close-out netting, the total credit exposure was $3.0 trillion, still a large number, but an 84.8% reduction from gross market value at risk. For the same date, the US Office of the Comptroller of the Currency estimated that for US banks close-out netting reduced counterparty credit exposure by 90.8%. These figures, of course, vary from period to period and market to market, but are remarkably consistent in showing an average reduction of gross credit risk in the region of 85%.

Financial collateral, if taken, is there to secure the remaining 15% of credit risk after application of close-out netting. In light of the numbers I have mentioned, it is hopefully clear that close-out netting must be legally robust to a high degree of certainty. The stakes are simply too high for it to be otherwise. It is essential to market stability.

Financial regulators insist on this, and deny regulatory capital relief to a supervised financial firm in relation to any master agreement that is not supported by a legal opinion showing that close-out netting works post-bankruptcy without material qualification.

The radical question, posed by a small number of academics, whether close-out netting itself should be permitted, has already been answered, irrevocably in my view and for many years now, by the global financial markets. Close-out netting is the norm worldwide. Every exchange-traded and OTC market operates on the assumption that each market participant has a net, rather than a gross, credit exposure to each other market participant.

Close-out netting is a fundamental part of the benefit of clearing. Each client has a net exposure to its clearing member and each clearing member has a net exposure to the clearing house.

Collateral or margin is taken both on exchange and off-exchange on a net basis on the assumption that close-out netting is legally enforceable. If it is not, then any taker of margin or collateral is potentially radically undersecured.

In order for the US financial market to remain competitive and for US financial firms and companies to participate on an equal footing in the global financial market with their foreign competitors, close-out netting must be enforceable under US law to a high degree of legal certainty, as it is in the 60 or so other legal jurisdictions for which ISDA has obtained a positive legal opinion on the enforceability of netting.

What would happen if the US safe harbors were simply repealed? There would be a severe reduction in credit capacity and liquidity in the system (a contraction of up to 85% potentially) and a massive increase in capital requirements for regulated financial institutions dealing with US counterparties.

A market counterparty dealing with a US firm would have to assess its credit against that US firm on a gross basis, severely reducing the US firm's capacity to access credit in the financial market for hedging and investment activities involving QFCs and raising the cost of that credit.

It would also become more difficult, costly and inefficient for a US firm to manage its overall credit risk exposure because individual transactions would have to be unwound manually, most likely at a higher cost, than would be the case if close-out netting were effective and the US firm could simply enter into an off-setting trade with its counterparty.

In addition to protecting the ultimate result, namely, the enforceability of the ultimate net claim under a master agreement, it is important to permit the close-out to occur rapidly following a default. This is because financial transactions are uniquely volatile compared to other forms of asset and, indeed, a QFC can swing between being an asset and a liability of a firm quite rapidly. Therefore, where a default occurs but there is material uncertainty as to when the affected financial transactions can be closed out, there is a severe risk of contagion and consequent market instability.

For this reason, an indefinite application of the automatic stay under Chapter 11 to close-out of QFCs under a master agreement would be unduly destructive of value and would raise systemic risk. This does not mean, however, that a short stay is necessarily problematic. There is currently a short stay in both the FDIC regime for US banks and in the Dodd-Frank Orderly Liquidation Authority (OLA) regime for other systemically important financial institutions. The key requirements of any such stay is that it is short and certain as to its duration and effect.

Given the volatility of financial values and the importance of certainty to preserving value and stability in the financial market, it is essential that any stay on close-out of QFCs be limited to two or three business days and that at the end of the stay either (1) close-out is permitted to occur in accordance with the agreed terms under the relevant master agreement or (2) the master agreement and all transactions continued to be performed, either by a solvent third party who has agreed to acquire the master agreement and its set of QFCs as a whole from the bankrupt US firm or by the firm itself, if it is in Chapter 11, subject to priority in favour of the counterparty and adequate assurances that the obligations of the firm will be performed in full.

Once close-out netting occurs against a bankrupt US firm, then if a net close-out amount is owed by that firm, this should be treated on exactly the same terms as any other debt owed by the US firm.

The final issue with which I wish to deal in my formal remarks is whether QFCs, a related master netting agreement or a related financial collateral arrangement should enjoy special protection from avoidance under the avoidance powers of the Bankruptcy Code.

The key point here is that neither a QFC, nor a master netting agreement nor a related financial collateral arrangement should be subject to avoidance merely because it operates in accordance with its agreed terms during the 90-day preference period prior to the commencement of Code proceedings.

Of course, I assume that each QFC, the master netting agreement and the related financial collateral arrangement were all agreed prior to the preference period on normal market terms and without any other circumstances suggestive of a fraud on creditors or other unfair preferential treatment.

Daily mark-to-market adjustments of financial collateral are an essential feature of derivatives markets, for both cleared and non-cleared transactions. It would create damaging instability in the market if potentially every delivery of collateral during the 90-day preference period were vulnerable to avoidance merely because it occurred during the 90-day period in accordance with the normal operation of the collateral arrangement. Thus, a delivery of top-up collateral by a US firm to its counterparty during the 90-day preference period should not be vulnerable to avoidance simply because it occurs during the 90-day preference period

However, there is no objection in principle to the preference rules applying in other circumstances, for example, where a QFC was entered into by a bankrupt US firm during the 90-day preference period for the purpose of giving an unfair preference to the counterparty to that trade. In other words, there is no need for a blanket exemption of QFCs from avoidance powers. The avoidance rules merely need to be appropriately calibrated, in the case of QFCs, to cure the mischief they were intended to cure. They should not create uncertainty or otherwise interfere with ordinary daily mark-to-market valuations and adjustments of exposure and collateral.

In conclusion, QFCs and financial markets require special treatment post-bankruptcy only if, and to the extent that, bankruptcy law creates legal uncertainty for the enforceability of close-out netting or creates legal uncertainty for the normal and fair operation of related financial collateral arrangements.

The need for special treatment arises because of the unique sensitivity of financial transactions to changes in market conditions and to sources of uncertainty such as legal uncertainty and also because of the rapidity with which financial values can change, and in particular deteriorate, relative to other forms of commercial value in response to adverse market changes and material uncertainty.

There are, of course, many potential sources of uncertainty that may affect markets and market transactions, and not all of them can be managed or controlled. But legal uncertainty can be effectively addressed by appropriately crafted, proportionate legislative protections for QFCs and related netting and collateral arrangements.

The US in framing its bankruptcy laws also needs to keep in mind the global nature of the financial markets and the importance for the continued competitiveness of its own financial industry of ensuring that the US legal framework for the trading of QFCs, including relating netting and collateral arrangements, is consistent with global standards.

The legislative safe harbors are about nothing more or less than creating legal certainty for close-out netting and related financial collateral arrangements. Legal certainty is fundamental to the safe and efficient operation of financial markets.