New legislation on netting and payments finality

By Loretta DeSourdy

1 Introduction

New Zealand joined the ranks of netting friendly jurisdictions on 26 April 1999 when the Banking Insolvency (Netting and Payments Finality) legislation[1] came into force. The legislation is designed to improve efficiency and reduce risk, particularly systemic risk, in the financial system. Systemic risk is the risk that the failure of a bank or other major financial institution may lead to the failure of other institutions. The legislation also aims to ensure that New Zealand institutions are competitive internationally. It does this by amending the law in the following ways.

First, the legislation amends the law applicable to netting to ensure that netting agreements are enforceable in the event that a participant in a netting agreement fails and is placed in liquidation, bankruptcy or statutory management. The aim is to remove doubt that previously existed regarding the enforceability of netting agreements in New Zealand. In passing legislation to clarify this, New Zealand has aligned itself with many other nations that have done the same.[2] On the international scene, the Basle Committee on Banking Supervision has been instrumental in promoting this move.

Secondly, the legislation amends the law to ensure payments finality. The payments finality provisions are designed to prevent payment transactions that are settled on the same day, but prior to the actual time that a liquidation, bankruptcy or statutory management commences, from being reversed.

This article examines these two areas in turn.

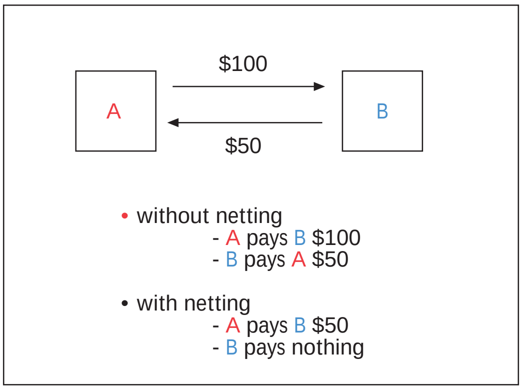
2 Netting

What is netting?

A netting agreement is a contract whereby each party agrees to set off amounts it owes against amounts owed to it. Netting agreements can be either bilateral, ie between two parties, or multilateral, involving several parties.

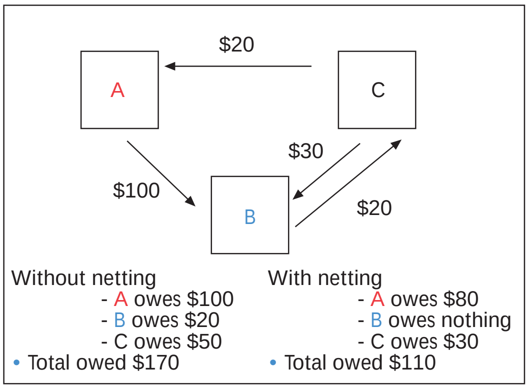
The following is a simple example of a bilateral netting contract where A owes B $100 and B owes A $50.

Figure 1
Bilateral netting



In the absence of a netting agreement, A will pay $100 to B and B will pay A $50. The total exposures in this scenario are $150. If a netting agreement is in operation, the amounts owing will be netted off and the netted balance will be payable. In this example, A will pay B $50 and B will pay A nothing. The total exposures of the parties have been reduced from $150 to $50.

Figure 2
Multilateral netting



[1] The Bill was divided into four separate acts at the committee stage. The legislation as enacted is contained in the following statutes: the Companies Amendment Act 1999, the Corporations (Investigation and Management) Amendment Act 1999, the Insolvency Amendment Act 1999, and the Reserve Bank of New Zealand Amendment Act 1999.

[2] Australia, for example, enacted the Payment Systems and Netting Act in 1998.

Multilateral netting arrangements involve settlement between more than two persons. In the following simple example of a multilateral netting agreement, A owes B $100. B owes C $20. C owes B $30 and A $20.

Without a netting agreement, A owes $100, B owes $20 and C owes a total of $50. The total amount owed is $170. Using a multilateral netting agreement, A owes $80, B owes nothing and C owes $30. The total exposures have been reduced to $110.

As the above examples illustrate, netting allows parties to reduce their exposures and consequently reduce their risk. This allows capital to be used more efficiently. Netting is widely used in financial markets, both in New Zealand and around the world, as a means of lowering the risks to which banks and other large institutions are exposed. However, its use is not restricted to these types of organisation.

How the law has been changed

Netting agreements must be enforceable if they are to be effective in reducing risk exposure. Questions about their enforceability usually arose only when one of the parties to the agreement was insolvent. Much of the uncertainty surrounding the enforceability of netting agreements occurred as a result of the statutory provisions that come into play when a party becomes insolvent. The new legislation removes this uncertainty by providing that netting agreements that come within the provisions of the legislation will be legally enforceable, if one of the parties to the agreement is insolvent.

The legislative solution that was adopted to rectify the problem of uncertainty was to amend the statutes that impeded or made uncertain the application of netting. The statutes in question are the Companies Act 1993, the Insolvency Act 1967 (which deals with personal bankruptcies), the Corporations (Investigation and Management) Act 1989 (which deals with statutory management) and the Reserve Bank of New Zealand Act 1989 (which also deals with statutory management). The detail of the legislation is examined below.

The legislation applies to written netting agreements and to all obligations under the netting agreements, whether those obligations are payable in New Zealand currency or some other currency.

The legislation allows for bilateral and multilateral netting but a distinction has been made between the two. In the case of multilateral netting, recognition is restricted to an agreement that is a "recognised multilateral netting agreement". This is a "multilateral netting agreement that is contained in, or is subject to, the rules of a recognised clearing house". The Reserve Bank has been given the task of recognising clearing houses. In doing so, the Bank must have regard to the extent that the application of the netting provisions to the multilateral agreement that is subject to the rules of the clearing house would assist in promoting the soundness or efficiency of the financial system. The netting provisions do not therefore automatically extend to cover multilateral netting agreements and multilateral agreements that are not part of the financial system will not be eligible. Parties are not prevented from entering into those agreements but they will not be able to rely on the protection provided by the netting provisions.

The legislation applies more widely in the case of bilateral netting in that coverage is not restricted to netting that promotes the soundness or efficiency of the financial system. Bilateral netting is, however, restricted to mutual transactions, that is, the transactions under the agreement must be between the same parties acting in the same right.

The definition of bilateral netting in the legislation covers the three forms of bilateral netting: close-out netting, netting by novation and payment netting.

- Under a close-out netting agreement, the obligations between the two parties terminate when some specified event occurs. The sums due between the parties are then calculated and set-off so that a single amount is payable.
- In netting by novation, a running account of what is due between the parties is kept pursuant to a master agreement. The parties may enter into any number of similar transactions so that the same process may be repeated several times until the settlement date.

- In payment netting, the parties have an agreement that the payment obligations they have to each other continue until settlement date. At that time, the party having the greatest gross liability pays the net amount of those payment obligations. Each party is liable for its gross obligations under the separate contracts until settlement occurs.

The legislation makes it clear that netting agreements to which the legislation applies operate despite the statutory set-off provisions. The Companies Act 1993 and the Insolvency Act 1967 both provide for mandatory set-off, on liquidation, in the case of the Companies Act, or on bankruptcy, in the case of the Insolvency Act. The focus in this article is primarily on the amendments to the Companies Act, rather than to the Insolvency Act, as companies are more likely to use netting in practice than individuals. However, the new netting laws apply to both statutes.

Prior to the enactment of the netting legislation, uncertainty arose where a netting agreement covered matters not dealt with by the statutory set-off provisions. The set-off provision in the Companies Act[3] provides for set-off of mutual credits, mutual debts, or other mutual dealings between a company and a person who, but for that section of the Act, would have a claim admitted in the liquidation of the company.

Statutory set-off is restricted to mutual dealings between the parties and would therefore not apply to many multilateral netting agreements. It is also restricted to monetary claims. This gave rise to doubt as to whether netting agreements where the underlying transactions were foreign exchange contracts would be eligible for statutory set-off or whether they would be excluded on the grounds that they could be classified as commodity contracts. The situation has now been clarified as the netting legislation states that set-off does not apply to a netting agreement to which the netting provisions apply.

The pari passu rule also caused doubt about the enforceability of netting because of the risk that a netting agreement might breach the rule. The pari passu rule is a fundamental principle of insolvency law. It provides that in an insolvency, unsecured creditors are to rank equally and if there are not enough assets to satisfy all of the claims, they will each receive a pro rata share of the pool of funds. The new legislation makes it clear that netting occurs despite the statutory pari passu provision[4]. However, this does not alter the ranking of a party to the netting agreement on a winding up.

Uncertainty about the enforceability of netting agreements also arose because of the statutory provisions[5] that allowed a liquidator to disclaim onerous property. When a contract is disclaimed, it brings to an end the insolvent party's rights, interests, and liabilities in the contract. "Onerous property" is an unprofitable contract or property of the company that is unsaleable, or not readily saleable, or which may give rise to a liability to pay money or perform an onerous act. In the netting context, the issue is whether there are separate contracts that would allow the liquidator to "cherry pick" among them. That is, a liquidator may be able to disclaim contracts that were unfavourable, for example, those where the party in liquidation would be required to pay out, but enforce the ones that were favourable to the party in liquidation. The law now provides that a liquidator is not allowed to disclaim as "onerous property" a netting agreement. The definition of onerous property has been amended to specifically exclude a netting agreement to which the netting provisions apply and any contract of the company that constitutes a transaction under a netting agreement.

Although the new legislation provides for the enforceability of netting agreements in a failure situation, it does not provide similar protection for the underlying transactions. These are still subject to statutory provisions relating to transactions having a preferential effect and transactions at an undervalue. These transactions can still be challenged by the liquidator or statutory manager. Netting cannot therefore be used as a means of protecting transactions that would normally be disallowed on a liquidation or statutory management. [6]

A netting agreement, as opposed to a netting transaction, can only be treated as a transaction having preferential ef-

3 Section 310 of the Companies Act 1993. The relevant provision in the Insolvency Act 1967 is section 93.

4 Section 313 of the Companies Act 1993.

5 Section 269 of the Companies Act 1993 and section 75 of the Insolvency Act 1967.

6 However, the presumption in section 292(2) of the Companies Act 1993 that applies to voidable transactions does not apply to a netting transaction.

fect or a transaction at an undervalue to the extent that the effect of entering into the agreement is to reduce any amount that was owed by or to the party at the time the party entered into the agreement.

A liquidator may apply to the court to have a bilateral netting agreement between a company in liquidation and a related person set side. The court may set aside a bilateral agreement that was entered into within two years prior to the liquidation[7] unless the related person can prove that, at the time the agreement was entered into, they did not have reason to suspect that the company was unable to pay its debts as they became due. This test is similar to the one in the Companies Act[8] that applies to statutory set-off with related parties.

The legislation makes a fundamental change to the law governing statutory management. Both the Corporations (Investigation and Management) Act 1989 and the Reserve Bank of New Zealand Act 1989 provide for a moratorium when a company or a registered bank is under statutory management. The new legislation amends these statutes by providing that the moratorium on set-off does not apply to any right of set-off provided for in the netting agreement. The moratorium does not limit or prevent the exercise of the termination of transactions, and the taking of an account, in accordance with a netting agreement to which the netting provisions of the Companies Act or the Insolvency Act apply. In the case of multilateral netting, the netting legislation goes further. It allows a recognised clearing house to exercise security rights relating to the netting agreement.

3 Payments finality

Prior to the enactment of the Banking and Insolvency (Netting and Payments Finality) legislation, a court ordered insolvency was deemed to take effect from the first moment of the day that the insolvency order was made. This is referred to as the zero hour rule. The effect of the rule was that transactions that were settled on the day of the court order, but prior to the time that the order was made, were at risk of subsequently being unwound. This could have resulted in large losses for institutions and substantial disruption to the financial system. The law was amended in order to achieve payments finality. The result is that payments that have been completed on the same day, but prior to the time at which a liquidation, bankruptcy, or statutory management commences, will not have to be unwound.

Amending the law became imperative once Real Time Gross Settlement (RTGS) became operative in March 1998. RTGS is a system for settling large wholesale payments among banks. One of the advantages of RTGS is that settlement occurs at the time that a transaction is completed. Before RTGS came into operation transactions between customers of the banks were processed during the day, but the banks did not transfer the funds among each other until the following morning. The result was that the banks owed each other large sums of money, thereby increasing the risk that the failure of one bank would lead to the failure of others.

RTGS eliminates the gap in time between the initiation of payment transactions and their final settlement and, consequently, the large intra-day exposures that resulted from this gap. However, the zero hour rule could have undermined this by requiring that payments completed on the day that a party became insolvent, but prior to the actual time of insolvency, be unwound back to the start of that day. If the insolvent party were a bank or major financial institution, the effect of reversing the transactions could have had a destabilising effect on the financial system. Institutions might have been put in a position where they had to pay out on reversed transactions but might have been unable to recover money that was credited to their customers.

This problem was less likely to occur under a statutory management because the time that the statutory management commenced could be specified in the Order in Council. However, it was felt that there was still a possibility that a court could have determined that a statutory management commenced at the start of the day on which it was declared.

The changes made to the law to achieve payments finality are largely technical. The Companies Act 1993, the Corpo-

[7] The Companies Amendment Act 1999 refers to a "restricted period" which is given the same meaning as in section 310(7) of the Companies Act 1993. Depending on how the liquidation commenced, the restricted period can exceed 2 years as it can also include the time between when an application was made to the court and date on which the liquidation commenced.

[8] Section 310(3) of the Companies Act 1993.

rations (Investigation and Management) Act 1989, the Insolvency Act 1967 and the Reserve Bank of New Zealand Amendment Act 1989 were amended to provide that both the date and time at which a liquidation, statutory management, or adjudication of a bankrupt, occurs is recorded.

The Companies Act and the Insolvency Act have been amended to deal with the situation where doubt exists about whether an act was done before or after the appointment of a liquidator, or in the case of a bankruptcy, the time of adjudication. The presumption is that, in the absence of evidence to the contrary, the act is presumed to have been done after the time of appointment or adjudication.

Although the payments finality provisions were necessary for the effective operation of RTGS, the legislation is not confined to registered banks. It applies broadly, to any entity in liquidation or statutory management, or to an individual who is adjudged bankrupt. This allows for the maintenance of a competitively neutral framework as well as providing certainty about the time of the commencement of all types of insolvency.

4 Conclusion

The passage of the Banking and Insolvency (Netting and Payments Finality) legislation has important consequences for New Zealand's financial system. It allows parties to reduce their risk exposures by ensuring the enforceability of netting agreements that come within the provisions of the legislation. This will reduce risk, and in particular, systemic risk and will allow for the more efficient use of capital by the parties concerned. Consequently, it should also lower business costs. Although the biggest impact will be experienced by the large players in the financial markets, such as the registered banks and other large financial institutions, other parties will also benefit.

The payments finality provisions also play an important role in reducing systemic risk. They allow the benefits of Real Time Gross Settlement to be fully realised by removing the risk that large numbers of transactions may have to be unwound if a party becomes insolvent. Again, the benefit may be most significant for large financial institutions but the legislation applies widely across all entities and removes the uncertainty about the time of commencement of a liquidation, bankruptcy or statutory management.