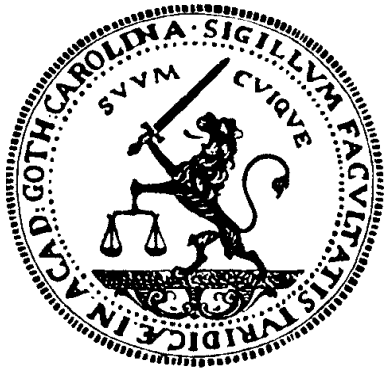

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Key Provisions of the International Deposit Netting Agreement

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Banking Law, Contract Law

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Contents

Summary

This thesis will examine the provisions of the International Deposit Netting Agreement (IDNA), published by the British Bankers' Association in 1996. The thesis takes the perspective of an eligible party to the agreement and analyses the interpretations of the agreement. There is a limited amount of documentation available regarding the interpretation of the IDNA, wherefore all thoughts and conclusions are those of the writer's, except where a particular source is referred to.

The IDNA sets out the contractual framework for banks to off set deposits taken by a bank from a counterparty, against deposits placed with the same counterparty bank, in the situation of a specified event of default. By entering into such an agreement, banks which operate in the cash markets have the possibility of reducing their counterparty risk and systemic risk through the method of *deposit netting*.

The essence is that banks agree bilaterally that deposits and interbank loans will be covered by a close-out agreement. In an event of default by one of the parties, for example failure of payment or insolvency, the party will immediately pay a net figure to the other party and this single figure replaces the old individual loans and deposits. This process will be discussed to a further extent in chapters 1.2 and 3.4.2.

The main advantage with deposit netting is that when an event of default occurs it reduces credit and liquidity risks for the parties. A further advantage is that a party becomes safe from so called "cherry picking" where banks (the parties to the agreement) with multiple counterparties pick and choose which agreements to honour or prioritise in an event of default. Cherry picking will be discussed in chapter 3.4.2.

In the light of credit and liquidity risk, the IDNA apparently becomes very relevant in the case of insolvency. Identifying and understanding insolvency issues will therefore constitute a reasonably central part of this paper. Since the agreement is triggered by an event of default and most commonly insolvency, this is very relevant to the application and interpretation of the IDNA.

The paper discusses the legal aspects of set off and netting abroad, for example; what would happen if a party becomes insolvent and its' deposits are held in a jurisdiction where the insolvency administrator is permitted to pick and choose between different agreements. Or what would happen if that jurisdiction does not recognise deposit netting all together. Furthermore, the provisions of the courts will be examined as to how far these reach. For example, a court in England and Wales may apply the laws of a different jurisdiction to the insolvency of an entity. More so, the implications of what will happen to any held deposits when a company becomes liquidated or wound up as a result of an event of default. How will such actions affect the deposit obligations involved? What guidance does the IDNA give in such case?

Preface

This thesis constitutes the final step towards pursuing my Jur Kand degree at the Faculty of Law, University of Lund in Sweden.

As an undergraduate, a final year student told me that as for the Juris Kandidat education, it would become even more interesting for every new semester. In hindsight, I can only agree with this statement. The journey has at times felt quite lengthy but looking back, I have enjoyed it immensely and I would recommend it to anyone who was to consider embarking on a legal profession.

My year in London, on exchange studies at Kingston University, Surrey helped me expand my legal horizons and introduced me, not only to the common law system, but also to the complex and dynamic area of banking and financial law. It is in the light of those aspects I came to choose the topic for this paper.

London 2010

Grace Tiderman

Abbreviations

BA87	Banking Act 1987
CA85	Company Act 1985
BBA	British Banker's Association
EFMLG	European Financial Market Lawyers Group
FDICIA	Federal Deposit Insurance Corporation Improvement Act
FSA	Financial Services Authority
ICOM	International Currency Options Market Terms
IDNA	International Deposit Netting Agreement
IFEMA	International Foreign Exchange Master Agreement
IFRI	International Financial Risk Institute
ISDA	International Swap and Derivatives Association
LIBOR	London Interbank Offering Rate

1 Introduction

1.1 The International Deposit Netting Agreement (IDNA)

In August 1996 the British Bankers' Association (BBA) published the International Deposit Netting Agreement.[1] (Here after referred to as "IDNA" or "the agreement").
The agreement was drafted with the help of international as well as British lawyers. It sets out the contractual framework for banks to off set deposits taken by a bank from a counter party, against deposits placed with the same counter party bank, in the situation of a specified event of default.

The IDNA is designed as a Master Agreement, which are often initiated and developed by trade associations to create a standard form of a certain industry type agreement, ensuring all parties take equal risks and conduct business in roughly a similar way.

One purpose of the agreement was to create an organised and clear ground when terminating a relationship when a bank had become bankrupt or if the bank became affected by insolvency proceedings. A second aim of the agreement was to provide a base for risk measurement which extended to the money taken or placed on deposit, irrelevant of its currency or maturity. Interestingly, some argue[2] that Master Agreements such as the IDNA will always be subject to challenge by their users, simply because it is a compromise solution which is the result of many parties lobbying for their desired outcome within the trade association. Whilst there may be some truth in this logic, I would still award the concept of Master Agreements sufficient importance as it provides a documented architecture for the standard terms of how parties should deal with issues of netting in insolvencies.

According to the BBA the financial market in its entirety would benefit where banks were enabled to set off deposits amongst each other. The BBA argued, provided set off would be permitted by governing laws, both banks would as a result severely reduce their credit risk.[3]

At the time of the agreement's formation the BBA estimated approximately $6000 billion cross-border interbank claims were outstanding in the G10 countries. Around the same time there were some $3 trillion interbank deposits in the world which would create a substantial base of situations for agreements such as IDNA to be effective upon. [4]

There was a call for measures to be taken regarding the tremendous losses banks

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[1] *International Deposit Netting Agreement (IDNA)*, BBA Enterprises Ltd 1996
[2] In particular, Alastair Hudson is known to be a critic of Master Agreements in general.
[3] *IDNA*, foreword page 1. See also below section 1.2 and 1.3
[4] www.bba.org.uk Public Policy Issues, *Deposit Netting* 15/01/2002

were making due to their global expansion and the lack of clear regulation. The credit risk associated with the inter bank deposit market had to be reduced.
The BBA believed the way to do this was by enabling a wider use of *deposit netting*.

The current global financial crisis has also highlighted that the interbank market can act like a double edged sword, playing a very important role in terms of ensuring liquidity among banks but also creating a credit crunch for businesses and private individuals.

1.2 The concept of Deposit Netting

What it is:
Banks that are active in the cash markets can reduce their counterparty risk by using the method of *deposit netting*. The use of deposit netting has been devised to improve the liquidity of the market and also help banks make more effective use of their credit lines.

In Sweden alone, the daily turnover of trading with financial instruments and currencies is estimated at several hundred billions SEK. Such transactions result in either delivery or payment obligations which must be settled between the transacting parties. It is therefore very widespread practice that parties set off their obligations against one another. The parties subsequently utilise the method of netting to achieve a *set off*.

Netting can be done with both derivatives and deposits and is widely used, both in off-balance sheet trading covering the whole trading portfolios of two counterparties, as well as through netting of deposits in the inter bank market. For deposits, which this paper will focus on, the netting procedure is logically known as *deposit netting*. The main benefit and purpose with netting is to reduce counter party risk and subsequently systemic risk in the financial market.

How it works:
Deposit netting works in such manner that the banks agree bilaterally that deposits and inter bank loans will be covered by a close-out agreement. In an event of default by one of the parties, for example a failure to pay or insolvency, the defaulting party will immediately pay a net figure to the other party and this single figure replaces the old individual loans and deposits.

The single figure is calculated[5] by regarding the principal amounts, the interest paid to date, and the replacement cost for the unexpired portion of longer dated contracts, also known as *break costs*.[6]

In such a situation, where the single net figure is payable by the defaulting party,

[5] Further discussed in section 2.4.3 *Calculation of aggregates.*
[6] *IDNA*, page 1 of the agreement, clause 1 “break cost amount”

the counterparty bank obtains a single claim in any liquidation and the particular amount can be ascertained straight away. The two banks will appoint certain offices which will cover all the unsecured deposits in different currencies[7] where applicable. However, entirely all unsecured deposits will not be covered by the two appointed banks as the agreement specifically excludes certain forms of deposits.[8]

Since the agreement is limited to unsecured deposits[9], to proceedings between banks and by using close-out netting instead of novation, various risks can be reduced without a call for change of the way agreements are contracted into. If a bank chose to reject these limitations, it would have to track both loans and deposits against its counterparty limits.

Worth stressing is that transactions with corporate customers are not covered by the agreement[10]. Two-way deposit dealings are uncommon in this particular market and major customer agreements typically already include provisions regarding offsetting of credit and debit balances.

1.3 Netting and Set off - the terminology

The terminology surrounding netting and set off is commonly subject to confusion.

The term *netting* is often used as a synonym for the word *set off*. In the financial markets the word netting is used regularly because of the fact that it has several connotations. The term *set off* however is a procedural obligation or a right which arises through law or contract to discharge or reduce a liability where two parties hold a claim on one another. Hence, by using the procedure of netting one can achieve the result of a set off.[11]

Interestingly, *set off* as a term was mentioned as early as 1939 by Lord Denning MR when the Court of Appeal were required to consider the term in the context of cross claims and set-off under s.28 of the Limitation Act 1939: '*These cross-claims must arise out of separate transactions, if there is no separate transaction but only opposing demands arising out of the same transaction, then no question of set off arises'*.[12]

Provided a situation of event of default has arisen, clause 2 of IDNA enables the non-defaulting party to set off all its deposit obligations regardless of their currency[13] or whether the deposit obligation lies with a designated office.[14] The non-defaulting party has a general right to set off the deposit obligations and the clause further provides for so called *automatic* set off. By logic, this means that the

[7] Certain currency aspects is further discussed in section 3.4.3 *Calculation of aggregates*.
[8] See below, section 2.1
[9] *IDNA*, page 1 of the agreement, clause 1 "deposit". See below section 2.1
[10] *IDNA*, page 1 of the agreement, clause 1 "deposit"
[11] See further *The In house Lawyer* (IHL), November 1996, page 52-53
[12] '*Close-out Netting and taking security in Financial Market Contracts'* , page 3, Alastair Hudson 1999 www.alastairhudson.com
[13] See further in section 2.6 Calculation of Aggregates
[14] See further below

set off will occur automatically with regard to all deposits as soon as an event of default occurs. What characterises such an event will be described in further detail in a section 2.4 Events of Default.

1.4 Close-out Netting

There are two main types of netting, namely *close-out netting* and *novation*. This section will explain the nature of close-out netting. It will not deal with novation as it is not relevant to the concept of deposit netting within the scope of IDNA.

Two parties can use close-out netting in order to settle all contracted but not yet due liabilities and claims on one another by one single payment. The payment is made immediately and upon the insolvency or event of default of a party, for example, the payment could be made when a liquidator is appointed for one of the parties.[15]

It is common in international standard agreements to include a clause which prohibits the defaulting party's estate[16] from participating in the netting. Such a clause will be known as a "close-out" agreement, and international standard agreements containing such a clause are known as close-out netting.

As mentioned in section 1.3 netting is regarded as a tool to reduce credit risk or counterparty risk, although there is an element of legal risk to the tool, meaning an agreement entered into may not go ahead as intended. This is due to the fact that netting may not be legally enforceable in all the countries where a bank or financial institution operates and each type of netting may have varying degrees of enforceability in the event of default.

Not all jurisdictions are equally favourable towards netting arrangements and some jurisdictions allow insolvency administrators to pick and choose between the contracts to be performed in insolvency, so called "cherry picking"[17].

Over the past two decades netting has been a topic of much debate internationally. Several working groups have in the past been assembled by the central banks of the G10 countries to analyse netting for cross-border currency transactions and large deposit payments.

1.5 Reasons to use Deposit Netting

It is held by the BBA that banks will benefit from entering into a deposit netting agreement. So what risks does the IDNA and deposit netting seek to mitigate?

[15] If a liquidator is not appointed then each transaction is settled individually on due date provided the counterparties do not have an additional obligation netting agreement. For *liquidation*, see further chapter 4 "Liquidation and Set off"
[16] "*Estate*" on this occasion to be interpreted as "*konkursbo*" in Swedish
[17] *Cherry picking*, see further section 3.4.2 "Set Off"

Firstly and the most obviously, *counterparty risk* or *credit risk*, the risk that a bank's counterparty becomes insolvent or otherwise defaults on its obligations. Secondly *systemic risk;* the risk that affects an entire financial market and not solely specific participants. As banks have many different deposits and interbank loans with one another the agreement seeks to mitigate a domino effect of several banks defaulting on their obligations and creating disruptions in the global interbank payment flows.

The exposure is reduced or even eliminated where the bank has a two way trading to the counterparty bank. This allows for a more extensive use of credit capacity since the initial risk is reduced. Similarly to netting of derivatives- the result comes to a possible increase of trading transactions but without a proportionate increase of the exposure of net credit.

Where these risks are reduced the possibility of a bank defaulting and causing other banks liquidity problems is radically minimised. Besides reducing credit and liquidity risks, and consequently systemic risk, a side effect of the agreement would be a reduction of transaction costs and communication expenses.[18]

Wood argues that the arguments in favour of set off are; (1) that it is unfair that the defaulting party can insist of payment, but avoiding payment himself; (2) set off helps creditors and mitigates the domino effect of bankruptcy; and (3) set off avoids circuitry and therefore reduces cost.[19]

In addition, the BBA argues that further advantages would be gained considering the fact that interbank deposits were poorly regulated. At the time, the legal basis was sought in untested practice and custom. The agreement therefore brought along clear documentation to the area.

1.6 Set Off in Practice

Then how is a set off practically achieved? To start, both parties must have a cross-claim against one another which usually arises from the same transaction, or a closely related transaction, as the debt owed. One, or often both, of the claims may be for an unliquidated sum. The deposit obligations owed by one party to the other will immediately become due and therefore payable. Exceptionally, the payments will however not become due if there exists other terms between the parties where those payments are already due or have been paid. The deposit obligations are aggregated and set off, and the difference between the two sums will be paid by the party with the larger aggregate obligation.[20] This method is known as an *equitable set off*. It is one of four different types of set off, although the remaining three will not be discussed in this paper.[21]

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[18] www.bba.org.uk Public Policy Issues, Deposit Netting 15/01/2002
[19] Page 15, *Principles of International Insolvency*, Philip R Wood, Sweet & Maxwell 1995
[20] IDNA, page 4, clause 2 "netting"
[21] The three other types of Set Off include: *Legal Set Off*, *Banker's Set Off* and *Insolvency Set Off*. The first two, along with *Equitable Set Off* can be extended by contract. See www.riskglossary.com

A different way of explaining set off is that the debtor can deduct the amount of the mutual cross-claim from the debt he owes, and tender the balance of the debt, provided there is any, to the creditor. As mentioned above the sums must obviously be due and payable before set off can be done.

Simplified one could illustrate a set off as follows:

Example

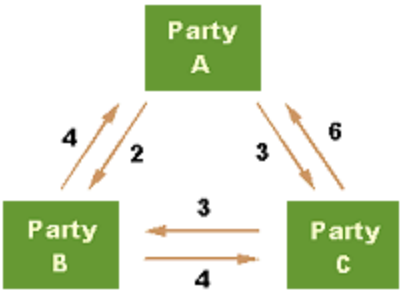
A owes B $5 million	**A → B ($5m)**
B owes A $10 million	**A ←B ($10m)**

When both parties have a claim against each other, a cross-claim, the party owing the larger sum (B) pays the difference between the two sums to the other party and the sums are this way netted against one another.

B pays difference of $ 5 million to A	**A ← B ($5m)**

How to achieve set off could also be shown with the help of the netting models below[22]. The first example shows a potential situation where the parties lack any kind of netting agreement. The second model in Example 2 contrasts the situation where a bilateral netting agreement, such as IDNA, is in force.

Example 1: **No Netting**

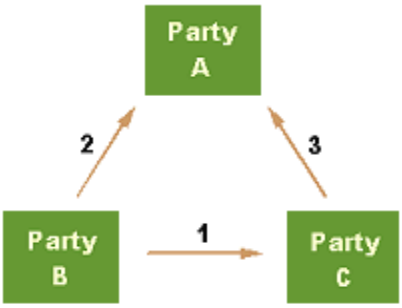


The example shows a situation where netting is not being used. The defaulting party is enabled to pick and choose between obligations[23]. He can demand payments on obligations that are owed to him at the same time as he defaults on his own payments to counterparties. In the above model, if Party C is in default, the counterparties A and B must fulfill their obligations towards C to the value of 4

[22] www.riskglossary.com Risk Glossary, Encyclopedia, and Resource Locater "Netting"
[23] In this context usually known as "cherry picking."

from B, and 3 from A.

Example 2: **Bilateral Netting**



IDNA provides for so called Bilateral Netting as shown in the above example.[24] Here, the parties have agreed that their obligations with one another will be netted. If one of the parties defaults, each party has its own commitments. Where Party C defaults, it must pay replacement costs towards the other parties. An obligation value of 3 will go to Party A and nothing will go to Party B as there is no obligation owed by C.

1.7 Risks and Previous Netting Standards

The section seeks to provide a historical backdrop and briefly study the origin of why netting standards were developed as well as an insight to IDNA's predecessors and previous netting standards.

How it all started: 'Herstatt' and Settlement Risk
One may ask what brought about the ideas and notions of creating a standard format of agreement for a netting agreement in the first place.

The search for comity in insolvency in Europe started in the 1960's with the intention to develop a bankruptcy convention that would parallel the 1968 Convention on Jurisdiction and the Enforcement of Judgments in Civil and Commercial Matters. Various unsuccessful attempts were made over the years but the outcome was often that EU member states failed to implement these conventions.

The initial trigger was the revelation of *settlement risk*, meaning the risk that a settlement in a transfer system does not take place as expected. This will normally happen because one party defaults on its clearing obligations to one or several

[24] See reference 31

counterparties. As such, settlement risk includes both credit and liquidity risks.

An early well-known example of settlement risk is the failure of a small German bank, Bankhaus Herstatt in 1974. In June that year, the firm's banking licence was withdrawn, and it was ordered into liquidation. But after the close of the German interbank payment system, some of Herstatt Bank's counterparties had irrevocably paid Deutschemarks to the bank during the day but before the banking licence was withdrawn. They had done so in good faith, believing they would receive US dollars later the same day in New York. However, it was only mid-morning in New York when Herstatt's banking business was terminated. Herstatt's New York correspondent bank suspended all outgoing US dollar payments from Herstatt's account; leaving its counterparties fully exposed to the value of the Deutschemarks they had paid the German bank earlier on in the day.[25] Subsequently the notion of *Herstatt risk* would refer to this type of settlement risk, where one party pays out the currency it has sold but does not receive the currency it bought.

More recent examples of Herstatt risk surfaced in the modern cases with the collapse of US investment bank Drexel Burnham Lambert in 1990, Bank of Credit and Commerce International in 1991 and Barings Bank in 1995 are all examples of situations where 'Herstatt' risk has been an issue.[26]

The best way, it was deemed, to mitigate settlement risk was to create an efficient and safe payment system which would incorporate accepted international standards and practices. Hudson provides an interesting, albeit slightly eccentric, approach to the matter. He states that financial markets create, manage and exploit risk; frequently at the same time. He states the role of lawyer in this context is to act as a risk manager. To achieve legal risk management, Hudson gives us two options; the first is to not enter into the markets at all and therefore avoiding all risk, the second is by creating contracts which seek to control those risks.[27]

In the past, various reports have been written on how netting schemes such as the IDNA should operate. One of the first reports on netting was the "*Angell "Report on Netting Schemes*" (1989).[28] It presented an analysis of the credit and liquidity risks experienced by participants in bilateral and multilateral netting arrangements for both inter bank payment orders and forward-value contracts such as foreign exchange trades. The report also looked at the effects of netting in regard of inter bank settlement arrangements, the conduct of monetary policy, the complications with the allocation of supervisory responsibilities, and the effective overview of cross-border netting schemes.

The Bank for International Settlements issued in 1990 minimum standards for the operation and construction of netting schemes. Nowadays we know them as the *Lamfalussy standards* after the Committee chairman who wrote the report, Alexandre Lamfalussy. The six standards laid down were:

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[25] http://en.wikipedia.org/wiki/Settlement_risk
[26] http://riskinstitute.ch/134710.htm
[27] Page 3 '*Close-out Netting and taking security in Financial Market Contracts'* Alastair Hudson 1999, www.alastairhudson.com
[28] *Angell "Report on Netting Schemes"* 1989

1. *Netting schemes should have a well-founded legal basis under all relevant jurisdictions.*

2. *Netting scheme participants should have a clear understanding of the impact of the particular scheme on each of the financial risks affected by the netting process.*

3. *Multilateral netting systems should have clearly defined procedures for the management of credit risks and liquidity risks that specify the respective responsibilities of the netting provider and the participants. These procedures should also ensure that all parties have both the incentives and the capabilities to manage and contain each of the risks they bear and that limits are placed on the maximum level of credit exposure that can be produced by each participant.*

4. *Multilateral netting systems should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single net-debit position.*

5. *Multilateral netting systems should have objective and publicly-disclosed criteria for admission which permit fair and open access.*

6. *All netting schemes should ensure the operational reliability of technical systems and the availability of back-up facilities capable of completing daily processing requirements.*

A year later, the Lamfalussy standards were subsequently explained in the "*Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries*" (1990). This report analysed the impact of netting on credit, liquidity and systemic risk and set out principles for central bank oversight of cross-border and multi-currency netting and settlement schemes. The report covered foreign exchange but not all types of important payment systems.

Later documentation on deposit netting has involved further developments of the Lamfalussy standards but also consultative papers by the Basle committee on for example on-balance sheet netting.[29]

Various latter community legal acts have sought to offer greater legal certainty to financial market participants on the enforceability of bilateral contractual set off and netting agreements. These acts include in particular, but will not be discussed in this paper:

[29] *"Interpretation of the Capital Accord for Multilateral Netting of Forward Value Foreign Exchange Transactions"*(1996), *Consultative paper on on-balance sheet netting* (1998) http://riskinstitute.ch
International Financial Risk Institute (IFRI) Forum documents: *Netting*

• Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings (the Insolvency Regulation)

• Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions (the Banks Winding-up Directive)

• Directive 2001/17/EC of the European Parliament and of the Council of 19 March 2001 on the reorganisation and winding-up of insurance undertakings (the 'Insurance Undertakings Winding up Directive)

• Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (the Collateral Directive).

Results and outcomes post-Herstatt

The previous efforts of creating a EU Convention of bankruptcy proceedings came close to success in the 1990 European Convention on Certain International Aspects of Bankruptcy (the Istanbul Convention).

Following only one ratification (Cyprus), the 1990 Convention was superseded by a draft European Union convention on Insolvency Proceedings. Although European Union member States came close to adopting that draft convention in November 1995, implementation ultimately proved impossible. The convention was revived in the form of a European Council regulation in May 1999, which was adopted by the Council on 29 May 2000 and came into effect on 31 May 2002[30]

The likes of Herstatt and latter cases along with the crash of 1987 made regulators review settlement procedures and consequently brought about such fundamentals as DVP (Delivery-versus-payment) and multi-DVP as set out in the CPPS in the 1993 (Noel Report).

DVP constitutes a sale-transaction of negotiable securities (in exchange for cash payment) that can be instructed to a settlement agent which seeks to enable automatic processing achieving a simultaneous exchange of assets.[31] The simultaneous exchange caters for a reduced risk in the delivery and settlement of funds as they will occur at the same time in real time.

The CPSS[32] concluded that the best way of eliminating principal risk was the creation of delivery-versus-payment (DVP) systems. This system along with the use of central securities depositories has aided settlement and post settlement, the latter especially for securities.

By taking measures to prevent settlement risk from occurring, you ultimately

[30]See further discussion in the below chapter "The EU's Approach to Insolvency Netting".
[31] http://en.wikipedia.org/wiki/Delivery_versus_payment
[32] 'Committee on Payment and Settlement Systems'; a standard-setting body within the Bank for International Settlements, http://www.bis.org/cpss/index.htm

reduce the possibility of *systemic risk*[33]. Hudson argues that without effective standard market contracts there would be an increase of systemic risk. It is the domino effect of market distress amongst marketplayers that is the essence of systemic risk. The marketplace has subsequently introduced protection against this variety of total risk to the market by standardising market practices and standardising legal documentation on termination- and netting provisions, a good example being the BBA's introduction of the IDNA.[34]

Further measures, such as what approach and actions the EU has taken in its response to the need for international standards in netting and insolvency, will be discussed later in the paper in chapter 4.

[33] *Systemic Risk*, known as the risk of collapse of entire financial system or market, as opposed to risk associated with any one individual entity, group or component of a system.
[34] *Close-out Netting and taking security in financial market contracts*, Alastair Hudson 1999, www.alastairhudson.com

2 Key provisions of IDNA

2.1 Definitions within IDNA

Despite that the IDNA clarifies definitions of certain relevant terms, not all expressions are defined to a far-reaching extent and are subsequently left to interpretation. Assumptions must be made regarding some provisions. For example a *bank* must be assumed to fall within the definition set out in the Banking Act 1987, as should a *company* fall within the definition in section 735 of the Companies Act 1985. I.e. such vocabulary must be interpreted in accordance with their definition in law, or otherwise by their common meaning.

Where IDNA refers to a *bankruptcy* or *insolvency*, we can assume it refers to such situations which are regulated under the Insolvency Rules and Act 1986, and the schemes of arrangement under section 425 of the Companies Act 1985.

The most detailed definition in the agreement is undoubtedly the definition of a *deposit*. A deposit, in the sense which is discussed in this paper, refers to a sum of money that is entrusted for safekeeping, as in a bank.

In the agreement a deposit is defined as any unsecured inter-bank money market cash deposit placed by one party with another.

The deposits must in any case be placed in through offices that are designated in the agreement by the parties. One must note the difference between a *deposit* and a *deposit obligation*. A deposit obligation is defined as an obligation to pay principal, interest or any other sum[35] with respect to a deposit held at a designated office of the non- defaulting party. The parties can therefore specifically agree that an obligation is to be known as a deposit obligation within the agreement's context.

There are exceptions to the definition of a deposit and the following instruments are excluded:[36]

(a) Instruments which are not legally deposits, such as notes, bonds, commercial paper, and sums paid relating to the transfer of securities under repos, reverse repos and securities loans.

(b) Any deposit held as or taken by way of credit support or collateral for the obligations of any person in relation to any transaction or transactions between the parties.

[35] "whether present or future, actual or contingent."

[36] *IDNA*, page 1 of the agreement, clause 1 "deposit"

(c) Any document which is represented by a Certificate of deposit and similar instruments.

(d) Deposits made for a specific purpose, such as deposits made with respect to inter-bank payment clearing and settlement and deposits made between banks where one is a correspondent bank for the other.

(e) A deposit which is not beneficially owned by a party, for example a deposit in respect of which the depositor has notified the deposit taker that the depositor is acting as trustee, agent or otherwise not as a principal in relation to the deposit. [37]

The last exclusion seeks to ensure the mutuality of claims, although this is not critical to contractual set off under English law, it is likely to enhance international effectiveness of the document.

Other more technically related definitions will be explained in their respective relevant chapters.

2.2 Assumptions in IDNA

The most important clause of the agreement which enables deposit obligations to be netted is the central provision of clause 2. It is the most substantial clause of the agreement with details of the parties' rights to set off in the event of one party's default. Although the interpreter is left to make certain assumptions.

One must assume that the agreement is legally binding for both parties and is enforceable against them under England and Wales laws. It is implied that the parties have the relevant power and authority to place and take deposits, as well as the capacity of entering into such an agreement in the first place.[38] Actions required for the agreement to come into force should adequately be taken. This involves any kind of licenses or approvals that must be obtained to ensure the agreement's validity.

One essential point in the context, albeit obvious, is that the parties must have formally entered into the agreement before any Insolvency proceeding is brought against any of the parties. IDNA can only be entered into by two solvent parties but if one party is on the brink of an event of default, this does in principal not affect the situation as long as the agreement has bound the parties prior to any insolvency proceeding commences.

The obligations and contractual arrangements under the agreement must be followed and can not be avoided apart from in the situation of a winding- up or an administration order by the courts.[39]

[37] See further www.practicallaw.com "deposit netting"
[38] See further *Legal Opinion of Clifford Chance* 1996, page 2, clause 2
[39] *Legal Opinion of Clifford Chance* 1996, page 3, clause 2 (7)

2.3 Governing Law

As mentioned above, the agreement is assumed to be binding on the parties according to England and Wales laws. This can be considered a well founded assumption as the agreement sets out in its clause 5, that the agreement will be governed and construed according to the laws of England and Wales. Here the intention of the BBA to recognise English law is clear.

However, there are certain conditions regarding the choice of law. The choice of English law must firstly be made of free will. Secondly, it must be made in good faith for "bona fide purposes". The choice can neither be made in opposition of English public policy, even where none of the parties are registered and incorporated within the jurisdiction. [40] The so called "choice" of law is therefore in effect restricted to English law. The agreement is drafted with English law as the governing law and the parties must consequently consent to this choice. There is a good reason for restricting the governing law to English law. The reason being that not all jurisdictions allow deposit netting; this will be discussed in further detail below.

Clause 5.2 of IDNA even states that the parties must irrevocably agree to the choice of jurisdiction for the benefit of the other party and that the English courts will thereby determine any future proceedings. The parties must also waive any objection they may have with regard to the place of proceedings or in which court proceedings are held. In addition, the parties can not insist that the proceedings have been brought in an "inconvenient forum".[41] As a natural consequence a party can not object that the English court lacks jurisdiction over it. Clause 5.2 further states that neither party is prevented by the agreement to bring proceedings in a different jurisdiction. In practice though, it is probably unlikely that a party will choose to bring a proceeding in another jurisdiction since it might cause unnecessary complications. Say one party would choose to bring proceedings in France in a French court. The French court will have to deal with the matter under the laws of England and Wales which it is not familiar with. It would be a disturbance for the French court to have to interpret English law and subsequently English law is probably easiest dealt with in an English court.

2.4 Events of Default

The event of default is the actual situation that must occur in order for set off to be enabled. A default can be characterised by one or a number of different shortcomings with regard to one of the parties. The agreement sets out six situations that constitute an event of default as follows.

1. Firstly, we have one party's failure to pay. A default occurs when a party has not paid a deposit obligation that is due. This party is subsequently referred to as the

[40] See further IDNA clause 5 and *Legal Opinion of Clifford Chance* 1996, page 3, clause 3 (1)

[41] IDNA clause 5.2

defaulting party. The failure to pay shall, according to the agreement[42], continue for two business days after a written notice has been given by the *non- defaulting* party to the defaulting party that the payment has not been made. A failure to pay will however not amount to an event of default provided the following situations are at hand.[43] The exceptions involve: (1) if the failure to pay is due to the defaulting party being prevented from making the payment on time because of force majeure, i.e. a situation which is beyond his control. It could (2) also be that the party is prevented by an act of State, the most obvious one being a declaration of war or similar. The third and last situation is where a payment is prevented when it is either (3) *unlawful* or *impossible*. Unlawful, is clear so far as it refers to where payment is illegal, for example when made under duress, threat etc. But, "impossible" is more difficult to determine which type of situations fall within the scope. One must assume that all situations that are neither force majeure, act of State nor unlawful will be directed to the final safety net of "impossible" and whether they fall within the boundaries of this situation will be a matter for the courts to decide upon.

2. An event of default will also be at hand when a party has begun a voluntary case proceeding in court. The agreement refers to proceedings where the party seeks liquidation or re-organisation (situations of moratorium included) in order to obtain relief for any debts it may have under a bankruptcy, insolvency or a similar situation. The sub clause also includes proceedings where the defaulting party seeks the appointment of a trustee, receiver, liquidator, conservator, administrator, custodian or similar representative[44] for the defaulting party or any considerable part of its assets.[45]

3. If the defaulting party does not itself apply for such proceedings or actions to be taken, an event of default will similarly occur when a banking supervisory, a governmental authority or a self regulatory organisation, which has jurisdiction over the defaulting party[46], starts an action against it. The structure of the sub clause is more or less identical to (ii) and permits the governmental institution or organisation to seek to obtain relief for the debts of the defaulting party, or to appoint a custodian correspondingly as above.[47]

4. The next sub clause (iv) provides for the commencement of a so called *involuntary* action or proceeding against the defaulting party to constitute an event of default. It encompasses the situations where neither the defaulting party nor a governmental institution as mentioned above, brings an action or starts a proceeding, but where procedures commence automatically. In the same way as sub clauses (ii) and (iii), relief can be sought through liquidation etc. for relief with regard to the defaulting party's debts or appointment of a custodian.[48] In addition, the involuntary case or procedure must not have been dismissed within five days of its institution.

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[42] IDNA, page 2 "defaulting party" (i)
[43] IDNA, page 2 "defaulting party" (i)
[44] The representatives are referred to in the agreement as "Custodians", IDNA "defaulting party", page 2.
[45] IDNA, page 2 "defaulting party" (ii)
[46] Or has jurisdiction over the defaulting party's assets. IDNA, page 2 "defaulting party" (iii)
[47] IDNA, page 2 "defaulting party" (iii)
[48] IDNA, page 3 "defaulting party" (iv)

5. Obvious events of default which the agreement provides for include when the defaulting party becomes bankrupt or insolvent.[49]

6. The final event of default is when the defaulting party or any custodian acting on its behalf shall disclaim, disaffirm or repudiate a deposit obligation. A decision by a party to reject or not accept any deposit obligation will subsequently amount to an event of default under the agreement.[50]

2.5 Set Off

As mentioned in section 1.5 where an event of default occurs, the non-defaulting party has a right to set off all or any of the deposit obligations. The set off will be done automatically if the parties agree to it by signing the Schedule of the IDNA verifying that the second sentence of clause 2 shall apply.[51] An automatic set off is therefore triggered by an event of default. The ability to opt for automatic set off is similar to the option which the parties have under the ISDA Master Agreement[52] where they may choose an automatic termination of derivative transactions under the ISDA Master Agreement. In deciding whether to select automatic termination, the parties will need to consider the jurisdictions in which their counterparty is incorporated, resident or domiciled, possibly also where its assets are situated, and whether automatic set-off is preferable, bearing in mind, in particular the insolvency laws of the relevant jurisdictions.

2.6 Calculation of Aggregates

The sums owed by both parties to one another are referred to in the agreement as *aggregates*[53]. In order to enable a set off, a calculation of the aggregates must take place. The agreement sets out provisions for how the calculation of aggregates should be made.

The non-defaulting party must translate an obligation which is not denominated in the *base currency*[54] into the base currency at the *spot rate*[55] on the date the set off takes place. If the base currency is not converted on the exact date, it must be done as soon as possible as the non- defaulting party can practically determine the rate.

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[49] IDNA, page 3 “defaulting party” (v)
[50] IDNA, page 3 “defaulting party” (vi)
[51] IDNA, page 3 “netting”
[52] See further *Practical Law*, PLC Reference: 9-100-2414, Legal & Commercial Publishing Limited 1996 and *ISDA Master Agreement* clause 2 C
[53] IDNA, page 4, clause 2 “netting”
[54] *Base Currency*, being the currency both parties agree on in the Schedule of IDNA which will be applicable to their mutual agreement.
[55] *Spot Rate*, in the context when converting one currency into the base currency, spot rate determines the rate of exchange that the non-defaulting party concludes at 11 am on the date of the set off. Where the non-defaulting party can not conclude the spot rate, one will use the rate quoted by the London Interbank market. It basically determines at which rate the base currency can be sold on a particular date. See, IDNA clause 1 “definitions”.

If the obligation can not be ascertained, the non- defaulting party must bona fide decide on the obligation's value, provided the obligation is due and payable at the particular time, and subsequently take such value estimated into account with respect to the aggregation and set off. In order to avoid doubt, any *break cost amount*[56] related to a deposit and payable under IDNA, will be included as part of the party's deposit obligation. Once an obligation is included in an aggregation for a set off, the obligation is considered discharged so far as it is included.[57]

There is a duty of notification when the non-defaulting party chooses to exercise his right of set off. The notice must be given to the defaulting party informing it of the action taken, along with specified information of the deposit obligations that are to be set off. Interestingly, this duty is not especially strictly imposed on the non-defaulting party. If he for any reason fails to give such a notice or the notice is delayed, this will not constitute an invalid set off or prevent the set off from taking place.[58]

When a deposit obligation becomes payable at an earlier stage than it normally would, due to an event of default under clause 2, the deposit taking party must pay a break cost amount[59] to the deposit giving party. This will take place provided the break cost amount is a positive sum and it must be paid with regard to the deposit it relates. On the other hand the deposit giving party, the depositor, is liable to compensate the deposit taking party for the absolute value of the break cost amount under the circumstance the amount is negative.[60] This means that if interest rates have increased from the time the deposit is taken until the deposit becomes payable, the depositor has a right to be paid for the interest earnings he missed out on. Where interest rates have gone down, the break cost amount becomes a negative sum and the deposit giving party must "pay up" to the original value of the break cost amount.

Furthermore, when calculating the amounts owed to and from the defaulting party, the insolvency representative of this jurisdiction shall include all the amounts of any deposit obligations held abroad within the designated offices. In short, it does not matter if the deposits have been held by a designated office in a different jurisdiction. All deposits will be taken into account for the calculation to achieve a set off in compliance with the terms of the agreement. The inclusion of all deposits for the calculation will apply in a reverse situation where the defaulting party is incorporated abroad but has a designated office within this jurisdiction.[61]

The IDNA restricts the governing law to England and Wales[62] stating that

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[56] *Break Cost Amount*, the amount of interest the depositor would have earned on that deposit during the time from the date of when the deposit becomes repayable to when it originally would have been repayable. It also means the amount of interest the depositor may have lost had the deposit been invested at the London Interbank market the best rate available between the time of when the deposit becomes repayable to the original agreed date of repayment.
[57] IDNA, page 4, clause 2 "netting", section 3
[58] IDNA, page 4, clause 2 "netting", section 4
[59] *Break cost amount*, see ref. 37
[60] IDNA, page 4, clause 2 "netting", section 5
[61] Clifford Chance opinion, IDNA page 5, section 3.3 (2)(ii a,b)
[62] Clifford Chance opinion, IDNA page 3, section 3.2 (1b)

regardless of in which jurisdiction the relevant deposit obligations are held, the provisions for set off and aggregation under the agreement, are effective and valid under England and Wales law. With this reasoning it seeks to promote that geographical location of the deposits will not affect the fact that English law will be applicable to the set off procedure where such terms have been incorporated into the agreement.

2.7 Provisions of the Courts & UK Court Rulings

The UK courts have the discretion to impact on certain aspects of a proceeding, such as where the proceeding should be held etc. A situation may occur where an English court comes to the conclusion that a certain proceeding will be better dealt with in a different forum. The court can in such case adjourn a proceeding in this jurisdiction and instead suggest the appropriate or more convenient forum.[63]

In a situation where a concurrent proceeding is already being held elsewhere, the English court may also here adjourn the proceedings in jurisdiction under some circumstances.[64] The court must then take into account if such an action will prejudice the plaintiff. Furthermore, where we are dealing with an insolvency proceeding, the court must regard whether the creditors in this jurisdiction may be subject to prejudice.[65]

Where a concurrent proceeding is taking place in a different forum, the courts of this jurisdiction have various discretions to get involved. They may take the proceeding into account as well as assist the other forum as appropriate. One important possibility enabled by the Insolvency Act is that an English court can apply the laws of a different jurisdiction to the insolvency of an entity if the proficient court of that other jurisdiction has requested it. The conditions are that the jurisdiction whose laws are to be applied must be among those of a certain specified list.[66] The entity subject to the insolvency must not be incorporated abroad, it may as well be a company incorporated and registered in England and Wales for the rule mentioned above to apply.[67]

As a consequence, where a claim is made by a creditor during an insolvency proceeding in this jurisdiction, the English courts will regard any received or recovered sum the creditor may have obtained from a proceeding held in a different

[63] Clifford Chance opinion, IDNA page 5, section 3.3 (2) (iv) (a)
[64] What these circumstances may be is yet to be decided upon. Such circumstances have not been specified to what they include.
[65] Clifford Chance opinion, IDNA page 5, section 3.3 (2) (iv) (a)
[66] The specified jurisdictions include the other parts of the UK except Scotland, the Channel Islands, the Isle of Man, Anguilla, Australia, the Bahamas, Bermuda, Botswana, Canada, Cayman Islands, Falkland Islands, Gibraltar, Hong Kong, Ireland, New Zealand, St Helena, Montserrat, Turks and Caicos Islands, Tuvalu and Virgin Islands.
[67] See further the Insolvency Act 1986, section 426

forum.[68]

If the result of a proceeding in a forum different than England or Wales is to extinguish liabilities or claims under the governing law of such claims or liabilities, then the English court can recognise that extinguishment.[69]

2.8 The Unhelpful View of UK Court Rulings

In England and other jurisdictions which share the same view of the set-off clause, the clause is mandatory in an insolvency proceeding and cannot be contracted out of. For example, insolvency set off has been statutory since 1705 which indicates the strong nature of the policy.[70]
But what view have the UK Courts taken in terms of contractual provisions to effect netting? No doubt, one of the most difficult issues with a netting agreement is whether or not liquidators are allowed to 'cherry pick' contracts, however there is generally no difficulty where amounts are owed that will create a one single payment which is subsequently exchanged between the parties. With that in mind, netting of deposits ought not cause any objections from the UK Courts in terms of enforceability.

I wanted to examine some previous cases where the courts have assesses the enforceability of netting agreements entered into between two or more parties.
Case law does not provide much in terms of deposits; however netting agreements between parties in derivatives transactions are plentiful.

There have been a few unhelpful rulings from the UK Courts where they have not recognised the contractual provisions which the parties had entered into. The circumstances in these cases were rather specific as I will now examine.

In the House of Lords case *British Eagle International Airlines -v- Air France*[71] the case involved a clearing house scheme where the two airlines would net amounts owed between one another on a frequent basis. British Eagle subsequently went into liquidation whilst still owing amounts under their mutual agreement. The Court held by a majority that it would be disadvantageous towards British Eagle's other creditors to uphold the clearing house agreement and that it would contravene the parri passu rule.[72] Some have argued that this case goes against the commercial understanding of the parties' agreement as the House of Lords' ruling suggests that the agreement cannot be honoured despite provision was made for an explicit

[68] Clifford Chance opinion, IDNA page 6, section 3.3 (2) (iv) (b)
[69] Clifford Chance opinion, IDNA page 8, section 4.2 (4)
[70] Page, 160, para 10-17, Philip R Wood, *Title Finance, Derivatives, Securitisations , Set-Off and Netting*, Sweet & Maxwell 1995
[71] (1975) 2 AllER 390 HL, see also further discussion in '*Close-out Netting and taking security in Financial Market Contracts'* , page 3, Alastair Hudson 1999 www.alastairhudson.com
[72] See reference 84 for definition of the *parri passu* rule.

clause under the contract.[73]

There have been a number of court rulings relating to the enforceability of netting contracts but where derivatives, and not deposits, were involved. To illustrate; in *Westdeutsche Landesbank v. Islington*[74] we can conclude that payment netting is permissible as the parties had in their agreement contracted that a liability to 'pay net sums' would occur and thereby set-off achieved. The contract provided that the only the party owing the greater sum would pay the net amount to the other party.

The difficulty in many subsequent derivatives cases is whether agreements are viewed as one single executory contract or whether the derivative instruments are viewed as a series of individual debts owed between the parties. This was the issue in *Kleinwort Benson v. Birmingham C.C.*[75] where the lack of a contractual nexus across a range of derivatives prevented netting 'across the board' of a series of transactions from being allowed.[76]

In relation to the right to set off in corporate liquidations, the House of Lords concluded in *Stein v. Blake*[77] that rule 4.90 of the Insolvency rules 1986 were upheld. The rule provides that where mutual claims were owed prior to the liquidation, the sums due from one party to another shall be set off against the other. However, worth noting is that rule 4.90 is restricted to English law transactions and will not have any bearing on international contracts and agreements, as Hudson highlights[78] that English law obviously cannot control private international law issues that arise from conflicting rules of national insolvency law.[79]

Hudson argues[80] that the problem with the rulings in the above mentioned derivatives cases is that the courts choose to ignore that the parties had in fact allocated the risks of their transactions and that interestingly despite extensive documentation between the parties, the courts made no mention to any of the mutually contracted terms.

This unhelpful approach by UK courts to not recognise the credit enhancement-and risk allocation solutions by market participants causes further systemic risk and removes an element of certainty for OTC agreements. Due to the lack of deposit cases (deposits being much less complex than derivatives) we can only make parallel assumptions that the view taken on netting agreements for derivatives

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[73] See Hudson's comments in '*Close-out Netting and taking security in Financial Market Contracts'* , page 5, Alastair Hudson 1999 www.alastairhudson.com
[74] [1996] A.C. 669
[75] [1996] 4 Al1 E.R. 733
[76] See Hudson's comments in '*Close-out Netting and taking security in Financial Market Contracts'* , page 8, Alastair Hudson 1999 www.alastairhudson.com
[77] [1996] 1 A.C. 243
[78] '*Close-out Netting and taking security in Financial Market Contracts'* , page 6, Alastair Hudson 1999 www.alastairhudson.com
[79] See further discussion on Conflicts of Law in chapter 3.3
[80] '*Close-out Netting and taking security in Financial Market Contracts'* , page 11, Alastair Hudson 1999 www.alastairhudson.com

instruments may potentially also apply to deposits.

One argument for why a netting agreement for deposits may be viewed more favorably than a similar one for derivatives could be due to the fact that deposits do not have problematic aspects such as proving nexus or title. Unlike a deposit, a derivative can consist of several elements and transactions within it which together constitute the instrument. If liquidation would occur in between two of such partial transactions the difficulty remains what would happen to the remaining leg of the transaction. This is why market participants introduced master agreements to enable set off and Hudson quite rightly argues that there is a need for UK courts to consider these agreements in a more commercial context instead of quelling the market's attempts to introduce effective and consensual regulation has become ineffective.

3 International Aspects of Netting and Set Off

3.1 The relevance of International Insolvency issues in relation to Netting and Set off

This chapter will examine the international aspects of netting and set off.
The International Deposit Netting agreement is governed by English law. Even though a contract must be enforceable under its governing law, netting is primarily a matter of insolvency law. Some insolvency jurisdictions, including England, provide for mandatory set off upon the occurrence of insolvency. This displaces any contractual set off agreed between the parties. Other jurisdictions limit or prohibit set-off in an insolvency situation. Therefore, when determining the usefulness of a netting contract such as IDNA, it is essential to consider whether contractual set off can survive the commencement of insolvency and, if it cannot, whether the relevant insolvency regime provides comparable protection.

When large financial firms become insolvent, it causes disruption and could trigger a systemic crisis. How to best manage international insolvencies is important to those who are immediately involved in such events, such as lawyers and the courts. But the systemic risk implications also make it a highly relevant concern for regulators and those bodies which develop guiding principles.

In an insolvency there are generally two main issues - how to maximise the value of the insolvent party and how to allocate appropriately the insolvent party's assets between those who have been affected by the insolvency. It varies enormously how these basic issues are dealt with in national legislation and public policy.

In some jurisdictions the main priority may be to protect the investor, in another the integrity and efficiency of markets is the prime objective so the insolvency procedures can be directed towards ensuring an operation of settlement and payment systems without unwelcome complications. Which ever insolvency system at hand, the enforceability of netting arrangements when a party becomes insolvent is an important feature in insolvency situations.

There are many differences in various jurisdictions' insolvency set off regimes. For example, some permit set off and others do not; some treat a multinational bank as a single legal entity while others will regard a branch of a multinational bank as a separate legal identity. The insolvency regimes are not improved by the fact that there appears to be a lack of generally accepted principles of private international law. In addition, there is no international convention regarding cross-border insolvency which provides for set offs in one jurisdiction to be recognised overseas or which specifies the system of law regulating the parties' rights.

The different features of the deposit protection schemes in member countries of the Basle Committee on Banking Supervision are described in a 1997 document, "Deposit Protection Schemes in the G-10 countries". Several European schemes have been reviewed to bring them in line with the May 1994 European Union's Directive on deposit guarantee schemes. The main changes brought about by this Directive are a standardisation of the minimum amount of protection (i.e. ECU 20,000) and a requirement for deposits with branches, subsidiaries not included, of EU banks to be covered by the home country scheme.[81]

3.2 Conflicts between National Insolvency Laws and Contractual Agreements

As mentioned above a deposit can be held in a different jurisdiction and still be used in an aggregation to be netted and to achieve a valid set off. The parties have the possibility when signing the agreement to specify which of their offices they would like to designate.[82] The question which is often discussed in this context is what would happen if a party becomes insolvent and its' deposits are held in a jurisdiction where the insolvency administrator is permitted to pick and choose between different agreements. Another question is whether the agreement still will be effective when the designated offices are situated in jurisdictions where netting is not permitted.

Conflicts between different national legislation
Where there is a conflict of law, the rule of *lex fori*[83] remains fundamental.

It is all well and good where both parties have agreed to a single netting agreement, but where there is conflict of law the situation may be much more complex. There are two main envisaged scenarios whereby;

a) The home jurisdiction permits set off but the foreign jurisdiction forbids it;
b) The home jurisdiction forbids set off but the foreign jurisdiction permits it.

A fundamental difference is that in the first scenario, if a creditor has proved his case in the English proceedings then he is entitled to set off even if the foreign jurisdiction prohibits set off.[84]

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[81] International Financial Risk Institute (IFRI) http://riskinstitute.ch Forum documents: *Netting*
[82] The parties specify the designated offices in the Schedule of the agreement.
[83] *Lex fori* meaning; the laws of the country where a legal action is brought shall govern any procedural matters.
[84] Page 146, para 9-9, Philip R Wood, *Title Finance, Derivatives, Securitisations , Set-Off and Netting*, Sweet & Maxwell 1995

Conflicts between national law and netting agreements

National legislation differs widely in regard to netting and set off arrangements and that in some cases may be a conflict of laws. The key issue in relation to this approach as well as to the other problems concerning netting is whether contractual arrangements can defeat bankruptcy legislation which expressly prohibits set off.

But what is case when there is a conflict between national insolvency law and a contractual Master Agreement. If for example the enforceability of IDNA was challenged and stood against English legislation, which of them would take precedence. Ought not national legislation be superior to contractual terms?

In theory, an insolvency administrator may be able to cherry pick between different agreements, but he should not be able to do so in respect of transactions contained within the same agreement. The deposit taking and giving within the contractual frames of IDNA should therefore not jeopardise the effectiveness or validity of the agreement. In relation to multibranch netting, the agreement should not become invalid merely due to one of the designated offices be situated in a jurisdiction that does not recognise netting. [85]

Discussions as to how the conflicts of law may be solved are included in chapter 4.

There may occur a situation for the defaulting party where it would be practical to deal with each set of deposits separately. It is held that the netting provisions of the agreement will not be affected if an insolvency representative of the defaulting party chooses to keep the deposits obligations held in a designated office in this jurisdiction separate from any other deposit obligations. The possibility of treating the different sets of deposits separately is subsequently made available to the defaulting party.[86]

[85] Clifford Chance opinion, IDNA page 4, section 3.3 (2)
[86] Clifford Chance opinion, IDNA page 5, section 3.3 (2) (iii)

4 Insolvency Issues with Set Off

4.1 The policies of Set Off and Insolvency

A classic historical view which many Roman jurisdictions take is that insolvency set off is a violation of the *parri passu*[87] covenant as a creditor with a set off received full payment, to the detriment of any other unknowing creditors.[88]
However Wood has argued that the notion that the set off constitutes a hidden advantage as an 'unpublished security interest' is irrelevant to the extent that it would be practically impossible for creditors with reciprocal claims to disclose all of these positions. Wood finds this argument of secrecy rather unconvincing, considering that the set off provision will only be of benefit provided it is deemed in whether it is enforceable or not in insolvency.[89]

If a defaulting party is incorporated and registered under England and Wales law and has designated offices in other jurisdictions, there is no prohibition against English authorities to commence insolvency proceedings with regard to the defaulting party. This applies regardless of whether authorities in the "designated office jurisdictions" or any other jurisdiction have started such a proceeding. Hence, two (or even several) insolvency actions could be taken against the defaulting party at one same time in different jurisdictions.[90] One might note that the same will apply in a reverse situation; where the defaulting party is incorporated and registered abroad but has a designated office within this jurisdiction.

4.2 Liquidation and Winding Up according to the Insolvency Act 1986

IDNA itself does not expressly mention liquidation or winding up, but as it expresses the choice of law to be that of England and Wales, the Insolvency Act 1986 will subsequently apply to matters of this nature.

In relation to insolvency proceedings, a central aspect is the liquidation or winding up of the company at hand. How do such actions affect the deposit obligations involved? This section will clarify the practical aspects of insolvency from a legal point of view.

If an English court decides to wind up a company due to insolvency, all

[87] The *parri passu* covenant meaning the borrower's promise to ensure that the obligation will always rank equally in right of payment with all of the borrower's other unsubordinated debts. The covenant is widely used as a clause in cross-border credit agreements.
[88] Philip R Wood, *Principles of International Insolvency*, Sweet & Maxwell 1995, page 15
[89] Philip R Wood, *Principles of International Insolvency*, Sweet & Maxwell 1995, page 16
[90] Clifford Chance opinion, IDNA page 4, section 3.3 (2)(i)(a)

dispositions of that company's property must be made prior to the commencement of the winding up, otherwise the dispositions will be void. It is unclear and the agreement provides no guidance as to whether any deposit obligations which arise after the winding up could be taken into account when calculating the aggregate sum and if the subsequent set off would be valid according to clause 2 of the agreement or rule 4.90 of the Insolvency rules 1986.

Where a party is wound up under England and Wales's law, the aggregation and set off of the deposit obligations need not necessarily be performed on the basis of the provisions of the agreement. There is a possibility for the aggregation and set off to be implemented under rule 4.90 of the Insolvency rules. It is held that a "rule 4.90 set off" should amount to a net sum which the parties will pay each other with regard to the deposit obligations.[91]

According to section 98 of the Insolvency Act 1986, a company which goes into a creditors' voluntary winding up must call a creditors' meeting which should be summoned for no later than fourteen days after a shareholders' meeting has been held where the decision of the voluntary winding up was taken. If a sum becomes due under a transaction which was entered in to at the time where the creditor receives notice of that a creditors' meeting has been summoned, that sum will not be governed by the provisions in the Insolvency rules relating to set off of mutual credits and debts.[92]

Such a sum, as above mentioned, will neither apply where the creditor has received a notice that a petition is awaiting for the winding up of the other party. Hence, any deposit obligations which arise after a notice has been given to either party regarding a winding up or a petition may not be allowed by the English court to be included in an aggregation or a set off under clause 2 of the agreement.[93]

Rule 4.91 of the Insolvency rules sets out that liquidation shall be conducted in (GBP) pounds sterling. If a party wishes to prove an arisen debt in a different currency, the 4.91 rule enables a conversion of the currency of the debt into pounds sterling according to the "official exchange rate". This rate is calculated on the market rate of the day the company at hand decides to go into liquidation or on the day the court makes its liquidation order.

In situations where assets are held in other currencies than pounds sterling, the possibility of a conversion is not quite so clear. Rule 4.90 does not set out certain provisions which provide for a conversion of non-sterling assets into pounds sterling to enable a "4.90 set off". It is held that, in reality however, a liquidator can convert claims in other currencies than sterling into sterling at an appropriate market based rate.[94] The official exchange rate is therefore not expressly excluded. Consequently, the time and rate which the liquidator determines when conducting a

[91] Clifford Chance opinion, IDNA page 6, section 4.1 (2)
[92] Insolvency rules, Insolvency Act 1986, section 98 and Clifford Chance opinion, IDNA page 6, section 4.1 (3)
[93] See reference 64
[94] Insolvency rules 4.90-4.91, Insolvency Act 1986, section 98 and Clifford Chance opinion, IDNA page 6, section 4.1 (4)

conversion in the liquidation of a party may override the time and rate specified in the provisions of the agreement.

4.3 The EU's Approach to Insolvency Proceedings

Despite the number of cross-border insolvency cases being on the increase during the 1990s, the adoption of legal regimes, either domestic or international, designed to address cases of a cross-border nature have not kept pace with that increase.

So one may ask what contribution the European Union has given to clarify uncertainties regarding international insolvencies and potential conflicting national laws.

It has been argued that a single universal form of insolvency proceeding for the Community is difficult to implement given the absence of a uniform system of security rights in Europe and the great diversity of national insolvency laws as regards to the criteria of priority for different classes of creditors.[95] However it can only be through international conventions or directives that a system could be created whereby national laws could be surpassed and European regulation takes precedence.

Therefore, the EU Regulation on Insolvency Proceedings entered into force 2002 as a part of a wider framework for a private international insolvency law system within the EU, namely '*The System of International Jurisdiction and Enforcement of Judgments in Civil and Commercial Matters'*.

The EU Regulation on Insolvency Proceedings
To overcome any potential future insolvency and bankruptcy problems with cross-border activities, the European Community Ministers of Justice met in 1989 and identified that a solution was needed and therefore re-launched discussions regarding a Convention on Cross-border Insolvencies that could apply to the European Community.[96] As insolvency proceedings with regard to insolvent companies or legal persons are excluded from the 1968 Brussels Convention, the EU Insolvency Regulation aims to fill that gap.[97] The main purpose of the Convention was to identify which court is the natural forum for an insolvency proceeding.

The definitive conclusion resulted in the European Convention of Insolvency Proceedings which was approved by the EU Council of Ministers the same year. Today, the majority of the content of the Convention is

[95] M Virgos and E Schmidt, Report on the Convention on insolvency proceedings, nr 12, 1995
[96] page 3, *Current topics of International Insolvency Law*, Bob Wessels, Kluwer 2004
[97] page 1, *Current topics of International Insolvency Law*, Bob Wessels, Kluwer 2004

included within the Insolvency Regulation. A regulation is a binding law instrument which is directly applicable to member states. The regulation was adopted in 2000 and took immediate effect 2002 in all EU states with the exception of Denmark.[98] As the activities of undertakings had an increasing cross- border effect they were increasingly being regulated by European Community law. This tied well in with the goal and method of the regulation which is to facilitate efficiently operating cross-border insolvency proceedings.

The Insolvency Regulation adopts a combined method (or: mixed model) which reflects the principle of *universality* but nevertheless permits local proceedings which are required to protect local interests.[99] The Insolvency Regulation therefore provides for two sets of special rules for applicable law. The result of this combination of different interests provides us with a system whereby the main insolvency proceedings can be opened in the Member State where the debtor has his main centre of interests. As the main proceedings are universal, they encompass *all* the debtor's assets. [100]

To protect the diversity of interests, the Regulation permits secondary proceedings to be opened in a Member State where the debtor owns an establishment. This second option serves two main purposes; (1) they protect local creditors from the main proceedings and (2) coincidentally they assist and support the main proceedings. For example, a local creditor may request that a secondary proceeding is commenced if he thinks chances will fare better in the local secondary proceeding than the main proceeding in a different State.[101] The secondary proceeding will therefore be conducted according to national law.

The Regulation (art. 4) sets out uniform rules on conflict of laws for insolvency proceedings, which replace national rules of private international law. This rule of conflicts is valid both for the main proceeding and for the local proceeding (regardless of whether it is secondary or independent territorial proceedings).[102] Therefore we can conclude that the law applicable of the state of the opening of the proceedings determines all the effects of the insolvency proceeding, both for persons and legal concerns. This principle is also known as *lex concursus.*

With regard to this context it is important to note that the right to set off is not affected by the lex concursus.[103]

The view on contractual set off

Contractual set off is governed by the law applicable to the contract establishing the set off arrangement. As a general rule, this law is determined in accordance with the Rome Convention of 19 June 1980 on the law applicable to contractual

[98] Although Denmark is a full member of the EU, it negotiated an exemption from the EC Treaty in respect of all legislative actions.
[99] page 5, *Current topics of International Insolvency Law*, Bob Wessels, Kluwer 2004
[100] Centre of Main Interest is often abbreviated 'COMI'. COMI is not explicitly defined but can be interpreted as the state where economic interests are located, for example the registered head office of a company, provided the contrary is not proved.
[101] page 8, *Current topics of International Insolvency Law*, Bob Wessels, Kluwer 2004
[102] page 12, *Current topics of International Insolvency Law*, Bob Wessels, Kluwer 2004
[103] page 14, *Current topics of International Insolvency Law*, Bob Wessels, Kluwer 2004

obligations. According to article 6 of the Insolvency Regulation, the opening of insolvency proceedings will not affect the right of a creditor to set off his claims against the claims of the debtor, where such set off is permitted by the law applicable to the set off agreement.[104]

Furthermore, article 6 states that it is applicable to agreements which enable their participants to manage their credit exposure arising from various types of transactions on a net basis.[105] Due to this provision we can conclude that netting agreements such as the IDNA therefore are permissible and acceptable under the EU's Insolvency Regulation. Article 6 therefore provides for the netting and set off agreements to act as an accessory pact within the main contract, the law of which would govern both the claim and the netting agreement. That said, some flexibility is offered by article 3 of the (1980) Rome Convention; the parties may select different national laws to govern separate parts of the contract.

UNCITRAL Model Law on Cross-Border Insolvency

The United Nations trade body UNCITRAL has also contributed to creating more clarity around international cross-border insolvency proceedings and conflicts of law. In 1997 UNCITRAL adopted their Model Law on Cross-Border Insolvency. The aim was to equip states with a fair and harmonised framework and promote cross-border cooperation between courts and authorities all with the ultimate goal of making trade and investments easier between states[106]. It was identified that, due to the increased cross-border trade leading to cases where companies and individuals have assets in more than one jurisdiction, there was an urgent need for coordination and cooperation for situations where financially troubled businesses would need rescuing or facilitating an efficient administration of a cross-border insolvency.[107] As a 'model law' it requires enactment into national law to provide a unilateral legislative framework. It is said to respect the differences among national procedural laws and does not attempt a substantive unification of insolvency law

Perhaps somewhat expectedly, the UNCITRAL Model Law does not specify how that cooperation and communication might be achieved, leaving it up to each jurisdiction to determine and apply its own rules. It notes, however, that the ability of courts to communicate "directly" and to request information and assistance "directly" from foreign courts intends to avoid the use of time-consuming procedures, such as sending letters between courts.[108]

4.4 Potential Miscellaneous Issues

There may emerge other issues, other than direct insolvency issues, which may

[104] page 118, Miguel Virgos et al, *The European Insolvency Regulation: Law and Practice*, Kluwer Law International 2004
[105] page 118, Miguel Virgos et al, *The European Insolvency Regulation: Law and Practice*, Kluwer Law International 2004
[106] See further http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model.html
[107] UNCITRAL Practice Guide on Cross-border Insolvency Cooperation
[108] page 11, UNCITRAL Practice Guide on Cross-border Insolvency Cooperation

become troublesome for a company when it seeks to conduct netting or set off. A few will be discussed below.

4.4.1 Undervalued transactions

If a company enters into a transaction, at a time within a certain period[109] which results in the commencement of an insolvency of the company, with a person with whom it has a mutual understanding that the company will receive no consideration, or alternatively the company will receive consideration which will be money worth substantially less in value than the consideration provided by it, that transaction may be set aside as an "undervalued transaction".[110] The pre-requisite is naturally that the transaction must be entered into during a time when the company was unable to pay its debts, section 123 of Insolvency Act 1986.

Important to note is that a court will not set aside such a transaction if it can be determined that the company entered into the transaction for bona fide purposes and with the intention of continuing its business. It must also have believed, at the time when entering into the transaction, there were reasonable grounds to trust that the carrying on of business was in the company's best interest.

If a deposit is made with intentionally narrow terms and at the existing market rates, it will hardly constitute an undervalued transaction. Whether it is an undervalued transaction or not must be determined in each case and it is entirely a matter of fact[111], meaning it will fall under the courts' discretion of interpretation.

4.4.2 Unjust positioning

In a situation where a certain thing is done, or suffered to be done by a company within a specified time resulting in an insolvency of that company, such as described above, the company will be subject to review as a voidable preference, section 239 of the Insolvency Act 1986. If the company in question is unable to pay its debts[112] during the time the certain thing done or suffered is carried out, that thing will be liable to be set aside. Similarly, it will also be set aside where the company became unable to pay its debts and the certain thing has the consequence of putting a person in a better position, upon the company's insolvent liquidation, than they normally would have found themselves in had the certain thing not been done or suffered.[113] Where the company gives such a preference as above mentioned but has no intention of placing the person in such a better position, it is unlikely a court would give an order of setting aside, provided one could satisfy

[109] Such as the date when a winding up begins, or the date of a petition for an administration order is presented.
[110] Insolvency Act 1986, section 238
[111] Clifford Chance opinion, IDNA page 7, section 4.2 (1a)
[112] According to section 123 Insolvency Act 1986
[113] See further Clifford Chance opinion, IDNA page 7, section 4.2 (1b)

that this was the company's intention. [114]

4.4.3 Schemes of Arrangement

There is a possibility for companies to set up a *scheme of arrangement* or voluntary arrangement through provisions under the Company Act 1985 and the Insolvency Act 1986. These arrangements must be agreed by creditors, and appropriately the shareholders of the company.

A scheme will be permitted provided reasonable efforts have been made to inform the creditors, whose rights would be affected by the scheme, that a meeting for the scheme's approval would take place. The courts cannot sanction the scheme where a satisfactory notification of the meeting has been given in accordance with section 425 Companies Act 1985.[115]

According to part 1 of the Insolvency Act 1986 with regard to company voluntary arrangements, these can not be binding upon a creditor if he has not been given notice of the creditor's meeting of the arrangement's approval.

The arrangements described will affect the creditor's set off rights but also the value of the claims which the creditors could have towards the company.[116]

In the situation of a company voluntary arrangement or a scheme of arrangement, there is no requirement for the affected creditors' to agree unanimously to the terms of the arrangement, regardless of whether the affected creditors can attend the meeting or not.

How is IDNA affected where these types of arrangements are in force? The arrangements could affect IDNA in a situation where the set off provisions in clause 2 of the agreement have not yet been enforced and the arrangement has already been approved. In this case the arrangement will knock out the provisions in clause 2. Where the set off provision in the agreement has been enforced before the arrangement has been approved, only the value of any resulting net claim could be affected by the arrangement.[117]

4.4.4 Reasonability and Misconduct

If anyone who is a party to the IDNA agreement is vested with the discretion or has the possibility to determine a certain matter, then England and Wales- law might impose that the discretion at hand is exercised or determination made in a reasonable manner. Where a provision in IDNA provides that any calculation or certification should be final and binding, such a provision will naturally not be effective if the calculation or certification is incorrect, unreasonable, fraudulent, or

[114] See reference 74
[115] See further Clifford Chance opinion, IDNA page 7, section 4.2 (2)
[116] Clifford Chance opinion, IDNA page 8, section 4.2 (2)
[117] See reference 77

arbitrary[118]. The English courts have the discretion to consider the calculation, determination or certification as no more than prima facie evidence in relation to the issue which is to be determined.[119]

4.4.5 Payment of Interest

If interest has been imposed on a party according to the agreement, there is a possibility the interest might not be recoverable on the following grounds: that it is a penalty or that it accrues on an unsecured debt after the making of a winding up order or the passing of a winding up resolution by the company liable to pay such interest.

The validity or legality of provisions of the agreement will not be prejudiced merely because it is suggested that interest held by a party is void, such a fact will not in itself prejudice the provisions.[120]

[118] Or proved to have not been given or made for bona fide purposes and will not necessarily prevent judicial enquiry into the merits of any claim by any of the parties. See further reference 80
[119] Clifford Chance opinion, IDNA page 8, section 4.2 (3)
[120] Clifford Chance opinion, IDNA page 8, section 4.2 (5)

5 International Approaches to Deposit Netting

One of the most significant discrepancies between jurisdictions is their attitude towards insolvency and set off. The simplest way of contrasting viewpoints would be to separate the jurisdictions in accordance to whether they are favourable or non-favourable towards set off and netting.

The majority of international opinion favour insolvency set off, with most states incorporating insolvency set off by statute. See Appendix for an exhaustive list.

For the non-favourable jurisdictions, the most common principle is that the mutual claims need to fulfill certain criteria of the solvent set off rules prior to the insolvency occurs. i.e. the claim must be mutual and payable before the insolvency date. Should the claims not fulfill this criteria, a set off is not achievable and the bank must cover the costs of deposits and accelerated loans. The view extends also to netting agreements.

When developing IDNA the BBA consulted counsel in several jurisdictions, including Belgium, Denmark, England and Wales, Germany, Hong Kong, Japan, the Netherlands, Singapore, Sweden and Switzerland. All the aforementioned jurisdictions opined that the deposit netting, set off, and close-out provisions of the IDNA are valid and enforceable under the laws of those jurisdictions.[121]

Since the publication of the Lamfalussy Report in 1990[122], the legal status of netting was considerably improved in most of the G-10 countries, especially due to new legislation. Specifically Belgium, Canada, France, Germany, the Netherlands, Sweden, Switzerland, the United Kingdom, and the US enacted new legislation to ensure the enforceability of netting arrangements or close-out mechanisms. Many jurisdictions that have yet not enforced such legislation, are examining the possibilities of doing so. One could argue that from a commercial point of view it will not be beneficial to them in the long run to prohibit netting and set off arrangements since it will cause difficulties when financial players in such a country wish to enter into business with foreign banks or parties whose legislation permits such arrangements. The non-favourable jurisdictions will lose out competitively in comparison to the favourable jurisdictions.

To illustrate the varying rules of different jurisdictions I will touch on the position of a few selected countries. Some have more difficulties than others when harmonising their own legislation with the concepts of set off and netting.

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[121] www.bba.org.uk "*Deposit Netting*" Public Policy Issues 15/01/2002
[122] See further above, section 2.2 *Netting Standards prior to IDNA*

5.1 USA

In the USA, netting and set off is enforceable through the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). It provides for netting contracts to be legal and enforceable in the event of bankruptcy or insolvency of one of the parties. The FDICIA netting provisions apply to bilateral netting contracts between financial institutions and multilateral netting contracts among clearing organisation members. Netting covers agreements to net payments as well as to net and close-out-, over the counter- and other transactions. The FDICIA however only applies to financial institutions. Netting between dealers and their end-user customers would not be covered by FDICIA unless the customer qualifies as a financial institution under the statute or due of a certain extent of market activity.[123] Bankruptcies by companies and commercial banks (which are not covered by FDICIA insurance rules) are covered by completely separate rules under the Bankruptcy Code 1978 which are typically regarded as debtor-friendly. Insolvency situations for these 'uninsured'companies are very much governed by the relevant State's law.[124]

5.2 Sweden

Close-out netting in relation to transactions are customarily documented under a netting agreement which would be enforceable under Swedish law. The Financial Instruments Trading Act[125] makes close-out netting binding in Sweden. There is some uncertainty amongst market participants as to whether or not the parties must have chosen automatic early termination in order for close-out netting to be enforceable. Usual market practice calls for that an election must be made in order for this to apply. Contractual set off and insolvency set off is generally enforceable with regard to mutual claims between the two parties in all types of Swedish insolvency proceedings subject to certain general equitable considerations. There are no additional stays or freezes when it comes to benefiting from rights of set off (except for the administrative delays in relation to the enforcement under a pledge).[126] Furthermore there is no requirement for the parties to assume a certain status to be a bank or financial institution.

The Financial Instruments Trading Act primarily targets financial instruments and question is whether a straight forward deposit would qualify as such. If not, then the Swedish Insolvency Act[127] also provides for netting of obligations upon insolvency, provided the possibility of netting was available prior to the insolvency occurred. So far it can be concluded that the Swedish position allows for set off

[123] Definition can be found under Regulation EE. See further, Federal Reserve Bank of New York, *Outline of Bank Supervisory Netting Issues* September 1996, www.frb.org/newsevents
[124] page 180, para11-24 , Philip R Wood, *Title Finance, Derivatives, Securitisations , Set-Off and Netting*, Sweet & Maxwell 1995
[125] Lagen om Handel med Finansiella Instrument (1991:980)
[126] See further, International Swaps and Derivatives Association Inc. Collateral Law Reform Group, Country reports: *Sweden* March 2000 www.isda.org
[127] Konkurslagen (1987:672)

between different currencies and also prevents the bankruptcy manager (trustee) from cherrypicking, i.e. choosing which favourable between contracts to honour. [128]

5.3 Spain

Close-out netting will be enforceable provided that a single agreement covering certain types of transactions is in place and that one of the parties to that single agreement is a financial institution or an investment services company. Contractual set off and/or insolvency set off can not be effected in Spain. There are few exceptions in the jurisprudence (note that these exceptions will not apply to derivative transactions). Since contractual set off and insolvency set off are not enforceable in the event of formal insolvency proceedings in Spain, there is in effect a stay or a freeze on any contractual- or insolvency set off. [129]

5.4 Belgium

Belgian law will only interfere if it is allocated as the applicable law to the agreement or if insolvency proceedings have commenced in Belgium against a company or individual that is governed by Belgian law. (The individual will need to be engaged in business with a principal establishment in Belgium). Close-out netting is permitted under Belgian law provided that insolvency proceedings have not commenced against a Belgian counterparty.

Legislation providing for the enforcement of automatic termination clauses and all types of netting agreements between financial institutions (banks, broker-dealers and any other kind of financial establishment) was adopted in article 157 of the Credit Institution Act of 1993. The article ensured the enforceability of netting and set off between two financial institutions when the insolvent party to the agreement is a Belgian financial institution.

If the two institutions do not qualify as financial institutions set off or netting will only be possible after insolvency proceedings have started and provided that the mutual debts to be set off have a nexus. Deposit transactions (and also derivatives transactions) entered into under the same agreement between the same parties will arguably be considered to be satisfactorily connected to permit insolvency set off. [130]

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[128] page 179, para11-22 , Philip R Wood, *Title Finance, Derivatives, Securitisations , Set-Off and Netting*, Sweet & Maxwell 1995

[129] See further, International Swaps and Derivatives Association Inc. Collateral Law Reform Group, Country reports: *Spain* March 2000 www.isda.org

[130] See further, International Swaps and Derivatives Association Inc. Collateral Law Reform Group, Country reports: *Belgium* March 2000 www.isda.org

To summarise, there is somewhat more reluctance or difficulty with regard to set off and netting in the Roman countries of Europe, while Germany, Benelux and the Scandinavian countries have less difficulty in recognising such arrangements and implementing them into their legal systems. Overall there is a fairly substantial international recognition of set off and netting arrangements. They are recognised, in particular, by the G10 countries but also others who realise the importance and benefits related to bilateral netting agreements. This assumes that the jurisdictions in question are able to enact such arrangements in a non-disruptive way and harmonising them with the national insolvency laws.

6 VI. Different Views on Deposit Netting Agreements

6.1 Regulatory views on deposit netting agreements

Certain lobbyist groups have argued that they believe the concept of close-out netting ultimately ought to be legislated. The European Financial Markets Lawyer Group for instance has stated that they would support an EU legal act on close-out netting.
The European Financial Market Lawyers Group (EFMLG) have argued that they have identified various legal uncertainties on the enforceability of contractual set off and netting agreements that result from certain provisions of the Insolvency Regulation, the Banks Winding-up Directive and the Collateral Directive. To resolve those uncertainties, they believe there is a pressing need for legislative clarification on the scope of protection for insolvency close-out netting arrangements under Community law.

The main reason for such legislative clarification is that they say it is deeply uncertain whether the set off protection in Article 6 of the Insolvency Regulation encompasses close-out netting. As a result, the enforceability of close-out netting arrangements in insolvency proceedings concerning non-financial counterparties is unclear in many EU Member States. They argue that financial market participants and regulators consider it essential to have a high degree of certainty on the enforceability of contractual set-off and netting agreements in case a counter party should default. The Community and the Basle Committee on Banking Supervision share this concern for certainty in view of the implications of the legal enforceability of set off and netting agreements for the prudential supervision of credit institutions and the stability of the international financial system. The EFMLG subsequently mean that by ensuring legal certainty the necessary level of legal protection for key financial instruments, which play a vital role in modern financial markets would be guaranteed. It would make transactions and the legitimate expectations of parties more certain in an area where any doubt creates severe risk of systemic damage and impaired market efficiency.[131]

A potential legal act, such as the one suggested by the EFMLG, would deal with what they call the inconsistencies between the body of netting legislation that exists on the level of the Member States by providing criteria by which a Member State can assess whether its own netting legislation is adequate against EU standards. Although, they argue the proposal may not be feasible in view of the legislative

[131] See further page 5 "*Report on protection for bilateral insolvency set off and netting agreements under EC- law*" 2004 www.efmlg.org

agenda of the Commission following the Financial Services Action Plan (FSAP) but that a possible review of the conflict-of-law provisions in Article 9 of the Collateral Directive in the light of the Hague Convention of 13 December 2002 on the law applicable to certain rights in respect of securities held with an intermediary, might offer an opportunity to address the issue. The group lobbies for the Commission to engage in such a review process, which they say would involve discussions in the European Parliament and the EU Council, to also amend and expand the Collateral Directive's close-out netting provisions.[132]

6.2 The Impact of and Relationship with the ISDA Master Agreement

With the introduction of the ISDA Master Agreement, which actually occurred a few years prior to IDNA, and the subsequent successful roll out of the agreement internationally, one might ask what impact it has had on the usage of the IDNA.

The BBA has reportedly not performed any comparison in terms of the usage of ISDA Master Agreement versus IDNA. They report it is very much up to each individual institution to decide whether to avail them of the agreement but notably the BBA does still receive many purchase requests for the IDNA which indicates that its position is still highly relevant to those wishing to use it.

However, the BBA state that there is the possibility of ISDA master agreement may allow for the IDNA to be imported. This scenario therefore allows for a co-existence of the two agreements, nullifying any matter of whether one agreement negates the other.

Furthermore, it is worth pointing out the fundamental difference between the two agreements in that the ISDA Master Agreement is typically used for derivatives transactions while the IDNA is restricted to regular deposits, an aspect that again may eliminate any scope for overlap between the two agreements.

6.3 Basle Capital Requirements

How does the agreement stand in relation to Basle accord guidelines when calculating capital requirements?

According to legal opinions collected by the BBA, the netting of off- balance sheet obligations is permitted provided an appropriate and effective netting agreement is in place. The bank's internal control systems must also reflect the net position in a correct manner. It should therefore be a logical development to extend the off-balance sheet netting to allow on-balance sheet netting on a similar basis

[132] See further page 7 "*Report on protection for bilateral insolvency set off and netting agreements under EC- law*" 2004 www.efmlg.org

considering modern trading portfolios contain both on and off- balance sheet instruments to effect a desired strategy. It is argued that it would be strange to discriminate against only a few trading portfolios. Certain jurisdictions already recognise the effectiveness of on- balance sheet netting and thus it is considered also in other countries[133].

The EU and the Basle Committee on Banking Supervision share a concern for legal certainty in view of the implications of the legal enforceability of set off and netting agreements for the prudential supervision of credit institutions and the stability of the international financial system. Consistent with the approach of the Basle Capital Accord, 12 Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions provides that the national authorities competent to supervise credit institutions may recognise bilateral agreements between a credit institution and its counterparty for contractual netting as risk-reducing only under the following conditions:[134]

1. *A credit institution must have a contractual netting agreement with its counterparty which creates a single legal obligation, covering all included transactions, so that, in the event of a counterparty's failure to perform owing to default, bankruptcy, liquidation or any other similar circumstance, the credit institution would have a claim to receive or an obligation to pay only the net sum of the positive and negative mark-to-market values of included individual transactions.*

2. *A credit institution must have made available to the competent authorities written and reasoned legal opinions to the effect that, in the event of a legal challenge, the relevant courts and administrative authorities would, in the cases described under (1), find that the credit institution's claims and obligations would be limited to the net sum, as described in (1), under the law of the jurisdiction in which the counterparty is incorporated and, if a foreign branch of an undertaking is involved, also under the law of the jurisdiction in which the branch is located, - the law that governs the individual transactions included, and – the law that governs any contract or agreement necessary to effect the contractual netting; and*

3. *A credit institution must have procedures in place to ensure that the legal validity of its contractual netting is kept under review in light of possible changes in the relevant laws.*

Despite the Basle committee on Banking Supervision and EU directives demand, certain requisites to be fulfilled, these requisites are not considered too imposing as they are fairly general and high-level in their structure. The Basle committee has no intention of making netting a complicated matter for the involved parties as it

[133] www.bba. org.uk "*Deposit Netting*" 1996
[134] See further page 7 "*Report on protection for bilateral insolvency set off and netting agreements under EC- law*" 2004 www.efmlg.org

recognises that netting can be a beneficial part of the risk management process when banks can net their claims and calculate capital adequacy.

According to the BBA, the netting of off-balance sheet obligations ought to be extended to developing and allowing on-balance sheet netting on a similar basis considering that modern trading portfolios contain both on and off-balance sheet instruments. The BBA argues that it is strange to discriminate against only a few trading portfolios. Certain jurisdictions already recognise the effectiveness of on-balance sheet netting and therefore this is considered in certain countries.[135]

[135] www.bba.org.uk "*Deposit Netting*" Public Policy Issues 15/01/2002

7 Concluding Remarks

Contractual set off and netting agreements, such as the IDNA, play an important role in reducing risks and enhancing efficiency in the increasingly integrated global, financial markets. The reduction of parties' gross exposures enables a more effective use of regulatory capital for regulated entities. It can extend the transaction volumes one party is prepared to assume towards another, increase the number of counterparties with whom a party may be prepared to transact and it can contribute to increasing access to, and subsequently the liquidity of, the wholesale financial markets.

These advantages explain the widespread use of contractual set-off and netting agreements by European financial market participants, including various master agreements governed by the laws of England, France, Germany, Spain and other jurisdictions both inside and outside the EU, (e.g., New York).

Indeed, the concepts of netting nowadays commonly exceed the boundaries of straight-forward deposits and commonly extend to an enormous volume of financial market transactions, including swap, derivative, foreign exchange, repurchase and securities lending transactions. Such transactions are documented under agreements containing such contractual set-off and netting arrangements, the most commonly used one being the ISDA Master Agreement.

In spite of the widespread use of contractual set-off and netting agreements, the enforceability of contractual set-off and netting rights at times remain uncertain. This is as we have learnt, mainly due to the national law governing insolvency proceedings may, as a matter of policy or tradition, fail to recognise such rights. The insolvency law policies of many European Member States are unfavorable towards set-off and netting agreements.

Where this is the case, the benefits of set-off and netting agreements are undermined in circumstances when they are most needed. However, such protective provisions are not universal, nor are those that exist identical in scope and operation.

The aim of the agreement is, as previously mentioned, to reduce the credit risk exposure for banks active in the interbank deposit market. Some may argue that the benefit of the agreement is limited as it does not encompass netting of products such as swaps or foreign exchange, nor does it regulate a situation where a deposit is used as collateral.

But the main reason for the non- inclusion of derivative instruments is that the ISDA Master Agreement includes these derivatives products and duplication in the IDNA would therefore be unnecessary, the IDNA was drafted with more straight forward bank deposits in mind. As for foreign exchange products, there already exists an agreement IFEMA (International Foreign Exchange Master Agreement) which applies to international money markets business and foreign exchange. In comparison with other more complex forms of standard netting agreements used in

the financial markets[136], the IDNA is simpler and more user-friendly.

The European Community has through International Conventions demonstrated its support for harmonised insolvency proceedings which enable netting provisions, all with the overreaching goal of reduced settlement risk and systemic risk in mind. The end effect sought to be achieved is an integrated market place where financial transactions can take place effectively without unnecessary obstacles without risking the implications of cross-border conflicts of law.

However, we will probably never see an entire 'one-size-fits-all'- solution due to a number of jurisdictions still being unfavourable towards netting and set-off provisions. Even English case-law has confusingly provided an inconsistent and not always favourable view on netting arrangements.

Future challenges which may demand further revision of the current set-off and netting provisions could include how interactions with Emerging Markets jurisdictions take place and whether the EU-style conventions may need replication in other parts of the world. Positive measures have already materialised in the form of established settlement and clearing procedures.[137]

To conclude, we must still recognise the approval that international netting arrangements receives. In line with the proposals of the Basle Committee[138], the EU Community and financial markets participants, netting agreements are indeed both endorsed and encouraged. For example, the Basle committee has even suggested the extension of their scope to include all on-balance-sheet and off-balance-sheet items. Whether this is appropriate or not will not be discussed here, but the conclusion can be made that within the financial services industry there is a general favour towards netting agreements and that they should continue to play crucial role in relation to inter bank deposit operations, for money market transactions with banks and for securities repurchase/reverse agreements and securities borrowing/ lending transactions

[136]Such as the International Foreign Exchange Master agreement (IFEMA) and the International Currency Options Market Terms (ICOM).

[137] The Emerging Markets Committee of IOSCO (International Organisation of Securities Commission) have recommended that each domestic market should establish a central securities depository (CSD) and produced a report "*Towards a Legal Framework for Clearing and Settlement in Emerging Markets*" (1997).

[138] Basle Committee on Banking Supervision set out in its consultative document of 7 April 1998

Appendix

Jurisdictions in favour of Insolvency Set Off[139]:

Europe
Austria, Czech Republic, Denmark, England, Germany, Guernsey, Ireland, Isle of Man, Italy, Jersey, Liechtenstein, the Netherlands, Poland, Scotland (case law, and not statute), Slovak Republic, Switzerland

Americas and Caribbean
Canada, USA, Panama, Bahamas, Bermuda, Cayman Islands

Asia and Pacific
Australia, China, Hong Kong, India, Japan, South Korea, Malaysia, New Zealand, Pakistan, Singapore, Sri Lanka, Thailand

Africa
Liberia, Nigeria, Zambia, and probably all of the former British colonies (apart from South Africa and nearby South African based jurisdictions such as Zimbabwe, Swaziland etc).

[139] See further discussion, page 76, para 6-8, Philip R Wood, *Title Finance, Derivatives, Securitisations , Set-Off and Netting*, Sweet & Maxwell 1995

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