ENSafrica

Understanding close-out netting

MON 31 MAY 2021

Purpose

- You will all be familiar with the concept of “netting” in relation to derivatives, securities lending and repo transactions
- The purpose of this presentation is to give you a better understanding of netting from a legal perspective.

Agenda

- Close-out netting basics: contractual netting prior to insolvency
- Commencement of insolvency proceedings
  - What would happen without section 35B?
  - What does section 35B do? Statutory netting
- Collateral in netting – outright transfers v pledges

Contractual netting

- Provisions of the ISDA Master (derivatives), GMSLA (securities lending) and GMRA (repos) provide for close-out netting as one of the most important counterparty risk mitigation features
- Main features of close-out netting on a contractual basis
  - Occurrence of an event of default
  - Non-defaulting party accelerates and then terminates all transactions/obligations
    - includes obligation to return collateral paid or transferred outright
    - pledged collateral cannot be "set off" – it stays in the possession of the pledgor and so there is no return obligation that can be valued
  - Non-defaulting party values each accelerated transaction/obligation and certain other costs incurred
  - All values set off to arrive at a single sum payable by one party

Commencement of insolvency proceedings

- What happens upon the commencement of insolvency proceedings in respect of a party to a contract (ignoring section 35B of the Insolvency Act):
  - Contracts can be terminated, but are dealt with by liquidator
  - Concourse of creditors is imposed – creditors must be treated the same (*pari passu* principle)
  - Limited rights of set off in Insolvency Act
  - Security can only be enforced in accordance with Insolvency Act provisions
  - Pledged securities can be sold (though not appropriated), following which proceeds must be paid over to the liquidator
  - Liquidator gains the right to impeach dispositions (including set-off) that occur during the suspect period prior to insolvency
  - Liquidator may gain the ability to “cherry-pick” transactions

The effect of Section 35B

- Section 35B: On sequestration/liquidation, master agreement and all obligations are terminated (including obligation to return outright transferred collateral), terminated obligations valued at market value, values are set off and a single net amount payable
- Section 35B is a statute of **mandatory** application
  - parties cannot contract out of it
  - applies to all master agreements together
  - parties cannot apply it to master agreements separately
- Applies to debtors under the Insolvency Act, banks in curatorship by virtue of section 69A of the Banks Act and companies by virtue of section of the Companies Act 1973

The effect of Section 35B cont.

- Does not apply to pledged collateral
  - pledged collateral under a master agreement dealt with in amended section 83 of the Insolvency Act
  - must sell the securities (not appropriate), but proceeds need not be paid to liquidator
- Disapplies the impeachment provisions
- Cuts against the *pari passu* principle and therefore must always be narrowly interpreted
- Frustrates any attempt by a liquidator to “cherry-pick”

Certain issues related to Section 35B

- Only applies to master agreements published by an industry body in accordance with standard terms – cannot use bespoke master agreements
- Unclear extent to which one can amend an ISDA/GMRA/GMSLA and still have a master agreement
- Included outright transferred collateral at a time when the common law was very unclear as to the validity of outright transfers of collateral
- Inability to ring-fence makes some uses difficult (*eg* securitization)
- Occurs automatically on date of sequestration/liquidation, but date of liquidation is determined retrospectively when liquidation order is granted; may make timing of valuations difficult
- No definition of "market value"
- From time to time the applicability of the Insolvency Act, and therefore Section 35B is questioned in relation to any entity not liquidated under the Insolvency Act (such as collective investment schemes, statutory corporations, government entities and any other entity that can only be wound up by an Act of Parliament)
- No court guidance, so still unclear how some of the aspects would be interpreted by a court

Collateral in post-insolvency netting

- Outright transferred collateral, *ie* cash paid or securities transferred
  - Gives secured party a strong position because can be netted immediately on insolvency
  - For security giver transferring collateral outright, netting is important
  - May create credit risk for security giver, particularly if large haircuts have been applied to the collateral valuation
  - Residual recharacterisation risk
- The pledge route: cash in a pledged account is unusual in these markets, but pledged securities are common and in fact will be required as initial margin
  - Cannot be netted as discussed above
  - Must be enforced under Section 83
    - improved process
    - no appropriation
    - dispute resolution procedure / timing aspects

Post-insolvency netting is key to a clean industry opinion

- South Africa and Mauritius are the only clean netting jurisdictions in Africa so far
- Ghana is close, need to clarify a few discrepancies in various applicable laws
- Uganda has a project to first bolster netting horizontally, and then to go ahead with a Netting Act to become a clean netting jurisdiction
- Clean industry opinion allows for reduced capital holding against exposures

Thank you

Africa's largest law firm

ENSafrica.com