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Financial services risk insights

Bilateral Netting of Qualified Financial Contracts Act, 2020: What does it mean for the financial markets

December 2020 | Volume V

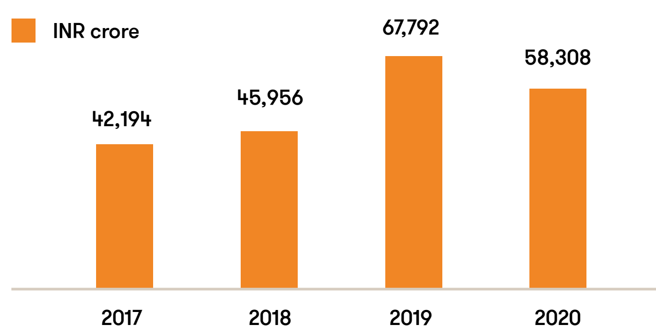
Background

The Bilateral Netting of Qualified Financial Contracts Act, 2020 (Bilateral Netting Law) came into effect on 1 October 2020. The law provides an unambiguous legal framework for the enforceability of netting for qualified financial contracts.

Netting is a very common practice in advanced economies. Before this law, the position on the netting of exposures for a counterparty under different financial contracts was never clear.

The common practice by the participants was to do gross settlement at a product level, instead of counterparty level. Hence, the counterparties had to keep reserves for the settlement of every financial contract, which resulted in locked capital.

Capital locked in gross settlement



Source: Finance Ministry

These numbers were based on an analysis of 31 public, private sector, and foreign banks. Had the bilateral netting law been applicable earlier, these amounts would have been available for lending. Thus, this law facilitates a more efficient allocation of capital, thereby deepening the financial system.

What does this mean for financial markets?

The Bilateral Netting Law is based on the International Swap Dealers Association's (ISDA's) Model Netting Act, which serves as a guide for regulators and policymakers worldwide. Here's an assessment of the impact of the change that this legislation will bring about:

1. Before, this regulation, settlements for every over-the-counter derivative contract were tracked separately, even if the counterparties were the same.
   Post this legislation, the exposures across various financial contracts for a single counterparty will need to be netted and a consolidated net position will be arrived at. This will help rationalise the counterparty's exposure limits at a financial market unit level for the bank, which is a more realistic assessment of the risks than the earlier practice, which was done on a gross basis. This will also result in the availability of more credit limits to the same counterparties.
2. Given that the counterparty exposure limits get rationalised, the corresponding required regulatory capital also reduces, freeing up more capital for onward lending.
3. Another implication of freed-up capital is the reduced pricing of derivative contracts. Since the amount of capital that is to be allocated to undertake derivative details with counterparties for the participants goes down, the opportunity cost of entering into a derivative contract (which is one of the markers for pricing a derivative contract) is also reduced.
4. Another important piece of change is the provisions of close-out netting. **The ISDA Research Notes document in 2010 states,** "Close-out netting refers to a process involving termination of obligations under a contract with a defaulting party and subsequent combining of positive and negative replacement values into a single net payable or receivable". The Bilateral Netting Law adopts a similar definition under the Act and accords its priority over the Insolvency and Bankruptcy Code, 2016, **vide Section 5(3) of the Bilateral Netting Law**, which deals with the enforceability of netting. This effectively provides a framework for the recovery of dues under the financial contracts even if insolvency proceedings are underway against the defaulting party and the net dues payable are binding on the administrator, for settlement on a priority basis instead of a usual pari-passu

approach adopted for settlement of creditor dues under an insolvency structure. The Reserve Bank of India (RBI) may come out with more details on the modus operandi to be followed to settle dues of qualified financial contracts under insolvency arrangements. The RBI guidelines can bring about the coherency between the Insolvency and Bankruptcy Code and the Bilateral Netting Laws. The provisions around close-out netting are like safe harbor provisions that exist globally and bring about stability in the financial system to promote liquidity in the market.

5 The Bilateral Netting Law reform is also a precursor to the reforms expected in the credit default swap (CDS) space. Given the nature of shocks expected in the fixed income papers in India, developing a deep CDS market is extremely important and given the large size of notional values of CDS instruments, the netting arrangement will ease capital requirements thereby enabling more activity in the CDS space. While a separate set of regulations is needed from a credit default swap reforms standpoint, especially around the early exit provisions and underlying position requirements, the bilateral netting arrangement serves as a good start.

6 Lastly, Bilateral Netting Laws help reduce the cost of operations, given the reduction in the number of gross positions across qualified financial contracts.

Our view

While details on how exactly the close-out netting arrangements will operate under the Insolvency and Bankruptcy Code, 2016, are yet to be worked out, this reform is expected to definitely deepen the OTC derivative markets and help rationalise capital in a far more efficient manner. This is probably the most significant reform in the banking space post the Insolvency and Bankruptcy Code.

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