ANALYSIS

Bilateral Netting of Qualified Financial Contracts Act, 2020

09 October 2020

This analysis covers:

1 Introduction

Netting is an important aspect of determination of exposure arising out of financial contracts and has received due attention from multi-lateral organisations and individual regulators alike, as financial and derivative products have only become more complex over time. Many advanced economies already have a legal framework to govern bilateral netting of financial contracts. Netting helps financial institutions measure credit exposure to a counterparty on net basis (as opposed to gross basis). This helps reduce credit risk exposure and systemic risk in the financial market in the event of default of a counterparty, contributing to overall financial stability.

The Indian Government has notified the provisions of the Bilateral Netting of Qualified Financial Contracts Act, 2020 (Act) on 1 October 2020. The Act provides a regulatory framework for offsetting claims between two parties to a financial contract in order to determine a single net payment obligation due from one counterparty to the other.

To reduce credit risk exposure and systemic risk in the financial market, the Bilateral Netting of Qualified Financial Contracts Act, 2020 has been notified on 1 October 2020. The legislation provides a regulatory framework to offset claims between two parties to a financial contract and to determine a single net payment obligation.

The Act is based on the Model Netting Act by the International Swaps and Derivatives Association (ISDA), with modifications and customisations to suit the Indian legal and regulatory framework. Interestingly, India has adopted ISDA's advisory to take a more flexible and principle-based approach instead of enumerating the categories of contracts or agreements that will be covered under the Act. Also, a significant leeway is provided to parties to agree upon the scope of concepts of 'event of default' and 'termination event', instead of prescribing a rigid statutory threshold.

While further notifications are currently awaited from various authorities identified in the Act, this update attempts to examine the construct and scope of the Act and its potential impact.

2 Key Features of the Act

2.1 Qualified Financial Contracts

At its heart, the Act provides legal validity to and confirms enforceability of bilateral netting. Bilateral netting refers to determination of net claim or obligations between parties to the relevant contract, after setting off or adjusting all the claims or obligations based or arising from mutual dealings between the parties to the relevant contract.

The Act covers Qualified Financial Contracts (QFCs), which will be notified by the Central Government, or the following regulators:

a. the Reserve Bank of India,

b. the Securities and Exchange Board of India,

c. the Insurance Regulatory and Development Authority of India,

d. the Pension Fund Regulatory and Development Authority, and

e. the International Financial Services Centres Authority.

The Act allows the regulators flexibility in identifying the QFCs. It would be interesting to see if the regulators also follow a similar principle-based approach or prefer to set out a more circumscribed list of contracts which may fall within this head.

2.2 Applicability of the Act

The Act applies to QFCs entered on a bilateral basis between 'Qualified Financial Market Participants' (QFMP), either under a netting agreement or otherwise, where at least one of the participants is regulated by any of the regulators mentioned above.

The definition of QFMP itself is very wide and apart from enumerating certain regulated entities (such as banks, insurance companies, pension funds, etc), also includes an individual, partnership firm, company, any other person or body corporate and includes any international or regional development bank or other international or regional organisation. Further, regulators may specify any other regulated entity as a QFMP.

2.3 Exclusions

The Act clarifies that contracts entered on a multilateral basis in accordance with the Securities Contracts (Regulation) Act, 1956 and the Payment and Settlement Systems Act, 2007 are excluded from the purview of the Act. As such, these laws deal with netting and settlement in specific situations (i.e. functioning of stock exchanges and central counterparties, and payment systems, respectively) and are well served by the exclusion in the Act.

2.4 Interplay with Insolvency Laws

The Act contains provisions to protect its mandate (and by extension, the parties in a bilateral netting agreement) from any adverse impact of insolvency laws, including the Insolvency and Bankruptcy Code, 2016. This is in line with ISDA recommendations that the principal focus of netting legislation should be to ensure the enforceability of a netting agreement against a party that is subject to insolvency proceedings. In fact, similar advice is set out in the principles governing financial markets which deal with functioning of central clearing counterparties.

The ISDA and the Model Netting Act also make a separate reference to enforceability in case of insolvency resolution of a financial institution and specifically highlight the need to balance the objectives of a netting legislation with the need to ensure that resolution measures are effective. No specific mention, however, is made in the Act on this aspect. However, looking at the protracted discussions on implementing a standalone insolvency resolution framework for financial institutions and the wide powers of the respective regulators, any attempt to definitively articulate the treatment of insolvency of financial institutions under the Act may perhaps have only resulted in stalling its enactment.

Concerns have also been raised by market participants previously on the inconsistent netting treatment under different laws pertaining to insolvency of statutory corporations and nationalised banks, as opposed to entities incorporated under company law. Given this, the Act specifically overrides the provisions of certain enumerated statutes and any law pursuant to which a QFMP has been incorporated, constituted or regulated.

2.5 Freeing Capital

Apart from the immediate impact by way of providing a motherhood legislation for bilateral netting and regulatory certainty on such arrangements, the expectations from the Act to the extent it can aid freeing up of capital and streamlining counterparty risk are quite high, and not without reason.

The codification of enforceability of bilateral netting helps mitigate risk while determining the extent of regulatory capital required to be retained to cover any potential loss, naturally leading to improved liquidity, better use of capital and reduced cost of business. The level of impact will, of course, depend on the exposure entities carry to such transactions in the first place.

While setting out the norms in relation to computing exposure for counterparty credit risk arising from derivative transactions, the Reserve Bank of India (RBI) has in the past cited ambiguity in the legal enforceability of bilateral netting agreements and stated that non-centrally cleared over-the-counter derivative trades will be considered a netting set of their own. Exposures under derivative contracts are typically covered by sums which are retained by parties and banks to cover any potential losses. The RBI had previously stated that computation of these amounts will not involve any offset among different derivative transactions. Further, the capital adequacy norms for banks also did not permit netting of mark-to-market values of such contracts.

The Act now accords a broadly worded sanction to bilateral netting and makes netting of QFCs enforceable even where the contract is entered into without a netting agreement. More guidance may however be forthcoming on the way the calculation of derivatives exposure can be changed when the RBI issues relevant notifications under the Act.

2.6 Margining Requirements

It is expected that the implementation of the Act would lead to more efficient use of margin monies since the legal framework may be revised to impose margining only on net amounts. The RBI is also considering a robust framework for margins in case of non-centrally cleared derivatives. Improvements in this front are likely to provide greater confidence to market participants.

2.7 Corporate Bond Market

The Act is likely to inject life into the lacklustre corporate bond market in India. The RBI had previously observed that one of the major reasons for lack of interest in credit default swaps was the restriction on netting of mark to market position for capital adequacy and exposure norms. Modifications to this would certainly have a positive impact. However, the Act may not be able to change the fortunes of the corporate bond market on its own and will need other improvements and changes, including simplifying operational guidelines for corporate bonds, standardisation of valuation and increased participation from long term investors.

3 Conclusion

The idea of providing a framework for bilateral netting was set out earlier in the Financial Resolution and Deposit Insurance Bill, but the bill was withdrawn in 2018 over concerns on treatment of bank deposits. The Government has therefore completed an important milestone by passing this Act.

Financial products and derivatives have only become more complex over time. The cornerstone of any economic system, and indeed the basis of currency itself, is the implicit agreement between all parties on the underlying fiction the system is built over. For modern financial markets, it has become increasingly important that this agreement extends beyond the parties to a contract and is encoded in the legal framework.

Risk is an inherent part of markets but uncertainty in legal and regulatory framework is a feature few financial systems can afford to have if they hope to invite participants to engage meaningfully. The expectations from the impact of the Act are high and the next few weeks and months will be interesting to watch as regulators take steps to operationalise the Act.