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NETTING: A UAE PERSPECTIVE

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Article outline:

- The role of netting as a key tool to mitigate counterparty credit risk as recognised by international legislative bodies and trade associations
- Key elements of a legal framework to support netting enforceability
- Successes to date in UAE financial free zones where legal certainty on close-out netting have been achieved
- Market participants impacted by netting enforceability: a case for federal-level netting law.

The legal recognition of close-out netting provisions in financial contracts is increasingly significant to parties in the UAE as the region advances implementation of Basel III principles. The consequences of non-netting impact a wide range of UAE market participants beyond financial institutions.

INTRODUCTION TO CLOSE-OUT NETTING

Close-out netting is one of the primary means of mitigating credit risks associated with over-the-counter (OTC) derivatives trading between two counterparties. Close-out netting provisions are typically incorporated into a master-level agreement (a Master Agreement) regulating all the relevant individual transactions between the two parties and providing for a single net amount to be payable between the parties in the event of a close-out.

A close-out netting process involves three steps:

1. Termination – where the non-defaulting party calls an end to all the transactions covered by the relevant Master Agreement
2. Valuation – where the value of the unperformed obligations under the outstanding transactions under the Master Agreement is determined
3. Determination of net balance – where the values owed to the non-defaulting party and the values owed to the defaulting party are aggregated and netted against each other to determine a single close-out amount owed by one party to the other.

Close-out netting therefore has the potential for limiting exposure which one party has in the insolvency of its counterparty by enabling the value of what the first party owes to the insolvent counterparty to be used in reducing the value of what the insolvent counterparty owes to the first party.

For close-out netting to be valuable as a credit risk mitigation tool in this way, it needs to be enforceable in the insolvency of the counterparty (a concept generally referred to as positive netting or, in the case of the laws of the counterparty's jurisdiction, a netting jurisdiction).

Further, financial institutions will typically use the post-insolvency exposure as the measure to set its counterparty credit limits meaning that, if a counterparty is in a jurisdiction where its insolvency laws recognise netting, then that credit limit is calculated on the assumption of a net exposure. However, if a counterparty is in a jurisdiction where its insolvency laws may not recognise netting, then the credit limit is (and may be required by that financial institution's regulator to be) calculated on the assumption of gross exposures.

SYSTEMIC IMPORTANCE OF CLOSE-OUT NETTING

A thriving financial services sector requires legal certainty on close-out netting following counterparty insolvency.

There has been much work done at international level to prescribe standards and recommendations for national legislators and regulators in order to achieve cross-border harmonisation of financial markets legislation, for example:

- the UNIDROIT Principles on the Operation of Close-out Netting Principles[i]
- the recommendations under the UNCITRAL Insolvency Legislative Guide
- the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions.[ii]

At the industry level, trade associations such as the International Swaps and Derivatives Association (ISDA) and the International Capital Markets Association (ICMA) are playing a significant role in facilitating the recognition of close-out netting, for example:

- ISDA's 2006 Model Netting Act[iii] and explanatory guide[iv] for legislators, which includes the fundamental principles for enforceable netting and related collateral arrangements
- the publication of netting opinions by ISDA and ICMA on jurisdictions which are commonly considered to be positive netting for reliance by their respective members.

Under the G20 OTC reforms, international legislators are increasingly discouraging of OTC trades with counterparties in non-netting jurisdictions, particularly following the implementation of uncleared margin rules.[v]

Figure 1

FINANCIAL PRODUCTS AND COUNTERPARTY-TYPES THAT ARE SIGNIFICANT FOR CLOSE-OUT NETTING

Financial products:

- Derivatives contracts
- Repurchase transactions
- Cross-product netting
- Clearing (derivatives contracts and securities).

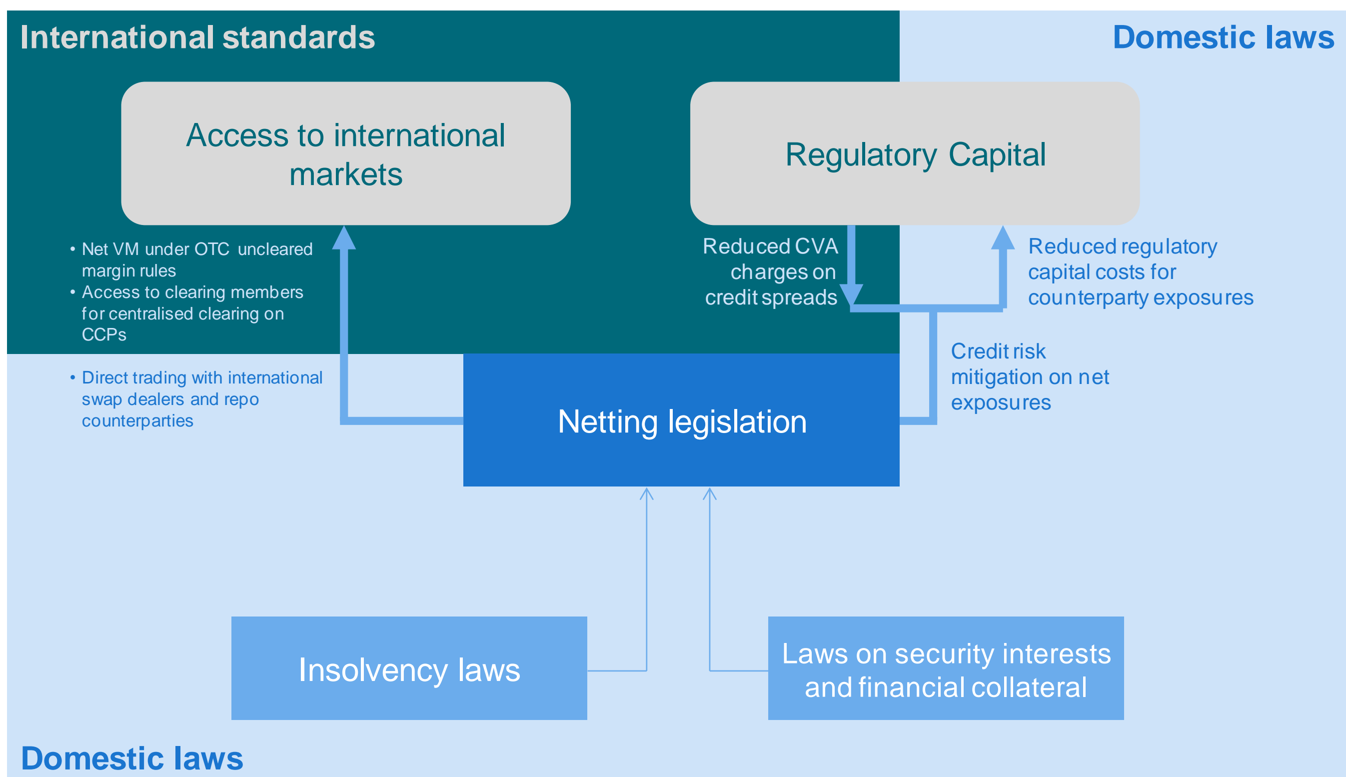
Counterparty types:

- Financial institutions
- Clearing houses (CCPs)
- Corporates (including government-related entities).

LEGISLATIVE FRAMEWORK FOR CLOSE-OUT NETTING

In jurisdictions which are generally considered to be netting jurisdictions, close-out netting[vi] is usually supported by other domestic legislation such as insolvency laws and laws on collateral arrangements. Set out in Figure 2 is a diagrammatic illustration of the legal framework to support a positive netting analysis, as well as how this impacts the relationship of the market participants in that jurisdiction with wider international standards in the context of financial transactions.

Figure 2



THE UAE: MOVING IN THE RIGHT DIRECTION

The UAE has already taken a number of policy-driven steps to create an environment conducive to the development of a financial services sector within its geographical territory.

Financial free zones: DIFC and ADGM

There are two financial free zones[vii] already established in the UAE: the Dubai International Financial Centre and the Abu Dhabi Global Market. Both the DIFC and the ADGM have passed laws[viii] which closely follow the ISDA 2006 Model Netting Act to specifically recognise the enforceability of netting agreements, close-out netting and related collateral arrangements.

There are industry-level netting opinions published by ISDA for its members in respect of these financial free zone jurisdictions.

Federal Law on bankruptcy

The UAE enacted a new law[ix] on bankruptcy which came into effect in December 2016 (the UAE Bankruptcy Law) that expanded and modernised aspects of the available insolvency procedures such as the protective composition procedure and also provided for a balance sheet test element to the insolvency test.

However, the UAE Bankruptcy Law does not cover governmental bodies, commercial banks, insurance companies and those companies incorporated within free zones that have their own comprehensive insolvency laws that provide for composition, restructuring or bankruptcy procedures (such as the DIFC and the ADGM). UAE established entities that are wholly or partially owned by local or federal government and are not incorporated pursuant to the UAE Commercial Companies Law are only covered by the UAE Bankruptcy Law if they had opted to be so under their constitutional documents.

Similar to the previous bankruptcy legislation, the Bankruptcy Law envisages a form of statutory insolvency set-off as commonly found in most civil law systems, which:

- allows set-off between a creditor and debtor if it had been contractually agreed between the parties prior to insolvency, but not in respect of debts which arise after the commencement of an insolvency procedure
- provides for a creditor to submit a claim for the post set-off amount against the insolvent party's estate or, if the creditor owes the insolvent party the post set-off sum, then the creditor would pay this sum to the insolvency estate.

In the absence of further clarity on the nature of the sums which can be used as part of this statutory insolvency set-off under the UAE Bankruptcy Law, the UAE Civil Code provisions governing mandatory set-off also remain relevant to a legal analysis on post-insolvency set-off, namely that:

'*Each of the parties must be both the obligor and the obligee of the other and the obligations must be of the same type and description, must be equally due and must be of equal strength or weakness*'.

The key difference between close-out netting and set-off is that close-out netting could take place across a number of transactions, regardless of when payments would otherwise have become due (in other words, values are calculated on unperformed obligations such as future swap payments or deliveries under outstanding swap transactions, which become part of the sums being applied as part of close-out netting).

"The key difference between close-out netting and set-off is that close-out netting could take place across a number of transactions, regardless of when payments would otherwise have become due."

In the absence of any UAE legislation providing specific recognition of close-out netting, statutory insolvency set-off can – in some respects – go part of the way to enable a similar effect to close-out netting upon counterparty insolvency. However, insolvency set-off provisions, unless combined with further provisions, do not alone provide sufficient support for a conclusive positive netting analysis because there remain other factors under which a lump sum close-out amount can be undermined under UAE laws.

For example:

- Termination of contract: the first step to effecting close-out netting is to terminate all outstanding transactions, which are often contrary to the statutory requirement for contracts to continue during a period of moratorium. Whereas the UAE Bankruptcy Law includes a carve-out to allow terminations required to effect statutory insolvency set-off for protective composition, an equivalent is not expressly provided for all insolvency procedures envisaged under the UAE Bankruptcy Law
- Cherry-picking: in all of the three procedures available under the UAE Bankruptcy Law, the insolvent party's officer has powers to review the sums which are submitted as claims on the insolvent estate. This power would make it possible for lump sum close-out amounts to be picked apart across multiple transactions, with the effect that the creditor has to pay the gross amount of all or some of the in the money transactions to the insolvency estate, whilst filing a claim separately for the claims under the out of the money transactions
- Valuation of close-out transactions: as mentioned above, the valuation of close-out amounts includes ascribing values to amounts which may not yet have become due (for example, on unperformed obligations) such as those in international template Master Agreements, which may otherwise be subject to challenge by a UAE insolvency officer.

The provisions of netting-specific legislation such as those in the ISDA 2006 Model Netting Act would provide considerable clarity to these issues.

Federal Law on the mortgage of moveable property

The UAE recently enacted a new law[x] on creating security over a new set of asset classes, including registration and enforcement procedures, which came into effect on March 15 2017 (the UAE Mortgage of Moveable Property Law).

Until that law was enacted, UAE laws on creating security (other than over real estate) focused almost exclusively on possessory pledges, thus creating difficulties with security over future property and fluctuating balances of secured assets.

In the context of collateral arrangements used in conjunction with Master Agreements that are reliant on close-out netting, the most welcome developments in the UAE Mortgage of Moveable Property Law are:

- the recognition of cash collateral (by way of security) in bank accounts, provided that such security is registered on the register of security[xi]
- the recognition of self-help remedies, provided that the realisation of the secured property is provided for under the terms of the security agreement and
- statutory timeframes for bringing court action for challenging the enforcement of security.

There remains some uncertainty over whether security over dematerialised securities (such as listed equities and bonds/sukuk) are covered under the UAE Mortgage of Moveable Property Law. The statutory timeframes for court action are also some way beyond the two days required under most international regulatory capital regimes to claim a more favourable regulatory capital treatment. However, the move towards a more modern legal framework for security taking is significant progress in providing better legal certainty on security interest over cash collateral arrangements.

"There remains some uncertainty over whether security over dematerialised securities (such as listed equities and bonds/sukuk) are covered under the UAE Mortgage of Moveable Property Law."

Draft Federal Law regarding netting

Following the enactment by the DIFC of the Netting Law, there has been a draft of a UAE federal-level netting law based on the DIFC Netting Law which has been under review by a number of UAE governmental stakeholders.

A UAE federal netting law would significantly progress international recognition of the UAE as a positive netting jurisdiction, which will benefit not just UAE financial institutions, but also UAE corporates and clearing houses (CCPs).

For the co-existence of netting legislation with other UAE laws, a federal-level netting law for the UAE should also clarify that:

- Any transactions under a netting agreement will not be characterised as gambling or wagering, whether under civil laws or penal laws
- Any collateral arrangements used in connection with a netting agreement should be exempt from: (i) provisions of the UAE Mortgage of Moveable Property Law which contemplate court procedures for enforcement of security over collateral assets that are otherwise covered under the UAE Mortgage of Moveable Property Law; and (ii) any requirement to enforce through a court order, in the case of collateral arrangements involving securities

  Netting under a netting agreement is enforceable notwithstanding that the (UAE) counterparty is under an insolvency proceeding other than through the UAE Bankruptcy Law[xii]
- The parties' choice of governing law of the netting agreement is enforceable.

"A UAE federal netting law would significantly progress international recognition of the UAE as a positive netting jurisdiction, which will benefit not just UAE financial institutions, but also UAE corporates and CCPs."

NETTING IN THE UAE: CURRENT CHALLENGES

There are macro-economic factors from global and domestic financial markets which have perhaps accelerated federal-level awareness by UAE financial services regulators of the necessity of netting recognition.

The benefits of being a positive netting jurisdiction might be most simply understood through the cost implications for UAE counterparties in the absence of positive netting recognition. We set out in Figure 3 a table of the cost drivers and the way they impact different types of market participants.

For smaller to medium-sized financial institutions which have a limited swap book with international swap dealers, the costs of compliance will inevitably have a prohibitive effect on their access to trading with financial institutions and swap dealers outside the Gulf region.

Figure 3

Cost driver	Financial institutions	Corporates (including government-related entities)	Clearing houses
Spreads on swaps and hedges	**Impacted** Spreads on OTC trades with international swap dealers include a higher credit valuation adjustment (CVA) charge due to the swap dealer's regulatory compliance requirements.	**Impacted** Credit spreads on hedges with international hedge providers include a higher credit valuation adjustment (CVA) charge due to the hedge provider's regulatory compliance requirements.	
Uncleared margin requirements	**Impacted** Although the treatment of non-netting counterparties by regulators in each G20 jurisdiction varies, and there is some divergence in application of the uncleared margin rules between EU swap dealers vis-à-vis UAE counterparties, G20 regulators would typically require their regulated entities to: • collect gross variation margin from non-netting counterparties • post either no or net variation margin to non-netting counterparties. It is particularly due to the effects of these uncleared margin requirements on UAE market participants that all major UAE financial institutions now trade through special purpose vehicales (SPVs) (see below).	**Indirectly impacted** The added costs of back-to-back hedging on the international OTC markets for its UAE hedge provider would, over time, have an impact on the pricing of spreads on hedges to domestic corporates.	
Access to OTC clearing	**Impacted** The UAE Central Bank prescribes more favourable regulatory capital treatment by UAE banks for derivatives contracts which are centrally cleared.	**Indirectly impacted** The added costs of back-to-back hedging on the international OTC markets for its UAE hedge provider would, over time, have an	**Potentially impacted** Although there is yet to be a major OTC CCP which is governed under UAE laws that will need to enter into co-operation agreements with other international CCPs to clear each others' derivatives

<table>
<tr><th>Cost driver</th><th>Financial institutions</th><th>Corporates (including government-related entities)</th><th>Clearing houses</th></tr>
<tr><td>Access to OTC clearing (cont)</td><td>In practice, many clearing members will not onboard clearing clients from non-netting jurisdictions, meaning that UAE financial institutions face difficulties in accessing international CCPs to clear derivatives contracts.</td><td>impact on the pricing of spreads on hedges to domestic corporates.</td><td>contracts, we would expect there would be some degree of difficulty for a foreign CCP to enter into co-operation arrangements with a CCP in a non-netting jurisdiction.</td></tr>
<tr><td>OTC trading through Swapco SPVs in positive netting jurisdictions</td><td>Impacted

Since 2013-2014, a number of UAE financial institutions have incorporated wholly-owned special purpose vehicles (swapco SPVs) in a positive netting jurisdiction in order to trade OTC derivatives contracts and repurchase transactions with international swap dealers. The swapco SPV's obligations are then guaranteed by its parent company.

Although the incorporation and annual corporate registration costs are minimal, the main costs to a UAE financial institution are:
• running two parallel swap books between itself and its Swapco SPV
• absorbing any basis risks which might arise from the two swap books
• uncertain regulatory capital of the parent company's OTC derivatives exposures under the UAE Central Bank's regulatory capital rules.</td><td>Potentially impacted

The added costs of back-to-back hedging on the international OTC markets through the UAE hedge providers' swapco SPV might, over time, have an impact on the pricing of spreads on hedges to domestic corporates.

For larger UAE corporates who have a significant non-hedging swap book, it may also need to set up its own swapco SPV.</td><td></td></tr>
<tr><td>Bespoke documentation structure</td><td></td><td>Impacted

Some foreign financial institutions have attempted to mitigate against the legal uncertainties on the enforceability of</td><td></td></tr>
</table>

Cost driver	Financial institutions	Corporates (including government-related entities)	Clearing houses
Bespoke documentation structure (cont)		derivatives contracts and close-out netting by creating off-market, bespoke documentation architectures. The legal costs of documentation negotiation and the structuring costs of these arrangements are much higher than trades which follow market-standard documentation.	
Obtaining third country recognition			**Potentially impacted** Although the European Securities and Markets Authority (ESMA) has given third country CCP recognition to Dubai Commodities Clearing Corporation (DCCC) in the absence of (amongst other things) netting enforceability, ESMA's recognition had been granted on the basis that the volume of OTC trades to be cleared by the DCCC would not be significant to the international OTC markets. However, a UAE CCP which clears a wider range and a greater volume of OTC trades may encounter challenges in obtaining EMSA third country recognition, without which EU clearing members would be prevented from using the UAE CCP.
Opportunity costs of OTC clearing business			**Potentially impacted** The Emirates Securities and Commodity Authority has ambitious plans to enable the establishment of CCP business in the UAE, with a recent new regulation to

Cost driver	Financial institutions	Corporates (including government-related entities)	Clearing houses
Opportunity costs of OTC clearing business (cont)			govern CCPs and their activities, including the clearing of derivatives contracts. This is an opportunity for the UAE to expand its offering of FMI-related services. The development of an OTC clearing industry would be severely curtailed without the UAE being recognised as a positive netting jurisdiction.

C L I F F O R D

C H A N C E

Concluding remarks: looking forward

Fostering greater awareness of the benefits of achieving recognition of positive netting for the UAE is needed, particularly in light of the demand driven by the wider G20 global financial market reforms. Further development of laws and regulations to provide certainty on netting enforceability is needed so that the UAE can continue on its trajectory to become one of the world's leading financial hubs.

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Footnotes:

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[i] Please refer to: http://www.unidroit.org/english/principles/netting/netting-principles2013-e.pdf for the full text of the Close-out Netting Principles.

[ii] Please refer to: http://www.fsb.org/what-we-do/policy-development/effective-resolution-regimes-and-policies/key-attributes-of-effective-resolution-regimes-for-financial-institutions/#footnote-1 for the full text of the Key Attributes, where Key Attribute 4 provides for a:

"*legal framework governing set-off rights, contractual netting and collateralisation agreements and the segregation of client assets should be clear, transparent and enforceable during a crisis or resolution of firms, and should not hamper the effective implementation of resolution measures*".

[iii] Please refer to: http://assets.isda.org/media/341bbbff/b732bf0a-pdf/ for a copy of the ISDA 2006 Model Netting Act.

[iv] Please refer to: http://assets.isda.org/media/341bbbff/1ec9a677-pdf/ for the full text of the explanatory memorandum to the ISDA 2006 Model Netting Act.

[v] For example, under the European Market Infrastructure Regulation (EMIR) for member states of the European Economic Area and the Dodd-Frank Wall Street Reform Act in the United States. Japan, Hong Kong, Singapore, Australia and Switzerland have also, as of the date of writing, implemented similar rules on uncleared margin. The application of the uncleared margin rules of each of these jurisdictions to non-netting counterparties are not identical, and this article does not purport to examine these issues.

[vi] Please refer to: https://www.isda.org/2017/04/26/status-of-netting-legislation/ for a list of the jurisdictions where netting is commonly thought to be enforceable.

[vii] The UAE Federal Law No. 8 of 2004 provided the legal basis for creation of financial free zones for the establishment of entities (including foreign financial institutions and other financial services providers) to carry out "financial banking activities". A financial free zone also has jurisdiction on civil and commercial matters, pursuant to which the financial free zone authorities can pass their own laws and establish their own courts as distinct from the "onshore" UAE legislative regime and "onshore" UAE courts.

[viii] For DIFC, under DIFC Law No. 2 of 2014. Please refer to: https://www.difc.ae/files/6514/5448/9189/Netting_Law_DIFC_Law_No._2_of_2014.pdf for the full text.

[ix] UAE Federal Law No. 9 of 2016.

[x] UAE Federal Law No. 20 of 2016.

[xi] The Register of Security will be established under implementing regulations to the UAE Mortgage of Moveable Property Law which, as of the date of writing, are pending publication in the UAE Official Gazette. The Register of Security is expected to be operational from mid-January 2018.

[xii] Precedent examples of the restructuring or bankruptcy of major government-related entities which are not covered by the UAE Bankruptcy Law would indicate that the insolvency regime applicable to such counterparties would be formed by decree at the time. An effective netting law would also need to apply during any such restructuring or "quasi-bankruptcy" procedures.