Client Updates

Shardul Amarchand Mangaldas

For Private Circulation only | September 2020

The Bilateral Netting of Qualified Financial Contracts Bill, 2020

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Introduction

In a significant development, the Bilateral Netting of Qualified Financial Contracts Bill, 2020 ("**Bilateral Netting Bill**") was passed by the Lok Sabha on 20 September 2020 and by the Rajya Sabha on 23 September 2020. The Bilateral Netting Bill essentially aims to provide legal sanction for enforceability of bilateral netting of qualified financial contracts ("**QFC**") entered into between Qualified Financial Market Participants. Netting enables two counterparties in a bilateral financial contract to offset claims against each other to determine a single net payment obligation due from one counterparty to the other, instead of undertaking multiple payments on a gross basis.

The Bilateral Netting Bill covers trades that are over the counter ("**OTC**") derivative contracts, negotiated bilaterally such as cross-currency or interest rate or commodity swaps, currency or interest rate futures or options and spot, future or forward foreign exchange transactions. Under existing laws, banks have to make higher provisions for such bilateral contracts since these are outside the Clearing Corporation of India's framework and credit exposure is measured for such OTC derivative contracts on gross basis rather than a net basis. This situation significantly increases credit risk exposure and systemic risk in financial market in the event of default of a counterparty, besides trapping significant amount of capital unproductively by banks. As per Economic Survey 2019-20 by the Department of Economic Affairs, Ministry of Finance, based on RBI estimates, bilateral netting arrangements introduced by the Bilateral Netting Bill could have helped 31 major banks participating in India's OTC derivatives market save about INR 22.58 billion in regulatory capital during FY2017-18.

Set out below is our analysis of the key provisions of the new regulatory regime.

Key Features

QFCs

- mean qualified financial contracts as notified by key regulators such as the Reserve Bank of India, the Securities and Exchange Board of India, the Insurance Regulatory and Development Authority of India, the Pension Fund Regulatory and Development Authority etc. ("Relevant Authority").

Key Qualified Financial Market Participants

- a banking institution, or a non-banking financial company, or such other financial institution which is subject to regulation or prudential supervision by the Reserve Bank of India;
- an individual, partnership firm, company, or any other person or body corporate whether incorporated in India or under the laws of any other country and includes any international or regional development bank or other international or regional organisation;

- an insurance or reinsurance company which is subject to regulation or prudential supervision by the Insurance Regulatory and Development Authority of India;
- a pension fund regulated by the Pension Fund Regulatory and Development Authority.

Bilateral Netting:

- Bilateral netting refers to offsetting of all claims arising from dealings between two parties, to determine a net amount payable or receivable from one party to other. The Bilateral Netting Bill allows for enforcement of netting for QFCs between Qualified Financial Market Participants provided at least one of the parties is an entity regulated by a Relevant Authority.
- Individuals, partnership firms, companies, or any other persons or body corporates are eligible for netting benefits only when the counterparty to the transaction is an entity regulated by a Relevant Authority.

Close-out netting:

- Close-out netting refers to a process involving termination of obligations under a QFC with a party in default and the subsequent combining of positive and negative replacement values into a single net payable or receivable.
- This process can be commenced by a notice given by one party to the other party on the occurrence of a default (failure to honour the obligations of a QFC) by the other party or a termination event, as specified in the netting agreement that gives one or both parties the right to terminate transactions under the agreement.
- Close-out netting is also enforceable against an insolvent party and against the person providing collateral (if applicable). Close-out netting is also enforceable against a party placed under administration, notwithstanding any injunction, moratorium, insolvency, resolution, winding up or order of a court issued under any law.
- Where any one of the parties to a netting agreement is subject to administration, no prior notice to or consent of the party in insolvency, winding up, liquidation, administration or resolution proceeding, or to the administration practitioner of such proceeding, is required.
- The net amount payable/receivable under the close-out netting would be determined:
  (i) in accordance with the netting agreement entered into by the parties, if one exists, or
  (ii) through agreement between the parties, or
  (iii) through arbitration.

  The collateral provided under a collateral arrangement may be liquidated without consent from any entity unless the netting agreement specifies otherwise.

Impact of netting off of transactions from a direct tax perspective

- Section 269ST of the Income-tax Act, 1961 prohibits persons from receiving amounts in excess of INR 2,00,000, otherwise than by way of approved banking channels, if the said amount pertains to a single transaction or transactions relating to one event/occasion from one person. While the intent of section 269ST of the Income-tax Act, 1961 is to discourage cash transactions, the judiciary has previously (in very fact specific circumstances) found payments made by way of journal entries to be in contravention of the section. Accordingly, it will be interesting to see if the tax authorities treat each QFC as a separate transaction and try to invoke 269ST of the Income-tax Act, 1961 upon their netting off (as is proposed in the Bill) or come up with a clarification/exemption to this effect. Currently, out of all Qualified Market Participants, only banking companies are exempt from the rigour of section 269ST of the Income-tax Act, 1961.

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Conclusion

- The Bilateral Netting Bill by providing an unambiguous legal framework for enforceability of bilateral netting and close-out netting seeks to reduce credit exposure of banks and other financial institutions from gross to net exposure.
- Netting is an effective strategy for reducing risk in the payment system and significantly reduces the liquidity required to enable the financial system to operate efficiently. The net obligations of an entity are likely to be considerably less than their obligations on a gross basis. Now financial institutions will not need to wait until one transaction is settled in order to meet their other payment obligation.
- The Bilateral Netting Bill also provides legislative certainty to close-out netting contracts, which are used in various global jurisdictions to lower the margins and to provide more lucrative pricing in financial markets transactions such as OTC currency and interest rate swaps. Not only will this permit termination of contracts if the counterparty becomes insolvent (or if some other pre-agreed event of default occurs), but will also encourage parties to determine the termination value upfront, so as to arrive at a net amount payable by the defaulting party. It would be interesting to see how the Indian financial markets develop a model to calculate the net payable costs in case of a default. Another interesting aspect would also be to see the inter play between establish security enforcement mechanisms in India and the provisions of collateral enforcement in the Bilateral Netting Bill. Having said that, it must be acknowledged that the Bilateral Netting Bill undoubtedly provides integrity and legal certainty to bilateral netting without the need for an exchange or a clearing house and is a welcome step towards sound financial market management. It will encourage an independent and more robust derivate market in the country.

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Please feel free to address any further questions or request for advice to:

Shardul S. Shroff
Executive Chairman and National Practice Head – Insolvency & Bankruptcy
shardul.shroff@amsshardul.com

Shilpa Mankar Ahluwalia
Partner - Banking & Finance
shilpa.mankar@amsshardul.com

Shubhangi Garg
Partner - Banking & Finance
shubhangi.garg@amsshardul.com