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Statement of The Bond Market Association

***Before the
United States House of Representatives
Committee on the Judiciary Subcommittee for Commercial and
Administrative Law***

***Hearing on Proposed Changes to Bankruptcy Laws
March 4, 2003
Submitted for the Record***

The Bond Market Association appreciates the opportunity to comment on proposed reforms to the bankruptcy laws. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2003 (H.R. 975) includes several provisions that would help insulate the financial system from systemic risk—the risk that the failure of one market participant could ripple through the capital markets and bring down other participants. The Bond Market Association represents securities firms and banks that underwrite, trade, and sell debt securities both domestically and internationally. The Association's membership collectively accounts over 95 percent of the nation's bond underwriting activity.

We commend Subcommittee Chairman Chris Cannon for calling this hearing. We also commend Chairman Sensenbrenner's longstanding commitment to comprehensive bankruptcy reform. Bankruptcy reform is long overdue and we urge quick enactment of H.R. 975.

In this statement, the Bond Market Association focuses on provisions in H.R. 975 concerning the netting, close-out rights and payment risk reduction reforms of the Bankruptcy Code and bank insolvency law.

I. Introduction

Financial institutions often utilize several different but related financial transactions to obtain and provide liquidity to the marketplace, while mitigating risk. For example, a financial institution may enter into a transaction which may entail exposure, but enter into an offsetting transaction which hedges such exposure. In these important market activities, which can involve huge sums and concentrated exposures, the inability of one party to exercise its contractual "self-help" rights in the event of the insolvency of the other party could cause ripple effects, given the interconnected nature of the financial markets, undermining the financial condition of the non-bankrupt party (and its counterparties) and the markets more generally.

Recognizing the important role of these transactions in capital formation and market liquidity and the potential for a chain reaction of insolvencies should non-bankrupt parties' contractual self-help rights be impaired, Congress has included provisions in the Bankruptcy Code and the bank insolvency laws that expressly protect the exercise of such rights in the event of bankruptcy or insolvency. However, it has been more than ten years since the last legislative update to the safe-harbor provisions. The financial markets have evolved during that time in ways that leave various transactions and parties subject to legal uncertainty. As more types of market participants have engaged in a broader range of transactions, statutory inconsistencies have surfaced that make it difficult to conclude that Congress's goal of minimizing systemic risk has been fully achieved through the existing market safe harbors. Important technical corrections are needed to minimize systemic risk in light of market developments.

The comprehensive bankruptcy bill would substantially improve the statutory regime that governs financial transactions when a party fails to meet its payment obligations. This legislation would harmonize the Bankruptcy Code and bank insolvency laws governing swaps, repurchase agreements, securities contracts, forward contracts, and commodity contracts. The Bond Market Association urges Congress to enact the full set of bankruptcy and insolvency law changes that are needed to protect modern financial markets. These proposed changes are entirely consistent with many statutory provisions that have already been enacted, and are in the nature of technical corrections.

II. The Current Safe Harbors Need to be Updated

A. Swap Agreements

Swap agreements are privately negotiated contracts between parties to exchange payments under specified conditions. The parties' obligations are linked to some index, commodity price, interest rate, currency or other indication of economic value. In an interest rate swap, for example, two parties agree to exchange payments based on some agreed upon notional principal amount. However, principal does not typically change hands in a swap contract. It merely serves as the reference for the calculation of the payments to be made.

The primary purpose of swaps is risk management. The universe of parties actively engaged in swaps is expansive and growing: banks, securities firms, mutual funds, pension funds both public and private, manufacturing firms, and state and local governments, just to name a few. Virtually all significant commercial enterprises face certain risks that can be managed through the use of swaps. In the example that follows, Party B attempts to manage its exposure to changes in interest rates through the use of an interest rate swap:

Example 1. Two parties to an interest rate swap agree to exchange payments based on a \$1 million notional amount. Party A agrees to pay a fixed rate of seven

percent, and Party B agrees to make floating payments based on some market index. If payments are exchanged once per year, Party A would pay Party B \$70,000 (seven percent of \$1 million) and Party B would pay Party A \$40,000 in the first year (four percent of \$1 million), assuming that the floating rate index were four percent at the time of calculation. In practice, the payments are netted so that Party A simply pays Party B \$30,000, or \$70,000 - \$40,000. (In this example, Party B may have floating rate assets and fixed rate liabilities, and it desires to hedge that mismatch. In this example, the payment that Party B receives makes up for the reduced return Party B receives on its floating rate assets, allowing it to satisfy its fixed rate liabilities. Party A may be a dealer, who hedges its position by taking an offsetting position, either in the swaps market or in another fixed income market.)

The fundamental contractual terms in a swap for the exercise of remedies in the event of bankruptcy or insolvency provide for "close-out," "netting" and foreclosure. Close-out involves the termination of obligations between the parties and the calculation of gain or loss. Netting involves offsetting the parties' gains and losses to arrive at a net outstanding amount payable by one party to the other. Foreclosure involves the use of pledged assets to satisfy the net payment obligation. The ability to execute this process swiftly is key to the financial markets and the solvency of its participants due to the potential exposure a counterparty in such transactions has to market risks and the possibility of changes in the values of financial contracts and collateral due to market movements. The inability of a financial market participant to exercise these remedies promptly could impair its liquidity and solvency.

The following is a basic example of the close-out, netting and foreclosure process:

Example 2. Party A and Party B enter into two interest rate swaps at different times (Swap X and Swap Y). Both contracts contain provisions that allow for close-out, netting and foreclosure and are in effect when Party A becomes insolvent. At the time of Party A's insolvency, Party A's mark-to-market loss under the terms of Swap X is \$30 million and its mark-to-market gain under the terms of Swap Y is \$20 million. Through the process of close-out and netting, the swaps are terminated and Party A owes Party B \$10 million. If Party A had pledged \$15 million of collateral to Party B, Party B would foreclose on the collateral, use \$10 million to satisfy Party A's obligation, and return \$5 million to Party A.

If Party A became subject to a proceeding under the Bankruptcy Code, Party B would be entitled under current law (Sections 362(b)(17) and 560 of the Bankruptcy Code) to exercise its self-help close-out, netting and foreclosure remedies as described above. If Party A were an FDIC-insured bank that became subject to a receivership (and Swaps X and Y were not transferred to a successor entity), Party B would be entitled under the Federal Deposit Insurance Act to exercise its self-help close-out, netting and foreclosure remedies as described above. In either case, if Party B were

unable to exercise such remedies, its liquidity and solvency could be impaired, creating gridlock and posing the risk of systemic problems.

The swaps market has evolved since the protections for interest rate and other swaps were first put in place. Parties have learned to apply the principles of risk management in many different ways that are not expressly covered under the applicable definitions in the Bankruptcy Code and the Federal Deposit Insurance Act. As a result, the markets in some cases proceed under some degree of legal uncertainty regarding the enforceability of certain contracts, even though they are economically equivalent to other contracts that are expressly protected and pose the same risks that Congress has sought in the past to avoid.

For example, if in the above hypothetical the two swaps were equity swaps in which the payments were calculated on the basis of an equity securities index, it is not entirely clear that the transactions would fall within the market safe harbor in the Bankruptcy Code or the Federal Deposit Insurance Act for "swap agreements." If both of the parties were "financial institutions" under the Federal Deposit Insurance Corporation Improvement Act or the Federal Reserve Board's Regulation EE and the swap agreement were a "netting contract," then Party B might (although it is not entirely clear) be able to exercise close-out, netting and foreclosure rights in respect to the equity swap transactions. If one of the parties were not a "financial institution" or the contract did not constitute a "netting contract" (for example, because it was governed by the laws of the United Kingdom), then Party B could be subject, among other things, to the risk of "cherry-picking"--the risk that Party A's trustee or receiver would assume Swap Y and reject Swap X, leaving Party B with a \$30 million claim (which would be undersecured because of the impairment of netting) and to the risk that its foreclosure on the collateral would be stayed indefinitely. This could impair Party B's creditworthiness, which in turn could lead to its default to its counterparties. The pending legislation would minimize these risks by making clear that an equity swap is a "swap agreement," entitled to the same market safe harbors as interest swap agreements.

B. Repurchase Agreements

Repurchase agreements, also known as "repos," are contracts involving the sale and repurchase of securities or other financial assets at predetermined prices and times. Although structured and treated for legal purposes as purchases and sales, economically repos resemble secured lending transactions. In economic terms, one participant in the repo transaction (the "seller") is borrowing cash at the same time that the other participant (the "buyer") is receiving securities. The recipient of cash agrees to re-pay the cash (e.g. to repurchase the securities)-- at a predetermined time and price, including a price differential (the economic equivalent of interest). The buyer agrees to purchase and later resell the securities to the seller.

According to published reports, on average in 2002, nearly \$3.8 trillion in repos were outstanding between dealers of U.S. government and federal agency securities, up from an average of \$3.1 trillion in 2001. Parties also routinely engage in repo

transactions involving non-agency mortgage-backed securities, whole loans and other financial instruments. Participants in the repo market are diverse, including commercial banks, securities firms, thrifts, finance companies, non-financial corporations, state and local governments, mutual and money-market funds. The repo markets also play an integral role in the Federal Reserve's open market operations, which allow the Federal Reserve to meet its Fed Funds target.

In 1984, Congress acted to protect certain types of repos from the insolvency of market participants after the 1982 Lombard-Wall bankruptcy court decision cast uncertainty on the ability of market participants to close out their positions. According to the Senate Judiciary Committee report on the 1984 legislation, that decision had a distinct adverse effect on the financial markets. At that time, Congress granted protection only to repos involving certificates of deposit, eligible bankers' acceptances, and securities that are direct obligations of, or that are fully guaranteed as to principal and interest by, the federal government. In doing so, Congress expressly stated that repos serve a vital role in reducing borrowing costs in the markets for these securities and sought to encourage market participants to use repos with confidence.

Unfortunately, the list of instruments protected by those 1984 amendments to the Bankruptcy Code has grown outdated as market participants have entered into repos involving a wide range of financial assets. Besides repurchase agreements on government and federal agency securities, which are covered under the Bankruptcy Code and Federal Deposit Insurance Act definitions of "repurchase agreement," firms now actively engage in repurchase agreements on the foreign sovereign debt of OECD countries, whole mortgage loans, and mortgage-backed securities of many types. Under H.R. 975, each of these types of repurchase agreements would be covered by the market safe harbors provided in the Bankruptcy Code (they are already covered by the Federal Deposit Insurance Act and regulations thereunder). Market participants could then enter into such transactions with greater confidence that they will be easily enforceable, improving the liquidity and cost of financing in the markets for the underlying instruments, and minimizing systemic risk.

C. Securities Contracts, Forward Contracts and Commodity Contracts

Market participants enter into contractual arrangements for the sale of securities and commodities where payment and delivery obligations are fulfilled at some future date. Securities contracts, forward contracts, and commodity contracts all can take many forms, but they can also be similar from an economic perspective. "Securities contracts" include forward purchases of securities, pursuant to which the parties agree to exchange payments and securities at a fixed date in the future. "Forward contracts" include privately negotiated arrangements where one party agrees to sell a commodity to another party at a fixed price for delivery at a future date. The terms of forward contracts can closely resemble those of futures contracts (which are "commodity contracts"). However, forward contracts are not traded on commodity exchanges under standardized terms and the parties envision actual delivery of the underlying commodity.

Despite the economic similarities of securities contracts, forward contracts and commodity contracts, the Bankruptcy Code and the Federal Deposit Insurance Act are inconsistent in their treatment of these transactions. Under the Federal Deposit Insurance Act, any counterparty can close out and net obligations under all securities contracts, forward contracts or commodity contracts it may have outstanding with the FDIC-insured bank in a liquidating receivership. However, if the failing counterparty is a debtor subject to the Bankruptcy Code, the enforceability of close-out provisions depends on a number of factors, including the type of counterparty, and the type of contract involved. In order to close out and net "securities contracts," the non-bankrupt counterparty must be a "stockbroker," "financial institution" or "securities clearing agency." In order to close out and net "forward contracts," the non-defaulting party must qualify as a "forward contract merchant." A few examples illustrate these differences:

Example 3. Party A, a mutual fund, and Party B, a securities dealer, have two outstanding contracts for the purchase of securities, one that is in-the-money to Party A, one that is out-of-the-money to Party A. If Party B becomes the subject of proceedings under the Bankruptcy Code, Party A would not be able to close out the contracts and net its obligations to Party B under the out-of-the-money contract against Party B's obligations under the in-the-money contract (unless it had acted through a bank agent). However, if it is Party A that becomes the subject of proceedings under the Bankruptcy Code, Party B would be able to close out the transactions and net its obligations. This is because Section 555 of the Bankruptcy Code allows liquidation of securities contracts only by stockbrokers, financial institutions and securities clearing agencies, none of which includes the mutual fund (unless it had acted through a bank agent).

Example 4. Now assume that in the above example Party B is an FDIC-insured depository institution. If Party B becomes the subject of receivership proceedings and the securities contracts with Party A are not transferred to a successor institution, Party A will be able to close out the transactions and net the obligations thereunder. This is because the Federal Deposit Insurance Act, since 1989, contains no counterparty restrictions.

Example 5. Party A, the mutual fund, and Party B, an affiliate of a securities dealer, have two outstanding forward foreign exchange contracts. If Party B becomes the subject of proceedings under the Bankruptcy Code, Party A would be able to close out and net the foreign exchange transactions. This is because Section 556 of the Bankruptcy Code allows liquidation of "forward contracts" (the foreign exchange transactions) by forward contract merchants, a classification that includes the mutual fund. (Note that the forward foreign exchange contracts would also be "swap agreements," and the mutual fund, as a "swap participant," could exercise its rights on that basis as well. Other "forward contracts" would not qualify as "swap agreements.")

Thus, parties of similar size who enter the markets with equal frequency and in the same manner enjoy different degrees of protection under the Bankruptcy Code and the Federal Deposit Insurance Act. This makes no sense from the point of view of the reduction of systemic risk -- the failure of these market players could trigger the same kind of chain reaction that a bank, broker-dealer or clearing agency failure could trigger. The pending legislation would improve the current situation by making certain technical definitional changes under the Bankruptcy Code (to bring it closer to the Federal Deposit Insurance Act). The amendments would expand the universe of counterparties whose contractual rights would be enforceable. In addition to stockbrokers, financial institutions, registered investment companies and securities clearing agencies, large and sophisticated market participants would be able to close out their securities contracts, forward contracts and commodity contracts against Bankruptcy Code debtors. Such counterparties would be defined as "financial participants" under the Bankruptcy Code through certain quantitative tests modeled on the Federal Reserve Board's Regulation EE. Once amended, the counterparty limitations under the Bankruptcy Code would have a more rational scope than they do under current law.

D. Cross-Product Netting

Financial market participants often have a wide range of transactions outstanding with one another at any given time. Thus, a given party's exposure to the risk of default by another party may be understood only by considering the total value of the payments that party expects to receive and pay under all of the various contracts. The Federal Deposit Insurance Act reflects an understanding of this and permits the netting of obligations stemming from one type of "qualified financial contract" against obligations stemming from another type of "qualified financial contract." This practice, known as "cross-product" netting, permits more rational risk management practices and allows market participants to resolve whatever problems arise from the insolvency of one of their counterparties in a more orderly fashion. Cross-product netting also reduces the likelihood of systemic risk, as it allows the non-bankrupt counterparty to crystallize its exposure and not be treated as a secured creditor with an interest in cash collateral subject to the automatic stay.

Cross-product netting is also permitted under the Bankruptcy Code, but to a lesser degree. Parties can net their obligations under securities contracts, forward contracts and commodity contracts against one another. It is unclear whether cross-product netting is permitted, however, when the contracts involved are swaps and repurchase agreements.

Example 6. Party A, a securities dealer, and Party B, a large corporation, have an outstanding securities contract that upon close-out is profitable for Party A. The parties also have an outstanding forward contract that upon close-out is profitable for Party B. When Party B becomes the subject of a proceeding under the Bankruptcy Code, Party A would be able to close out each of the contracts and offset its obligation to pay Party B under the forward against Party B's obligation to Party A under the securities contract.

Example 7. Party A and Party B have an outstanding swap that upon close-out is profitable for Party A. The parties also have an outstanding repurchase agreement under which Party A holds securities purchased from Party B that upon close-out is profitable to Party B (i.e., the value of the securities exceeds the repurchase price). If Party B becomes the subject of proceedings under the Bankruptcy Code, Party A would not clearly be able to offset the excess repo proceeds against Party B's outstanding obligation under the swap. At worst, Party A would be treated as a secured creditor with a security interest in the repo proceeds. Its rights could, however, be subject to the automatic stay, thereby impairing its liquidity and creating the potential for systemic risk.

There is no plausible rationale for treating cross-product netting between securities, forward and commodity contracts differently from cross-product netting between those contracts, swap agreements and repurchase agreements. These anomalies emerged over time, as various protective provisions were added to the Bankruptcy Code to protect various types of markets. (Because the "qualified financial contract" provisions of the Federal Deposit Insurance Act were enacted at the same time, no such anomalies exist in those provisions.) However, the capital markets have grown and matured to such an extent that various types of market participants now engage in many types of transactions, and it is time for the market safe harbors to be rationalized and made consistent in their application to all financial products for all participants.

Wider and more certain cross-product netting in cases of bankruptcy should allow parties to enter into additional types of transactions with the same counterparty without necessarily increasing, on a net basis, their overall credit exposure or risk to the markets as a whole. Indeed, some cross-product transactions will serve to reduce a counterparty's overall risk, facilitating better risk management and reducing overall risk in the financial markets.

III. Conclusion

The above examples illustrate the need for Congress to enact bankruptcy reform and the financial contract provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2003, which would make important, but highly technical changes to the Bankruptcy Code and the Federal Deposit Insurance Act. These changes are consistent with the existing market safe harbors in the Bankruptcy Code and the Federal Deposit Insurance Act and will encourage broader use of sound risk management techniques and help to minimize overall systemic risk. We urge Congress to act quickly on this important legislation.