What is Netting?
How Does Netting Work?

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Definition of Netting

A method of reducing credit, settlement and other risks of financial contracts by aggregating (combining) two or more obligations to achieve a reduced net obligation.
Benefits of Netting

• Reduction of credit risk
• Reduction of settlement risk
• Reduction of liquidity risk
• Reduction of systemic risk
Types of Netting

• Payment Netting
• Novation Netting
• Close-Out Netting
• Multilateral Netting
Payment Netting

Also called “Settlement Netting”.

On a payment date, each party will aggregate the amounts of a currency to be delivered by it, and only the difference in the aggregate amounts will be delivered by the party with the larger aggregate obligation.
Example: Payment Netting

A owes B GBP 7.0

B pays A GBP 1.0

B owes A GBP 8.0
Types of Payment Netting Agreements

- Master Agreement with a Payment Netting Clause
- Stand-Alone Payment Netting Agreement
- Informal, “ad hoc” agreement
Payment Netting reduces settlement risk, but does not achieve netting for balance sheet or regulatory capital purposes because the transactions remain in gross.

Contrast with Novation Netting, which achieves true netting through the cancellation of offsetting transactions and their replacement with a new, net transaction.
Novation Netting

If the parties enter into a transaction which gives rise to an obligation for the same value date and in the same currency as an existing obligation, then the two obligations are cancelled and simultaneously replaced with a new obligation for the net amount.
Novation Netting

Two Types of Novation Netting:
• Matched Pair Novation Netting
• “Comprehensive” Novation Netting
Matched Pair Novation Netting

Netting only occurs if the two transactions involve the same pair of currencies.
Example: Matched Pair Novation Netting

Deal 1: Buy JPY / Sell USD
Deal 2: Buy USD / Sell EUR
Deal 3: Buy EUR / Sell JPY

No two deals involve the same currency pair, and therefore no netting under matched pair novation netting.
Example: Matched Pair Novation Netting

Deal 1: Sell 145 USD / Buy 100 GBP
Deal 2: Buy 147 USD / Sell 100 GBP

Here there is a matched pair: USD/GBP

After Netting: 2 USD
Example: Comprehensive Novation Netting

<table>
<thead>
<tr>
<th>Deal</th>
<th>USD</th>
<th>EUR</th>
<th>JPY</th>
<th>GBP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10</td>
<td></td>
<td>-1,050</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>-10</td>
<td></td>
<td></td>
<td>7</td>
</tr>
<tr>
<td>3</td>
<td></td>
<td>8</td>
<td></td>
<td>-5</td>
</tr>
<tr>
<td>4</td>
<td>-11</td>
<td></td>
<td>1,050</td>
<td></td>
</tr>
<tr>
<td>Net</td>
<td>-11</td>
<td>8</td>
<td>0</td>
<td>2</td>
</tr>
</tbody>
</table>
Close-Out Netting

Effective upon a default:

• Existing transactions are terminated
• Termination values are calculated
• Termination values are netted to arrive at a single net amount
• Recourse to credit support, if any
Example: Close-Out Netting

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overdue Payment Owed:</td>
<td>50</td>
</tr>
<tr>
<td>Spot Contract:</td>
<td>2</td>
</tr>
<tr>
<td>Forward Contract 1:</td>
<td>10</td>
</tr>
<tr>
<td>Forward Contract 2:</td>
<td>-15</td>
</tr>
<tr>
<td>Option:</td>
<td>-20</td>
</tr>
<tr>
<td>Net Amount Owed</td>
<td>27</td>
</tr>
</tbody>
</table>
Extent of Close-Out Netting

Beyond the Basics:

• Cross-Product Netting
• “Master Master” Netting Agreement
• Cross-Affiliate Netting
Multilateral Netting

Bilateral Netting is between two parties.

Multilateral Netting involves netting among more than two parties, using a clearing-house or central exchange.
Example: Bilateral vs. Multilateral Netting

Bilateral Netting

A
B
C
Example: Bilateral vs. Multilateral Netting

A

B

C

Multilateral Netting
Requirements for
Multilateral Netting Systems

Six Standards of Lamfalussy Report:

• Well founded legal basis under all relevant jurisdictions
• Participants have clear understand of system on each of the risks affected by the netting process
• System should have clearly defined procedures of management of credit and liquidity risks that specify the responsibilities of the system and the participants
Requirements for Multilateral Netting Systems

Six Standards of Lamfalussy Report:

- System capable of timely completing of daily settlements even if the participant with the largest position fails
- System should have objective and disclosed criteria for admission that permit fair and open access
- System must ensure operational reliability of systems and availability of back-up facilities