Available online at www.sciencedirect.com
SCIENCE DIRECT
Journal of Financial Stability 2 (2006) 55–70
Journal of FINANCIAL STABILITY
www.elsevier.com/locate/jfstabil

Derivatives and systemic risk: Netting, collateral, and closeout

Robert R. Bliss[a,b,*], George G. Kaufman[b,c,1]

[a] *Wake Forest University, Calloway School of Business, USA*
[b] *Federal Reserve Bank of Chicago, USA*
[c] *Loyola University Chicago, USA*

Received 1 October 2004; accepted 3 May 2005

Abstract

In the U.S., as in most countries with well-developed securities markets, derivative securities enjoy special protections under insolvency resolution laws. Most creditors are "stayed" from enforcing their rights while a firm is in bankruptcy. However, many derivatives contracts are exempt from these stays. Furthermore, derivatives enjoy netting and closeout, or termination, privileges which are not always available to most other creditors. The primary argument used to motivate passage of legislation granting these extraordinary protections is that derivatives markets are a major source of systemic risk in financial markets and that netting and closeout reduce this risk. To date, these assertions have not been subjected to rigorous economic scrutiny. This paper critically re-examines this hypothesis. These relationships are more complex than often perceived. We conclude that it is not clear whether netting, collateral, and/or closeout lead to reduced systemic risk, once the impact of these protections on the size and structure of the derivatives market has been taken into account.

JEL classification: G18; G28; G33

Keywords: Derivatives; Systemic risk; Netting; Closeout; Bankruptcy

1. Introduction

In recent years, derivatives and some related financial instruments have been accorded different legal treatment in insolvency resolution in many countries from other creditor claims on firms

* Corresponding author. Tel.: +1 336 758 5957.
E-mail addresses: rbliss@gsbalum.uchicago.edu (R.R. Bliss), gkaufma@luc.edu (G.G. Kaufman).
[1] Tel.: +1 312 915 7075.

1572-3089/$ – see front matter © 2006 Elsevier B.V. All rights reserved.
doi:10.1016/j.jfs.2005.05.001

in bankruptcy.[2] The special treatments, which include the ability of these contracts to net or set-off offsetting positions between counterparties, to access collateral promptly, and to closeout or terminate positions quickly without being subject to prolonged legal stays, effectively places these contracts outside the normal bankruptcy process applied to other creditors. These exceptions to the usual resolution process are important because derivative contracts have expanded significantly in recent years to where defaults in these markets are perceived by many to be likely to produce serious systemic damage to financial markets and macroeconomies. This systemic risk argument has been the major rationale used to justify the enactment of legislation and regulations providing these securities with special protections. Indeed, recently enacted bankruptcy reform in the U.S. expanded the special provisions to a broader range of instruments and contracts, and attempts to do the same are ongoing in other countries. Yet, surprisingly, there has been very little rigorous analysis of the economic implications of these provisions for netting, collateral, and closeout. Such an analysis is the primary contribution of this paper. We conclude that it is not clear whether the netting and collateral provisions when combined with closeout, as is typically the case in derivative contracts, decreases the potential for economic damage, as is generally claimed in previous work, or indeed increases the risk.

Both netting (or more generally, set-off) and collateral are legal concepts with long histories in commercial and private property law. Legislative and common-law developments have perfected these activities with respect to derivative markets and payments systems. This process has been international. While cross-jurisdictional disparities remain in the treatment of netting and collateral for most contracts, there is widespread consistency in the treatment of netting and collateral associated with derivative contracts in many jurisdictions. Closeout, which permits the immediate termination of contracts under certain conditions, is a more recent concept. Except for some minor exceptions (e.g., wages, suppliers) to permit the continued operation of the insolvent business, non-bank insolvency resolution procedures are universally based on staying claims while the insolvency is being adjudicated.[3] Closeout of covered derivative contracts is directly antithetical to the spirit of staying claims and is aimed at protecting not the firm in insolvency, but the counterparties to the contracts.

These legal protections, which place covered contracts outside of the normal bankruptcy (or insolvency) resolution process, have been justified by the argument that financial derivatives markets are critical to the efficient functioning of financial markets, and that closeout netting and collateral protection are necessary to prevent the failure of any one or more large firms from being propagated to other firms and markets resulting in a systemic breakdown of those institutions. This argument has been made by regulators and industry groups and has been cited by legislatures when enabling legislation has been discussed. The result has been a regulatory and legislative consensus that strongly supports these existing special protections and attempts to expand them further. Indeed, the adoption of these protections in many industrialized countries is a notable example of successful progress towards international legal harmonization.With rare exceptions, the debate on protecting derivative contracts even at the expense of placing them

[2] These developments have occurred more or less in parallel in the markets for exchange-traded derivatives, (most) OTC derivatives, associated margining and collateral practices, repos, payments systems, and securities settlement systems, to name a few. For reasons of expository convenience, we shall focus on OTC derivatives markets. However, the economic issues involved apply in differing degrees and ways to all of these important markets.

[3] Stays are handled differently in U.S. bank insolvency procedures. For a discussion of stays and other differences between bank and non-bank insolvency regimes, see Bliss and Kaufman (2006).