Practice Questions

Objective 3

XP ACTUARIAL

The xVA Challenge, Gregory, 3rd Edition
Chapter 5: Netting, Close-out, and Related Aspects

1. Define payment netting and explain what risk it can reduce.

2. Describe closeout netting.

3. Briefly describe the need for netting and closeout.

4. List what the ISDA agreement provides for counterparty risk mitigation

5. Describe the impact of netting on the derivatives market

Solutions

Objective 3

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1. Solution

Payment netting is when cash flows between counterparties occurring on the same day are netted.

Payment netting reduces settlement risk (Settlement risk arises at final settlement if there are timing differences between when each party performs on its obligations under the contract)

2. Solution

Netting is the concept of an institution to able to offset what they lose to a defaulted counterparty against what they themselves are owned.

Closeout netting: terminating all contracts with the defaulted counterparty and offsetting transaction values

Closeout netting consists of:
- Closeout – right to terminate transactions and cease payments to the counterparty
- Netting – right to offset amounts due on contracts and determine a net balance owing
- If the institution owes money, then it makes a payment; if it is owed money, it makes a bankruptcy claim

3. Solution

Closeout and netting are needed as some market participants have a large number of positions with a specific counterparty
- Would be ideal to net the payments to the counterparty into a single payment
- Also, if there was a default, would want to be able to quickly terminate the contracts and re-enter contracts with other parties

4. Solution

For mitigating counterparty risk, the ISDA Master agreement provides:
- The terms for posting collateral
- Events of default and termination
- All transactions referenced are combined into a single net obligation
- The mechanics around the close-out process are defined

5. Solution

The impact of netting on the derivatives market is:

- Close-out netting is the single biggest risk mitigants for counterparty risk
- Has allowed the OTC market to grow significantly
- When an offsetting transaction is needed, the desire is to do it with the original counterparty – so both the market risk and the counterparty risk are hedged (due to the netting)