BILATERAL NETTING UNDER THE CAPITAL ADEQUACY FRAMEWORK

The HKMA has revised its capital adequacy framework to bring it in line with the amendment to the Capital Accord made by the Basle Committee in July 1994 that broadens the recognition of bilateral netting for capital adequacy purposes. This article sets out the legal position on netting under Hong Kong law, the conditions under which the HKMA will be prepared to recognise netting arrangements and the method of calculating the credit exposures on bilaterally netted transactions for capital adequacy purposes.

Introduction

In the context of credit risk management, it is sensible that banks should use risk reduction techniques such as netting agreements and collateralisation of transactions, provided that such arrangements are soundly based. The recognition of netting for capital adequacy purposes is one of the features of the Basle Committee's[1] 1988 Capital Accord. Such recognition means that capital requirements apply only to net rather than gross claims arising from off-balance sheet interest rate and exchange rate contracts ("rate contracts") with the same counterparties.

The original Capital Accord only recognised netting by novation[2], a rather limited form of bilateral netting. The Basle Committee reconsidered the treatment of netting following the issue of the BIS Lamfalussy Report on Interbank Netting Schemes in 1990, which concluded that netting arrangements have the potential to improve both the efficiency and the stability of interbank settlements, by reducing not only costs but also credit and liquidity risks. In July 1994, the Capital Accord was amended to recognise, in addition to netting by novation, other forms of bilateral netting arrangements, provided that certain conditions are met.

Wider Recognition of Bilateral Netting

The amendment provides that, in addition to netting by novation, banks may net transactions subject to "any legally valid form of bilateral netting". In both cases, the primary burden rests on banks to demonstrate to their supervisors the legal enforceability of their netting arrangements in all relevant jurisdictions.

Specifically, a bank needs to satisfy its national supervisor that:

(a) in the event of a counterparty's failure to perform due to default, bankruptcy, liquidation or similar circumstances, the bank's claim (or obligation) under the netting agreement would be to receive (or pay) only the net sum of the mark-to-market values of included transactions;

(b) it has obtained written and reasoned legal opinions stating that in the event of legal challenge, the netting agreement would be upheld in all relevant jurisdictions; and

(c) it has procedures in place to ensure that the netting arrangements are kept under review in light of possible changes in relevant law.

Each supervisor's satisfaction as to the legal enforceability of a particular netting agreement is therefore a key criterion for recognition of these agreements for capital adequacy purposes. Apart from the specific terms of individual agreements, it is fundamental that the law in the relevant jurisdiction should be sympathetic to the concept of netting. In respect of the legal position under Hong Kong law, the Company and Financial Law Committee of the Law Society of Hong Kong (CFLC) has issued a Statement of Law (Hong

1 The Basle Committee on Banking Regulations and Supervisory Practices comprises representatives of the central banks and supervisory authorities of the Group of Ten countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, United States) and Luxembourg. The Committee meets at the Bank for International Settlements, Basle, Switzerland.

2 Netting by novation refers to an arrangement under which any obligation between a bank and its counterparty to deliver a given currency on a given value date is automatically amalgamated with all other obligations for the same currency and value date, legally substituting one single amount for the previous gross obligations.

Kong) and a Guidance Notice on the Netting of Counterparty Exposure. The Statement of Law (Hong Kong), which records a consensus of the views of leading practitioners in the fields of insolvency and banking law in Hong Kong, confirms that bilateral netting in principle works under Hong Kong law for off-balance sheet instruments such as swaps and options.

The HKMA has taken the view that the CFLC's Statement provides a basis to implement the wider recognition of bilateral netting in the capital adequacy framework in Hong Kong.

HKMA's Policy

The HKMA issued in February 1995 a policy paper setting out the conditions under which it will be prepared to recognise bilateral netting agreements for capital adequacy purposes. Under these, an authorised institution may net rate contracts subject to a bilateral netting agreement, provided that:

(a) the bilateral netting agreement is in writing;

(b) the bilateral netting agreement creates a single legal obligation for all individual rate contracts covered by the bilateral netting agreement, and provides, in effect, that the authorised institution would have a single claim or obligation either to receive or pay only the net amount of the sum of the positive and negative mark-to-market values of the individual rate contracts covered by the bilateral netting agreement in the event that a counterparty, or a counterparty to whom the bilateral netting agreement has been validly assigned, fails to perform due to any of the following events: default, insolvency, bankruptcy, or other similar circumstances;

(c) the authorised institution obtains a written and reasoned legal opinion(s) that represents that in the event of a legal challenge, including one resulting from default, insolvency, bankruptcy, or similar circumstances, the relevant court and administrative authorities would find the authorised institution's exposure to be the net amount under:

(i) the law of the jurisdiction in which the counterparty is chartered or

Statement of Law (Hong Kong)

Where a company goes into insolvent liquidation in Hong Kong and there have been mutual credits, mutual debts or other mutual dealings between the company and another party prior to liquidation, set off applies. An account must be taken of the mutual dealings and the ultimate net balance only is required to be paid to the liquidator or proved for in the liquidation.

This rule of Hong Kong law is contained in Section 35 of the Bankruptcy Ordinance (Cap.6) (applicable by virtue of Section 264 of the Companies Ordinance). The object of the rule is to achieve substantial justice between the parties having regard to the whole of their mutual dealings. The rule achieves this result by imposing a requirement for a complete set off in respect of all the mutual dealings between the parties.

All obligations in respect of the mutual dealings are required to be brought into account.

The set off applies whether or not there is any contractual entitlement to the same. The requirement for set off in respect of all mutual dealings is mandatory and cannot be excluded by agreement between the parties.

Where a bank and its corporate customer enter into various transactions with each other prior to the customer's insolvent liquidation and the customer goes into liquidation before the transactions are closed mandatory set off applies. The bank will have a claim (or obligation) on a net basis only to receive from (or pay to) the liquidator the net amount in respect of the transactions taken as a whole.

Method of calculating credit exposure

The Capital Accord provides for two methods of calculating the credit exposure on rate contracts: the current exposure method and the original exposure method. The two methods are recognised in Table B of the Third Schedule to the Banking Ordinance.

Under the 1994 amendments to the Capital Accord, for authorised institutions using the *current exposure* method, the credit exposure on bilaterally netted transactions will be calculated as the sum of:

(a) the net amount of the sum of the positive and negative mark-to-market replacement values of the individual off-balance sheet rate contracts included in the bilateral netting agreement, if positive; and

(b) an "add-on" for potential future exposure derived by multiplying the notional underlying principal of all the individual contracts by the relevant credit conversion factor.

Pending further Basle proposals to recognise netting effects in the calculation of add-ons, the conversion factors will, for the time being, remain the same as those for non-netted transactions:

Residual maturity	Interest rate contracts	Exchange rate contracts
Less than one year	Nil	1.0%
One year and over	0.5%	5.0%

For authorised institutions using the *original exposure* method, the conversion factors to be used when calculating the credit exposure of bilaterally netted transactions will be as follows:

Original maturity	Interest rate contracts	Exchange rate contracts
Less than one year	0.35%	1.5%
One year and less than two years	0.75%	3.75% (i.e. 1.5% + 2.25%)
For each additional year	0.75%	2.25%

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Residual maturity	Interest rate contracts	Exchange rate contracts
Less than one year	Nil	1.0%
One year and over	0.5%	5.0%

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Original maturity	Interest rate contracts	Exchange rate contracts
Less than one year	0.35%	1.5%
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For each additional year	0.75%	2.25%