

# Banking Newsletter

Number 3 Year 1997



Financial Services  
Commission

## On-Balance Sheet Netting And Cash Collateral

- 1 This newsletter supplements the Commissioner of Banking's Administrative Notice number 1 ("Implementation in Gibraltar of the Solvency Ratio Directive") dated 25th September 1992 and amended on 1st August 1996. It sets out the conditions under which the Commissioner of Banking will be prepared to view on-balance sheet transactions as either net or cash-collateralised for capital adequacy purposes. This newsletter, which takes immediate effect, applies to all licensees under the Banking Ordinance 1992 which are incorporated in Gibraltar<sup>1</sup>.
- 2 Licensees are reminded that in reporting on a net basis for capital adequacy purposes they must not only observe the criteria outlined below but must also have regard to accounting guidelines where relevant.

## On-Balance Sheet Netting

- 3 Debit balances on accounts with the licensee may be offset against credit balances on other accounts with that licensee only where all the following criteria have been met:
  - (a) a legal right of set-off exists, and the licensee has obtained an opinion from its legal advisers to the effect that its right to apply set-off is legally well-founded in all relevant jurisdictions and would be enforceable in the default, liquidation or bankruptcy of the customer(s) or in the liquidation or bankruptcy of the licensee itself;
  - (b) the debit and credit balances relate to the same customer, or to customers in the same company group, e.g. a parent company and its subsidiary. For all customers, the netted accounts should be managed and controlled on a net basis, and in the case of a group facility, the facility should be advised in the form of a net amount.

The licensee's application of these principles must remain consistent.

- 4 Where a legal opinion is required, the Banking Supervisor expects such opinions to be provided by an independent, external source of advice of appropriate professional standing. In seeking these opinions, the licensee will need to bear in mind that in certain jurisdictions assets may be seized to satisfy local creditors. In those cases involving cross-jurisdictional transactions, the Banking Supervisor will require a side-letter from the licensee's advisers confirming that the set-off arrangements have a well-founded legal basis in all relevant jurisdictions. In certain cases the Banking Supervisor may wish to be provided with a copy of the legal opinion.
- 5 Credit balances which cannot be off-set against debit balances may be eligible for inclusion as cash collateral.

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<sup>1</sup> The institutions covered by this newsletter will be referred to as "licensees" without further qualification for the purposes of this newsletter.



## Cross-guarantee arrangements

- 6 Group facilities which are reported on a net basis should preferably be supported by a full cross-guarantee structure. It is not the Banking Supervisor's intention to require that each member of the group makes itself responsible for all of the debts of the other members, so it would be acceptable for the cross-guarantee to be restricted to the amount of any credit balances held.
- 7 The cross-guarantee requirement is intended to create mutuality of debts. In the case of accounts which are the joint and several liabilities of all group members, it is not necessary to create a mutuality so cross-guarantees are not required.

## Accounts to be managed on a net basis

- 8 The Banking Supervisor believes that licensees' reporting should not only reflect the legal position, but also the economic substance of the relationship. It is therefore not sufficient that the licensee has the legal right to set-off credit balances against debit balances; it must also manage the relevant accounts on a net basis. This is also important from a prudential point of view, in that the licensee should be in a position to control its true (i.e. net) exposure. Thus for a group of customers facilities should be advised and controlled on a net basis. For single customer balances also the licensee should have regard to the overall position of the customer's accounts. This can be demonstrated in a number of ways, but the existence of a formal agreement allowing the licensee to net credit balances against debit balances would provide a strong indication that the accounts were being managed in this way. The Banking Supervisor may ask the licensee's auditors to verify the licensee's application of this principle.

## Denomination

- 9 A debit balance in one currency may be offset against a credit balance in another.

## Cash Collateral

- 10 Where exposures which do not meet the rules for set-off are collateralised by cash, i.e. balances held with the licensee denominated in sterling, foreign currency or gold, or Certificates of Deposit issued by the licensee and lodged with it, such exposures should be reported under the relevant item in the 0% band. For these purposes an exposure is collateralised by cash only if the cash is held by the licensee for the account of the depositor/customer on express terms such that:
  - (i) the cash may not be withdrawn for the duration of the exposure; and
  - (ii) the licensee may apply the cash to discharge the exposure if and to the extent that it is not discharged by the borrower/customer in accordance with the terms of the loan etc. agreement with the borrower/customer.

In the case of an exposure partially collateralised by cash only that part of the exposure which is fully collateralised should be reported in the 0% weight band.

To qualify as cash collateral:

- (i) The licensee must obtain an opinion from its legal advisers to the effect that the set-off arrangements, charges, or other equivalent security interests referred to below are legally well founded in all



relevant jurisdictions, and would be enforceable in the default, liquidation or bankruptcy of the licensee itself.

- (ii) In the case of the licensee's unconsolidated return, the cash must be held with the licensee. In the case of a licensee's consolidated return, the cash must be held with the company which has the exposure.
- (iii) Where the cash is held at a Gibraltar office of a Gibraltar incorporated lending institution, the licensee should have a legally enforceable right of set-off over the cash. Where the cash is held at an overseas branch of the licensee it should have a first charge over cash held with itself where this is enforceable in the local legal jurisdiction or other equivalent security interest or a legally enforceable right of set-off over the cash.
- (iv) Where the Banking Supervisor has agreed, cash may be held with another bank which is consolidated with the licensee for the purpose of calculating the licensee's consolidated capital ratio. In this case the licensee should have a first charge over the cash held with the other bank or other equivalent security interest. Where an exposure is reported by the licensee as collateralised by cash under this provision, the cash is not available to the other bank as collateral for reporting purposes, and should not be subject to set-off in the other bank's books.

Where the licensee is a member of a syndicate and cash has been deposited with, and is held by, the agent itself for the benefit of the syndicate, the claims (or portion of the claims) of members of the syndicate which are cash collateralised may attract the weight appropriate for claims on the agent. If the agent is a bank its own claims which are cash collateralised may be eligible for a 0% weight.

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Financial Services Commission,  
Suite 943, Europort,  
PO Box 940,  
Gibraltar.

Email : [info@fsc.gi](mailto:info@fsc.gi)  
<http://www.fsc.gi>

Tel (+350) 40283  
Fax (+350) 40282

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