



**Financial Services  
Commission**

# **Administrative Notice No. 6**

## **Implementation In Gibraltar Of The Netting Directive**

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## Netting Of Counterparty Credit Risk Associated With Sale And Repurchase Agreements And OTC Derivatives

- 1 This notice supplements the Commissioner of Banking's Administrative Notice Number 1 ("Implementation in Gibraltar of the Solvency Ratio Directive") dated 25th September 1992 as amended on the 1st August 1996. It sets out the conditions under which the Commissioner of Banking will be prepared to treat sale and repurchase transactions on a net basis for capital adequacy and large exposures purposes from 1st July 1996. It also sets out the conditions under which the Commissioner of Banking will be prepared to treat the counterparty risk arising from OTC derivatives transactions on a net basis for capital adequacy and large exposures purposes from 1st July 1996. The notice permits the netting of current exposures (replacement costs) only; add-ons where applicable should continue to be calculated on a gross basis. Because Gibraltar branches of non-Gibraltar incorporated banks are not required by the Commissioner of Banking to maintain capital in Gibraltar, this Notice applies only to Gibraltar-incorporated institutions licensed under the Banking Ordinance.
- 2 To report transactions covered by the scope of this notice net, licensed banks must (except where the netting is as described in paragraph 19 below) first inform the Banking Supervisor of the scope of netting they plan to undertake, in particular (but without limitation) the nature of the netting agreement involved and the jurisdictions, counterparties and different types of transactions and products covered. Bilateral netting of transactions covered by the scope of this notice will be permitted where the licensed bank has informed the Banking Supervisor that it is satisfied that the legal requirements for netting and the system requirements for management of counterparty exposures on a net basis set out below are met.
- 3 In general, only agreements for the netting of counterparty exposures on OTC derivatives and sale and repurchase agreements (and related transactions) fall within the scope of this notice. Where such agreements contain provisions for the exchange of collateral as well as for the netting of exposures, the licensed bank must ensure that the collateral arrangements comply with the Banking Supervisor's requirements on collateral.
- 4 Transactions not referred to in paragraph 3 do not fall within the terms of this notice. Other arrangements for netting, under a single agreement, on- and off- balance sheet claims and obligations will be considered on a case by case basis. Arrangements in which cash or OECD government securities are held as collateral against a licensed bank's contingent liabilities must meet the Banking Supervisor's requirements on collateral.

### Legal Requirements

- 5 Licensed banks may net transactions with a counterparty subject to a netting agreement. Such an agreement must create a single legal obligation, covering all included transactions, such that the licensed bank would have either a claim to receive or an obligation to pay only the net sum of the positive and negative mark-to-market values of the included individual transactions in the event:
  - (a) that a counterparty fails to perform due to the default, liquidation or bankruptcy (or other similar circumstances) of the counterparty; and/or
  - (b) of the liquidation or bankruptcy of the licensed bank or (as the case may be) the member of the licensed bank's group which is a party to that agreement.



- 6 The licensed bank must be in possession of written and reasoned independent legal opinions to the effect that in the event of termination of the netting agreement due to the default, liquidation or bankruptcy (or other similar circumstances) of the counterparty or the liquidation or bankruptcy of the licensed bank or (as the case may be) the member of the licensed bank's group which is a party to that agreement, the relevant courts would find the licensed bank's exposure to be the single net amount determined by the netting agreement to be payable or receivable by such licensed bank in the event of such a termination under:
- the law of the jurisdiction in which the counterparty is incorporated and, if the foreign branch of a counterparty is involved, then also under the law of the jurisdiction in which the branch is located;
  - the law that governs the individual transactions; and
  - the law that governs any agreement necessary to effect the netting.
- 7 Where one or both parties have entered into transactions subject to a netting agreement with each other through one or more of its (or certain designated) branches, then all such branches included in the agreement will be considered to be located in relevant jurisdictions for the purpose of this notice. Transactions through a branch located in a jurisdiction where a satisfactory legal opinion cannot be obtained may be included in such agreements provided that a legal opinion has been obtained confirming that the netting agreement will not become void or voidable because the legal validity of netting is not recognised in relation to transactions connected with that branch. In addition to this, legal opinions must be obtained from all remaining jurisdictions as referred to in paragraph 8.
- 8 Where the laws of more than one jurisdiction are relevant, the licensed bank must have, as a minimum, a legal opinion for each jurisdiction which covers the issues set out in the Annex to this notice and which provides assurance that the netting provisions in the agreement are enforceable in that jurisdiction notwithstanding actions that may be taken by insolvency officials in other jurisdictions. An additional opinion to address the interrelationship of the different jurisdictions and to assess the potential for conflicts of law will not generally be required. However, licensed banks will be required to evaluate the opinions they receive to satisfy themselves that there are no potential conflicts of law.
- 9 In circumstances where the licensed bank is aware that the supervisor of the counterparty has given notice, directly or through the Banking Supervisor, that it is not satisfied that the netting agreement is enforceable under its laws, the netting agreement cannot be recognised regardless of the opinions obtained by the licensed bank.
- 10 Netting agreements containing walkaway clauses will not be eligible for recognition. A walkaway clause is a provision which permits a non-defaulting counterparty to make only limited payments, or no payment at all, to the estate of a defaulting party, even if the defaulting party is a net creditor.
- 11 Legal opinions should be provided by an external source of advice of appropriate professional standing. Such opinions may be in the form of memoranda of law and addressed direct to the licensed bank or to the sponsors of a particular netting agreement or may be the product of a number of licensed banks pooling together to seek a collective opinion on a particular netting agreement.



- 12 In each case, the licensed bank must first satisfy itself that the netting agreement and supporting opinions that it proposes to use and rely upon are applicable to the counterparty, transaction type, product and jurisdictions involved. Where an agreement seeks to include transactions or products of a type not covered by the opinion or is entered into with a counterparty outside the categories covered, or materially alters any of the terms in the agreement relevant to netting, additional legal opinions governing such matters should be obtained.
- 13 Certain issues that the Banking Supervisor would expect to be addressed in the legal opinions are listed in the Annex. To the extent that any items in the Annex are not explicitly referred to in each legal opinion obtained by a licensed bank, such licensed bank must assess if, as a result, there is material doubt as to the enforceability of the agreement. If the licensed bank determines that there is such doubt as to enforceability, it should assume that the requirements of this notice are not met.
- 14 It is recognised that, with certain aspects of the agreement, it may not be possible to offer a definite opinion or that a positive opinion regarding enforceability of the netting agreement can only be offered subject to certain assumptions and/or qualifications.
- 15 Where qualifications are made, they should be specific and their effect adequately explained. In the same way, assumptions made by the legal advisers in providing the opinion should not be unduly restrictive. Assumptions underlying the opinion should be specific and of a factual nature (except in relation to matters subject to the law of a jurisdiction other than that covered by the opinion) and should be adequately explained in the opinion.
- 16 The licensed bank is required to examine and assess all qualifications, assumptions and omissions from the Annex. If, as a result, there is material doubt as to the enforceability of the agreement the licensed bank should assume that the requirements of this notice are not met.

## Compliance With Legal Requirements

- 17 It is the responsibility of the licensed bank to ensure that the legal requirements set out above are met. Compliance with these requirements will be monitored in two ways:
  - (a) licensed banks that wish to report on a net basis should apply to the Banking Supervisor. With this application, the institution should specify:
    - the netting agreement, counterparties, jurisdictions and different types of transaction and products involved;
    - the source of each legal opinion (whether addressed to the licensed bank or obtained collectively);
    - the date of each legal opinion; where the opinion has been obtained more than twelve months before application for recognition, the licensed bank should obtain a letter from its external legal advisers confirming that there have not been any changes in law or regulation or other legal developments, including (without limitation) court decisions, which would have an adverse effect on the conclusions reached in the opinion; and
    - that the requirements of the notice are met in relation to the transactions to be reported on a net basis.



Where the agreement involves relevant overseas jurisdictions (referred to in paragraphs 6 and 7 above), the licensed bank should provide the Banking Supervisor with a side letter from its legal advisers (internal or external) to the effect that the licensed bank has a legal opinion in respect of each jurisdiction listed in that side letter and that, subject to the assumptions and qualifications stated in the legal opinion(s), each such legal opinion meets the requirements of this notice so far as the relevant jurisdiction is concerned. The legal advisers providing the side letter will not be responsible for legal opinions of other legal advisers.

Provided with the aforementioned information the Banking Supervisor reserves the right to ask for copies of the netting agreement and the legal opinions to be supplied before agreement to reporting transactions on a net basis is conferred. The Banking Supervisor may also ask licensed banks what steps they have taken to satisfy themselves that there are no potential conflicts of law.

- (b) the licensed bank should maintain records showing that in relation to the legal requirements the following considerations have been addressed:
- the applicability of the netting agreement to the counterparties, jurisdictions, transactions and products involved;
  - the applicability of the opinions to the counterparties, jurisdictions, transactions and products involved;
  - where more than one jurisdiction is involved, that the combined effect of the opinions it has received is to confirm that the requirements of this notice are met in a way which would satisfy the conditions under which netting is to be allowed;
  - all documentation is complete; that the parties involved have capacity, power and authority in relation to the agreement; and that the agreement has been properly executed;
  - the nature and effect of any assumptions, qualifications and omissions from the Annex in the legal opinions, and an assessment that these do not appear to impair the enforceability of the netting provisions of the agreement.

From the date of recognition the licensed bank should annually review the validity of its opinion(s) and confirm the result to the Banking Supervisor. If branches are added to a multibranch netting agreement, which has been previously recognised by the Banking Supervisor, the licensed bank should update its opinion(s) to reflect this and notify the Banking Supervisor accordingly.

- 18 Compliance with these requirements will be checked from time to time by the Banking Supervisor.
- 19 Where netting is performed by the novation of contracts, licensed banks are not required to inform their line supervisors in advance of their intention to report on a net basis. They must obtain satisfactory legal opinions as to the enforceability of the novation and maintain records to evidence that the legal requirements have been addressed and met. These records should be available to the Banking Supervisor or the Banking Supervisor for inspection on demand.



## Systems Requirements

20 To report transactions covered by the scope of this notice on a net basis, a licensed bank must demonstrate that it manages its position to the counterparty on the basis of the net exposures. In its application to the Banking Supervisor, along with providing assurances concerning compliance with the legal requirements, the institution should confirm:

- that exposures on transactions falling under the netting agreement are calculated using current exposure (replacement cost) methodology;
- that exposures on the transactions subject to the netting agreement which are reported on a net basis are calculated on a net mark to market basis;
- that limits to the counterparty are monitored in terms of such net exposures.

These requirements do not preclude the maintenance of systems to monitor exposures on a gross basis (indeed gross monitoring may be seen as a necessary complement to net monitoring).

21 In addition, the licensed bank should be able to demonstrate that it has systems to monitor roll-off exposures (ie the potential for sudden increases in exposure when short-dated obligations are netted against longer-dated claims). Such exposures can arise under on- or off- balance sheet netting arrangements. Both should be monitored.

22 Where the legal requirements are met, cross-product netting is permitted. However, the licensed bank must have the systems to monitor the exposures arising under the different products on a net basis. If systems do not allow for exposure arising from certain transactions or products under a netting agreement to be monitored net, then such exposure should continue to be reported gross.



## Annex: Legal Opinions For Sale And Repurchase And OTC Derivative Netting Agreements

A list of issues that should be addressed in legal opinions on netting agreements is set out below. The list is not intended to be exhaustive. Although the Banking Supervisor will not insist that every opinion address each of these points explicitly he believes that in general the legal opinions should make clear:

- (a) which are the central clauses in the documentation which provide for the netting of transactions;
- (b) that the unenforceability or illegality of any other clause in the documentation would be unlikely to undermine these central netting clauses;
- (c) what are the factual circumstances in which the documentation may validly be used, including the type of counterparty. Institutions should take particular care in obtaining opinions regarding counterparties governed by special rules relating to insolvency (eg local government institutions, insurance companies etc);
- (d) whether the netting and other default provisions would be enforceable in non-liquidation insolvency events (including administration, receivership, voluntary arrangements or schemes of arrangement);
- (e) to what extent, if at all, the netting needs to be reflected in the records of the counterparties in order for it to be effective;
- (f) whether a court or other relevant administrative authority in the jurisdiction covered by each legal opinion would uphold the rate chosen for conversion of foreign currency obligations for the purpose of calculating the close-out amount; if statutory or any other applicable rules were applied by a court would this detract from the enforceability of the agreement;
- (g) if there is anything in the detail of the close-out methodology which might be held inconsistent with the view of the transactions as part of a single agreement insofar as the relevant law requires the same, and if so the effect of this on the enforceability of the netting (if a single agreement provision is not vital to the enforceability of netting in any jurisdiction the opinion should confirm this);
- (h) whether the use of the documentation with branches in a number of different jurisdictions, including some where the legal basis for netting is not clear, would jeopardise the validity of netting in more favourable jurisdictions and whether the netting agreement precludes or permits severability of individual transactions and the consequences thereof;
- (i) though it might be difficult to state absolutely that enforceability would not be affected by the law of another jurisdiction, whether there is any reason to believe that the agreement would be unenforceable because of the law of another jurisdiction;
- (j) whether there is a legal preference for automatic rather than optional close-out; and
- (k) if there would be any legal problem in exercising discretion or flexibility to the extent allowed under the netting agreement.