

Conference on Netting of OTC
Financial Contracts in Latin
America and the Caribbean

Netting for Capital Purposes: The Need for Netting Opinions

Marjorie E. Gross
Senior Vice President &
Associate General Counsel
The Chase Manhattan Bank

Netting Opinion Coverage

- Principally FX and Derivatives
- Market participants also interested in netting of exposures under repurchase agreements
- Some European banks interested in deposit netting



Legal Opinion Requirements

- Must be written and reasoned
 - May be opinion or memorandum of law
- May be given by outside law firm or in-house counsel
- Must reach conclusion with high degree of certainty
 - Opinion may conclude that a court “should” reach this conclusion, instead of that court “would” reach it
 - Does not require legislation or prior court opinions on the subject
 - Does not require absolute certainty

Legal Opinion Requirements

- Must conclude that the netting contract is enforceable in all relevant jurisdictions
 - jurisdiction where counterparty is chartered
 - if branch is involved, law of jurisdiction where branch is located
 - law that governs master agreement (or each individual contract if different from master)
- In practice, banks do not obtain a single opinion covering all relevant jurisdictions, but separate opinions in each relevant jurisdiction

Legal Opinion Requirements

- Opinions may be general, standardized opinions on a form of master agreement
 - e.g. an opinion obtained by a trade association such as ISDA
 - Do not need opinion on a specific agreement between two counterparties
- But banking organization must review its contracts to make sure the provisions do not contain variations from the master

Scope of Legal Opinion

Opinion must conclude that:

- entire netting contract is a legal, valid and binding contract, enforceable in accordance with its terms (ENFORCEABILITY OPINION)
- netting provisions are enforceable even if counterparty is subject of bankruptcy or reorganization proceeding (BANKRUPTCY OPINION), i.e.
 - In the event of a legal challenge,
 - the banking organization's claim against a bankrupt counterparty
 - would be determined by the relevant court
 - to be the net sum of the positive and negative marks to market
 - of all individual transactions under the Master Agreement

Special Federal Reserve Requirement

Netting provisions do not violate public policy or law in applicable jurisdiction

Updating Requirements

- Opinions must be updated regularly
 - Major trade associations obtain yearly updates
- Financial institution must review its contracts to make sure changes in law do not adversely affect existing contracts

The Problem of “Bad Branches”

- What happens if Counterparty deals through branches in 10 countries and netting is not enforceable in one of the ten?
- Two possible approaches
 - Good branch/bad branch master agreements
 - Single master agreement with opinions in the 9 “good” jurisdictions that absence of netting in jurisdiction 10 does not undermine netting in 9 other jurisdictions

The Problem of “Bad Branches”

- Rules allow banks to use master agreement covering all branches
- Bank calculates net current exposure for jurisdictions where netting clearly is enforceable
- Remaining contracts are “severed”
 - treated as if they were not subject to the master agreement
- Opinion must state that severing “bad branches” does not undermine netting in other branches

Severing “Bad Branches”

- May be problem in countries that follow “single agreement” theory
- Fed notes that its requirement that contracts net to a single amount applies only to contracts that are included under the netting contract for capital purposes
- US capital rules do not require short-term contracts to be included in netting, e.g. exchange rate contracts with original maturity of 14 days or less

Collateral Opinions

- Capital Rule permits institutions to take qualifying collateral into account
 - When assigning “credit equivalent amount” under contract to appropriate risk weight category
- Collateral must be legally available to cover the credit exposure of the netting contract if default occurs
 - Collateral pledged against only one contract under a master agreement would not be generally available to cover other exposures under the master agreement

Problems in giving Netting Opinions that can be alleviated by legislation

- Types of counterparties covered
 - financial institutions
 - corporations
 - mutual funds, pension funds
 - insurance companies
 - supranational agencies
 - governmental agencies
- Types of products covered
 - Interest rate and currency swaps
 - credit derivatives
 - commodity swaps (including physically settled)
 - equity derivatives

Problems in giving Netting Opinions that can be alleviated by legislation

- Effect of attachments by third-party creditors
 - Can third party creditor interfere with netting, or does third party attacher take subject to the right of set-off in existence at time creditor received notice of attachment?
- Effect of “ipso facto” clauses, i.e. laws that prohibit a credit from accelerating a debt merely by virtue of a bankruptcy filing