Netting for Capital Purposes:
The Need for Netting Opinions

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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