2004-05-27

TO ALL BANKS, BRANCHES OF FOREIGN BANKS AND MUTUAL BANKS

BANKS ACT CIRCULAR 9/2004

SET-OFF AND NETTING UNDER REGULATION 12 AND 23 OF THE REGULATIONS RELATING TO BANKS

1. INTRODUCTION

Banks often make use of risk-mitigation techniques, such as netting agreements, in order to:

- reduce a bank's prudential requirements; or
- be exempted from prudential requirements; or
- manage a bank's risk exposures in general, including credit risk and liquidity risk.

The concern of regulators is that if a liquidator of a failed counterparty has, or may have, the right to unbundle netted contracts, demanding performance on those contracts favourable to the failed counterparty and defaulting on unfavourable contracts, there will not be any reduction in risk. If a bank that is a counterparty to such an unbundled transaction has relied on the netting agreement, reported net amounts and failed to maintain prudential requirements against the underlying positions, losses for which provision has not been made will be suffered, potentially resulting in systemic risk.

Therefore, it has been agreed internationally that, for capital-adequacy purposes, banks may net transactions subject to novation. Accordingly, 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, thereby legally substituting one single amount for the previous gross obligations.

2. CURRENT TREATMENT

It is precisely because regulators are concerned about the legal position and the enforceability of the legal position in all relevant jurisdictions that regulators prescribe minimum requirements to ensure that the calculated net position will be enforceable in all relevant cases. Netting contracts developed by market participants and used by banks may or may not meet the minimum requirements specified in law. Therefore, it is the duty of each bank, instead of the regulator or standard-setting authority, to ensure that any agreement, regardless of the form used, meets the specified legal requirements. For the aforementioned reason, this Office has indicated in the past that the 1988 Capital Accord, for example, does not allow ISDA or ISMA agreements *per se*, since ISDA and ISMA agreements may or may not be recognised and/or enforceable, from time to time, in terms of the laws and regulations in force in different countries.

Furthermore, the requirements of regulation 23 of the Regulations relating to Banks ("the Regulations") do not in any way conflict with the 1988 Capital Accord. The Regulations are consistent with the minimum requirements to which the Basel Committee on Banking Supervision agreed and which were subsequently incorporated into the 1988 Capital Accord. In line with the 1988 Capital Accord, regulation 23 of the Regulations prescribes minimum requirements that have to be met at all times, instead of allowing or disallowing certain types of netting agreements developed by market participants. Each bank that wishes to apply netting has to determine whether a particular type of netting agreement meets the said requirements.

The objectives of regulations 12 and 23 of the Regulations are largely consistent, in the sense that both regulations are aimed at ensuring that a bank has a well-founded legal right to apply set-off or netting and would either have a claim to receive, or an obligation to pay, only the net sum of the individual transactions covered by the set-off or netting agreement. The abovementioned regulations, however, often apply to different situations. Regulation 12 deals with situations in which a client maintains both debit and credit balances with a bank and when such balances are denominated in the same currency and are due and payable on the same date and the client and the bank have entered into an agreement in terms of which a legal right to apply set-off in respect of such balances exists at all times. When a right to set-off exists, the amount payable by one person to another may be reduced by the size of the other's debt, leaving a net amount, or no amount, payable. Regulation 23, however, deals with situations in which gross claims between a bank and its counterparty in respect of unsettled transactions exist and the said bank and its counterparty enter into a netting agreement. Whether the netting agreement will be legally enforceable is a legal question. In this regard, it should be noted that:

- If a bank and its counterparty are situated in different jurisdictions, the situation is more complex than when both parties are situated in the same jurisdiction.

- If a netting agreement provides for netting by novation, obligations between a bank and its counterparty to deliver a given amount on a given date are automatically amalgamated with all other obligations to deliver on the same value date. This type of agreement is very similar to the situations regulated by regulation 12 and provides more legal certainty than most other forms of netting.

- If a netting agreement provides for close-out netting, all outstanding transactions between the counterparties that are subject to the netting agreement are combined and reduced to a single payable sum. Normally, the process has three stages, namely, termination, close-out and netting. Termination is typically caused by the occurrence of an event such as liquidation or bankruptcy. The loss or cost to each party is calculated and often relates to the cost of replacing the transaction in the market at the prevailing time. The sums due are converted into a single currency and netted to one single payment. In the last mentioned case, the following play a critically important role.

    - The legislation of the jurisdiction(s) in which the counterparties are chartered.

    - The legislation governing the individual transactions.

- The legislation governing any contract or agreement necessary to effect netting.

In many cases, there is uncertainty whether all transactions and types of contract that may be included in an ISDA master netting agreement, for example, will be recognised and be enforceable in terms of the provisions of section 35B of the Insolvency Act, 1936. Furthermore, different positions that may arise from different types of contract, but which are included in the same ISDA agreement, have not been tested for enforceability under section 35B of the abovementioned Act in a court of law. Therefore, this Office is not in a position to state that all positions covered by ISDA and ISMA agreements will definitely comply with the requirements of regulation 23 of the Regulations, or that positions covered by the netting agreement may be netted in all cases.

It is, therefore, the responsibility of the banks board of directors to ensure that the bank has satisfied itself that the bank is netting in terms of regulation 12 and 23 of the Regulations. Furthermore, this Office confirms that the requirements of regulations 12 and 23 of the Regulations are in line with international practice and that all banks should adhere thereto at all times.

3. ACKNOWLEDGEMENT OF RECEIPT

Two additional copies of this circular are enclosed for the use of your institution's independent auditors. The attached acknowledgement of receipt, duly completed and signed by both the chief executive officer of the institution and the said auditors, should be returned to this Office at the earliest convenience of the aforementioned signatories.

E M Kruger
Registrar of Banks

The previous circular issued was Banks Act Circular 8/2004 dated 25 May 2004.