

GUIDANCE NOTICE**Netting of Counterparty Exposure**

Commercial and investment banks, financial institutions and securities houses (referred to collectively as "banks") constantly monitor their exposure to individual counterparties. This is necessary for prudent credit assessment, and for the calculation of the appropriate capitalisation of the business activities concerned.

The primary calculation of exposure to a counterparty takes the "at worst" case. It assumes that the organisation concerned goes into liquidation, and that the liquidation yields no dividend for unsecured creditors. The basic exposure of the bank is the maximum amount which might be due in this situation to the bank, which will not be paid.

Crucial to this consideration is whether the bank must examine each transaction with the counterparty in isolation, and take its exposure to be the sum of the figures so shown as owing to it. The alternative is that the bank nets the results of the individual transactions, setting off obligations which it would have to the counterparty against sums due to the bank (and which would otherwise not be paid out of the insolvent liquidation of the counterparty).

It is prudent for banks to calculate exposures on the net basis if, but only if, the relevant legal rules will, on the liquidation of the counterparty, lead to the result assumed by the method of calculation.

With the growth in complexity of routine financial transactions, and the increase in the gross amount of obligations involved, banks have felt the need for a restatement of the principles of English law on this subject. The purpose of this Guidance Notice is to provide a clear statement of what is widely agreed by lawyers to be the basic rule of English law.

The Statement of Law

The Statement of Law set out in schedule 1 records a consensus of the views of leading practitioners in the fields of insolvency and banking law. The results of consultation and consideration by the Panel Secretariat were presented to counsel, Michael Crystal QC, who wrote the text of the Statement of Law. That text was then presented to the subscriber firms listed in schedule 2, who confirmed their agreement with its terms, as set out below.

No general explanation of law, in any jurisdiction, can provide a complete and inevitable prediction of the legal effect of all transactions or circumstances which might thereafter fall within its ambit. Such a general statement, therefore, cannot be taken as anything other than a template, against which future factual situations can be evaluated. It cannot be assumed that the facts of every transaction will necessarily fit exactly within the terms of the Statement of Law.

This Guidance Notice does not relieve banks from the need to form a view of their legal relationships, and to take appropriate legal advice.

Further, the Statement of Law and, accordingly the conclusions of the Panel set out below, reflect the law as at today's date. The accuracy of this Guidance Notice may be affected by a development in the law.

Context of the Statement of Law

The Statement of Law, while expressed in general terms, has been formulated to cover the situations which most banks will experience arising from standard business transactions. It is likely that the majority of relationships, which will fall for consideration by banks for these purposes, are within this context. The Statement of Law does not consider the effect of situations where any of the following apply:-

- the counterparty's insolvency is governed by the law or procedures of a jurisdiction other than England;

- either the bank or the counterparty was acting outside the scope of its legal powers in entering into any of the transactions, or was otherwise behaving unlawfully or improperly;
- one or both of the parties was acting as an agent for a third party, and not in its own right;
- the transactions concerned are affected by the rules of an organised market or clearing system, or by some other form of multilateral netting arrangement;
- the bank was aware of the counterparty's insolvency when, or the liquidation of the counterparty had commenced before, one or more of the transactions were concluded;
- the circumstances giving rise to the transactions do not involve mutuality between the bank and the counterparty.

Further, the Statement assumes that the transactions consist of contracts for forward and spot foreign exchange, cross-currency and interest rate swaps, currency and interest rate options (including caps, floors and collars), forward rate agreements and similar commodity and equity-related derivatives, as well as loans by and deposits with the bank. It does not take account of transactions outside this field.

Conclusion

The Statement of Law represents the consensus view of the English legal profession on the matters with which it deals, and in the context set out in this Guidance Notice. The Panel is satisfied that business may properly be conducted on this view of the law.

Schedule 1

STATEMENT OF LAW

Where a company goes into insolvent liquidation in England and there have been mutual credits, mutual debts or other mutual dealings between the company and another party prior to liquidation, set off applies. An account must be taken of the mutual dealings and the ultimate net balance only is required to be paid to the liquidator or proved for in the liquidation.

This rule of English law is now contained in Rule 4.90 of the Insolvency Rules 1986. The object of the rule is to achieve substantial justice between the parties having regard to the whole of their mutual dealings. The rule achieves this result by imposing a requirement for a complete set off in respect of all the mutual dealings between the parties.

All obligations in respect of the mutual dealings are required to be brought into account.

The set off applies whether or not there is any contractual entitlement to the same. The requirement for set off in respect of all mutual dealings is mandatory and cannot be excluded by agreement between the parties.

Where a bank and its corporate customer enter into various transactions with each other prior to the customer's insolvent liquidation and the customer goes into liquidation before the transactions are closed mandatory set off applies. The bank will have a claim (or obligation) on a net basis only to receive from (or pay to) the liquidator the net amount in respect of the transactions taken as a whole.

Schedule 2

The following firms have confirmed their agreement with the terms of the Statement of Law set out in schedule 1, in the context of this Guidance Notice, read as a whole:-

Allen & Overy
Ashurst Morris Crisp
Cameron Markby Hewitt
Clifford Chance
M W Cornish, Batty & Co
Denton Hall
Dickson Minto W.S.
Dundas & Wilson CS
Field Fisher Waterhouse
Freshfields
Herbert Smith
Linklaters & Paines
Lovell White Durrant
MacFarlanes
McKenna & Co
Nabarro Nathanson
Norton Rose
Richards Butler
Simmons & Simmons
Slaughter and May
Stephenson Harwood
Watson, Farley & Williams
Wilde Sapte