DIRECTIVE 96/10/EC OF THE EUROPEAN PARLAMENT AND OF THE COUNCIL

of 21 March 1996

amending Directive 89/647/EEC as regards recognition of contractual netting by the competent authorities

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 57 (2) thereof,

Having regard to the proposal from the Commission [1],

Having regard to the opinion of the Economic and Social Committee [2],

Having regard to the opinion of the European Monetary Institute [3],

Acting in accordance with the procedure laid down in Article 189b of the Treaty [4],

Whereas Annex II to Council Directive 89/647/EEC of 18 December 1989 on a solvency ratio for credit institutions [5] lays down the treatment of off-balance-sheet items concerning interest and foreign-exchange rates in the context of the calculation of credit institutions' capital requirements;

Whereas with a view to the smooth functioning of the internal market and in particular with a view to ensuring a level playing field Member States are obliged to strive for uniform assessment of contractual netting agreements by their competent authorities;

Whereas this Directive is in accordance with the work of an international forum of banking supervisors on the supervisory recognition of bilateral netting, in particular the possibility of calculating the own-funds requirements for certain transactions on the basis of a net rather than a gross amount provided that there are legally binding agreements which ensure that the credit risk is confined to the net amount;

Whereas the rules contemplated for the supervisory recognition of netting at the wider international level will lead to the possibility of reducing the capital requirements for internationally active credit institutions and groups of credit institutions in a wide range of non-member countries credit institutions which compete with Community credit institutions;

Whereas for credit institutions incorporated in the Member States, only an amendment of Directive 89/647/EEC can create a similar possibility for the recognition of bilateral netting by the competent authorities and thereby offer them equal conditions of competition; whereas the rules are both well balanced and appropriate for the further reinforcement of the application of prudential supervisory measures to credit institutions;

Whereas the competent authorities in the Member States should ensure that the calculation of add-ons is based on effective rather than apparent notional amounts;

Whereas, having regard to this situation, this Directive complies with the principle of subsidiarity, since the aim of this Directive can be achieved only by means of the harmonized amendment of existing Community legislation,

HAVE ADOPTED THIS DIRECTIVE:

Article 1

Annex II to Directive 89/647/EEC shall be replaced by the Annex hereto.

Article 2

Article 1 shall be without prejudice to the competent authorities' recognition of bilateral contracts for novation concluded before the entry into force of the laws, regulations and administrative provisions necessary for the implementation of this Directive.

Article 3

1. Member States shall bring into force the laws, regulations and administrative provisions necessary for them to comply with this Directive after its entry into force and no later than 30 June 1996. They shall forthwith inform the Commission thereof.

When the Member States adopt those measures they shall contain references to this Directive or shall be accompanied by such references on the occasion of their official publication. The methods of making such references shall be laid down by the Member States.

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[1] OJ No C 142, 25. 5. 1994, p. 8, and OJ No C 165, 1. 7. 1995, p. 6.
[2] OJ No C 393, 31. 12. 1994, p. 30.
[3] Opinion delivered on 16 January 1995 (not yet published in the Official Journal).
[4] Opinion of the European Parliament of 16 February 1995 (OJ No C 56, 6. 3. 1995, p. 79), Council common position of 5 September 1995 (OJ No C 288, 30. 10. 1995, p. 30) and Decision of the European Parliament of 14 December 1995 (OJ No C 17, 22. 1. 1996). Council Decision of 26 February 1996.
[5] OJ No L 386, 30. 12. 1989, p. 14. Directive as last amended by Commission Directive 95/15/EC (OJ No L 125, 8. 6. 1995, p. 23).

2. The Member States shall communicate to the Commission the texts of the main provisions of national law which they adopt in the field governed by this Directive.

Article 4

This Directive shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Communities*.

Article 5

This Directive is addressed to the Member States.

Done at Brussels, 21 March 1996.

For the European Parliament	*For the Council*
The President	*The President*
K. HÄNSCH	A. GAMBINO

ANNEX

'ANNEX II

THE TREATMENT OF OFF-BALANCE-SHEET ITEMS CONCERNING INTEREST AND FOREIGN-EXCHANGE RATES

1. SCOPE AND CHOICE OF METHOD

Subject to the consent of their competent authorities, credit institutions may choose one of the methods set out below to measure the risks associated with the transactions listed in Annex III. Interest-rate and foreign-exchange contracts traded on recognized exchanges where they are subject to daily margin requirements and foreign-exchange contracts with an original maturity of fourteen calendar days or less are excluded.

2. METHODS

Method 1: the "mark-to-market" approach

Step (a): by attaching current market values to contracts (mark to market) the current replacement cost of all contracts with positive values is obtained.

Step (b): to obtain a figure for the potential future credit exposure [1], the notional principal amounts or underlying values are multiplied by the following percentages:

TABLE 1

Residual maturity	Interest-rate contracts	Foreign-exchange contracts
One year or less	0 %	1 %
More than one year	0,5 %	5 %

Step (c): the sum of the current replacement cost and the potential future credit exposure is multiplied by the risk weightings allocated to the relevant counterparties in Article 6.

Method 2: the "original exposure" approach

Step (a): the notional principal amount of each instrument is multiplied by the percentages given below:

TABLE 2

Original maturity [1]	Interest-rate contracts	Foreign-exchange contracts
One year or less	0,5 %	2 %
More than one year but not exceeding two years	1 %	5 %
Additional allowance for each additional year	1 %	3 %

[1] In the case of interest-rate contracts, credit institutions may, subject to the consent of their competent authorities, choose either original or residual maturity.

Step (b): the original exposure thus obtained is multiplied by the risk weightings allocated to the relevant counterparties in Article 6.

[1] Except in the case of single-currency "floating/floating" interest-rate swaps in which only the current replacement cost will be calculated.

3. CONTRACTUAL NETTING (CONTRACTS FOR NOVATION AND OTHER NETTING AGREEMENTS)

(a) **Types of netting that the competent authorities may recognize**

For the purposes of this point 3 "counterparty" means any entity (including natural persons) that has the power to conclude a contractual netting agreement.

The competent authorities may recognize as risk-reducing the following types of contractual netting:

(i) bilateral contracts for novation between a credit institution and its counterparty under which mutual claims and obligations are automatically amalgamated in such a way that this novation fixes one single net amount each time novation applies and thus creates a legally binding, single new contract extinguishing former contracts;

(ii) other bilateral netting agreements between a credit institution and its counterparty.

(b) **Conditions for recognition**

The competent authorities may recognize contractual netting as risk-reducing only under the following conditions:

(i) a credit institution must have a contractual netting agreement with its counterparty which creates a single legal obligation, covering all included transactions, such that, in the event of a counterparty's failure to perform owing to default, bankruptcy, liquidation or any other similar circumstance, the credit institution would have a claim to receive or an obligation to pay only the net sum of the positive and negative mark-to-market values of included individual transactions;

(ii) a credit institution must have made available to the competent authorities written and reasoned legal opinions to the effect that, in the event of a legal challenge, the relevant courts and administrative authorities would, in the cases described under (i), find that the credit institution's claims and obligations would be limited to the net sum, as described in (i), under:

— the law of the jurisdiction in which the counterparty is incorporated and, if a foreign branch of an undertaking is involved, also under the law of the jurisdiction in which the branch is located,

— the law that governs the individual transactions included, and

— the law that governs any contract or agreement necessary to effect the contractual netting;

(iii) a credit institution must have procedures in place to ensure that the legal validity of its contractual netting is kept under review in the light of possible changes in the relevant laws.

The competent authorities must be satisfied, if necessary after consulting the other competent authorities concerned, that the contractual netting is legally valid under the law of each of the relevant jurisdictions. If any of the competent authorities is not satisfied in that respect, the contractual netting agreement will not be recognized as risk-reducing for either of the counterparties.

The competent authorities may accept reasoned legal opinions drawn up by types of contractual netting.

No contract containing a provision which permits a non-defaulting counterparty to make limited payments only, or no payments at all, to the estate of the defaulter, even if the defaulter is a net creditor (a "walkaway" clause), may be recognized as risk-reducing.

(c) **Effects of recognition**

(i) *Contracts for novation*

The single net amounts fixed by contracts for novation, rather than the gross amounts involved, may be weighted. Thus, in the application of Method 1, in

— Step (a): the current replacement cost, and in

— Step (b): the notional principal amounts or underlying values

may be obtained taking account of the contract for novation. In the application of Method 2, in Step (a) the notional principal amount may be calculated taking account of the contract for novation; the percentages of Table 2 must apply.

(ii) *Other netting agreements*

In the application of Method 1, in Step (a) the current replacement cost for the contracts included in a netting agreement may be obtained by taking account of the current hypothetical net replacement cost which results from the agreement. In Step (b) the single net amounts may be taken into account only for forward foreign-exchange contracts and other similar contracts, in which notional principal is equivalent to cash flows, in cases where the amounts to be claimed or delivered fall due on the same value date and in the same currency.

In the application of Method 2, in Step (a)

— for forward foreign-exchange contracts and other similar contracts, in which notional principal is equivalent to cash flows, in cases where the amounts to be claimed or delivered fall due on the same value date and in the same currency, the notional principal amount may be calculated taking account of the netting agreement; to all these contracts Table 2 must apply,

— for all other contracts included in a netting agreement, the percentages applicable may be reduced as indicated in Table 3:

TABLE 3

Original maturity(1)	Interest-rate contracts	Foreign-exchange contracts
One year or less	0,35 %	1,50 %
More than one year but not more than two years	0,75 %	3,75 %
Additional allowance for each additional year	0,75 %	2,25 %

(1) In the case of interest-rate contracts, credit institutions may, subject to the consent of the competent authorities, choose either original or residual maturity.'