

**Recommendation of the Technical Committee  
on the Recognition of Bilateral Netting Agreements in the Calculation  
of Capital Requirements for Securities Firms**

*March 1996*

The Technical Committee recognizes the increased importance of OTC derivatives business in the overall business of securities firms. The Committee is also mindful of the need for the regulatory capital requirements for securities firms to encourage best practice in risk management and risk mitigation.

In this context the Committee recognizes the increasing importance of bilateral netting provisions whether by means of novation or by closed out arrangements as a method of reducing the overall credit risk of securities firms, and has taken note of the position which the Basle Committee on Banking Supervision has already taken on this subject.<sup>1</sup>

Accordingly, the Committee recommends that members of IOSCO should recognize the benefits of bilateral netting agreements within their capital adequacy standards for securities firms, subject to the following considerations.

A securities firm should be required to satisfy its regulator that it has:

1. A netting contract or agreement with the counter party which creates a single legal obligation, covering all included transactions, such that the firm would have either 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 in the event a counter party fails to perform due to any of the following: default, bankruptcy, liquidation or similar circumstances.
2. Written and reasoned legal opinions that, in the event of a legal challenge, the relevant Courts and administrative authorities would find the firm's exposure to be such a net amount under:
  - the law of the jurisdiction in which the counter party is chartered and, if the foreign branch of a counter party is involved, then also under the law of the jurisdictions in which the branch is located;
  - the law that governs the individual transactions; and
  - the law that governs any contract or agreement necessary to effect the netting.

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<sup>1</sup> *Treatment of Potential Exposure for Off-Balance Sheet Items* - Basle Committee on Banking Supervision, April 1995.

The national supervisor, after consultation when necessary with other relevant supervisors, must be satisfied that the netting is enforceable under the laws of each of the relevant jurisdictions.

3. Procedures in place to ensure that the legal characteristics of netting arrangements are kept under review in the light of possible changes in relevant law.

Contracts containing walkaway<sup>2</sup> clauses should not be eligible for netting for the purpose of calculating capital requirements.

The Committee has requested its Working Group on the Regulation of Market Intermediaries to keep this recommendation under review, and to provide guidance to members of IOSCO on the practical aspects of the interpretation of the above conditions.

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<sup>2</sup> A walkaway clause is a provision which permits a non-defaulting counter party to make only limited payments, or no payment at all, to the estate of a defaulter, even if the defaulter is a net creditor.