

## **OPINION OF THE EUROPEAN MONETARY INSTITUTE**

on a consultation from the Council of the European Union under Article 109 f (6) of the Treaty establishing the European Community as amended by the Treaty on European Union and Article 5.3 of the Statute of the EMI;

on a Proposal for a European Parliament and Council Directive amending Council Directive 89/647/EEC with regard to the recognition of contracts for novation and netting agreements (“contractual netting”) by supervisory authorities (COM (94) 105 final).

### **CON/94/7**

1. The present consultation was initiated on 22 November 1994 by the Council of the European Union which, for this purpose, transmitted document “COM (94) 105 final” containing the proposed Directive and various explanatory memorandums to the EMI.
2. The proposed Directive aims at adjusting Community legislation to arrangements already made within the framework of the Basle Committee on Banking Supervision. These arrangements entail that not only bilateral netting by novation but also other forms of bilateral netting such as bilateral netting by close-out are accepted by supervisory authorities as risk reducing, provided that certain conditions are met, and may therefore be taken into account in the determination of a solvency ratio for credit institutions. As such determination in the Member States of the European Union is governed by Council Directive 89/647/EEC, this Directive needs to be changed.
3. Netting, or set-off, is a legal instrument which over the past few years has become increasingly important in the foreign exchange markets (for contractual netting) and in payments systems (for payments netting) with a view to reducing counterparty and systemic risks. This importance was underlined by the establishment in 1989 of a working group of the G10 countries under the chairmanship of Mr A. Lamfalussy, at the time General Manager of the Bank for International Settlements, which undertook an extensive study to netting and laid down its observations in the so-called Lamfalussy-Report of November 1990. One of the conclusions of this report is that netting should have a sound legal basis.
4. The present proposal for a Directive deals with bilateral contractual netting of rights and obligations arising from over-the-counter interest rate and exchange rate derivatives contracts between two counterparties and its main objective is to bring European Union credit institutions

with regard to the determination of a solvency ratio in the same position as non-European Union credit institutions whose solvency ratios are based on the recommendations of the Basle Committee on Banking Supervision. In the past, it was already accepted that bilateral netting by novation may be taken into account in the determination of a solvency ratio, provided that this form of netting is legally valid in all relevant jurisdictions. This has now been extended to other forms of bilateral netting with the same effect, namely that (at the latest) at the moment of insolvency of a party to a netting agreement all mutual rights and obligations covered by the netting agreement are amalgamated in one net amount. This would preclude the liquidating authority from requiring fulfilment of contracts which are favourable to the insolvent party, whilst refusing the fulfilment of unfavourable contracts (also known as “cherry picking”). Provided that such an arrangement is legally valid in all relevant jurisdictions, it would not only reduce counterparty risk for the parties to the contract but more in general enhance the stability of the financial markets (a matter which has been mentioned in Article 4.1, fourth indent, of its Statute as of specific interest to the EMI). The EMI therefore supports the use of these forms of netting, agrees with the view that such forms (provided that they have a sound legal basis) may be taken into account in the determination of a solvency ratio and consents that this for credit institutions in the Member States of the European Union indeed requires the proposed adjustment of Directive 89/647/EEC.

16th January 1995