

Basle Committee
on
Banking Supervision

Consultative paper on on-balance-sheet netting

1. In the Basle Capital Accord of July 1988 explicit reference is made to off-balance-sheet netting vis-à-vis the same counterparty but not to the offsetting of on-balance-sheet assets and liabilities. Over recent years, certain methods of on-balance-sheet netting have developed and the Basle Committee has decided that the time has come to establish certain principles for the guidance of its members and of other countries that are applying the Basle Capital Accord.

2. In the 1988 Accord, the netting of off-balance-sheet items was recognised only in cases where the netting was supported by a novation agreement, such that a single net amount was contractually substituted for the previous individual gross sums owed between two parties. This approach was subsequently widened to allow other forms of legally sound bilateral netting agreements in determining off-balance-sheet claims against individual counterparties.

3. With respect to on-balance-sheet netting, the Committee proposes to accept novation as a means of reducing gross exposures to a single net amount. In addition, the Committee has decided to permit other forms of on-balance-sheet netting of loans and deposits of a bank to or from any other counterparty subject to the following conditions:

- the reporting bank has a well-founded legal basis for concluding the netting or offsetting and the agreement is enforceable in each relevant jurisdiction. In this regard, national supervisors will look to sub-section (c) of the provisions related to bilateral netting of off-balance-sheet items in Annex 3 of the Accord as amended in April 1995 (see attached);
- the maturity of the deposit is at least as long as the corresponding loan;

- the positions are denominated in the same currency;¹ and
- the reporting bank monitors and controls the relevant exposures on a net basis. If a bank wishes to secure a reduction in capital requirements as a result of netting, it must have the systems in place and be in a position to demonstrate that it monitors net positions resulting from netting in a safe and sound manner on an on-going basis.

4. At the present juncture, the Basle Committee is inclined to restrict the scope for on-balance-sheet netting to loans and deposits only. However, recognising that netting can be a beneficial part of the risk management process, the Committee may be prepared to consider other circumstances under which banks might be allowed to net on-balance-sheet claims in calculating capital adequacy. The industry is invited to comment on the scope of additional permissible netting and what explicit measures should be required to ensure that such netting has a risk-reducing effect and is performed in a safe and sound manner. Specific examples of the types of instruments that might be included would be particularly helpful.

5. The Basle Committee invites industry comments on this matter by *30th June 1998*.

7th April 1998

¹ The Basle Committee is currently exploring the modalities of permitting cross-currency netting.