Credit Risk Mitigation Techniques Supervisory Requirements Changes

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Relying on netting and offsetting mechanisms is key to financial institutions in assessing derivatives exposures and calculating resulting capital adequacy requirements.

Until recently, most supervisory authorities allowed financial firms to rely on internal or external legal reviews and advice confirming that netting and offsetting mechanisms are legally effective and enforceable in the relevant jurisdictions. These did not usually involve formal legal opinions.

Recent regulatory developments resulting from the regional implementation of the Basel III framework*, however, require that credit risk mitigation techniques such as netting and offsetting mechanisms **should now be established using formal legal opinions for all relevant jurisdictions.**

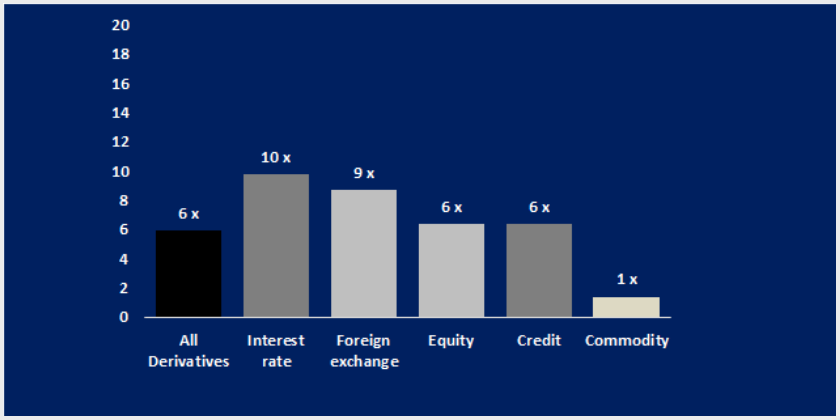
This is a significant change for financial firms using derivatives products: an increasing number of banks are required to obtain legal opinions for both new and existing arrangements. If no opinion exists, netting and offsetting mechanisms may be challenged, **resulting in potentially significant increases in capital requirements.**

Figure 1 illustrates the potential increase in derivatives mark-to-market resulting from the loss of the ability to use netting and offsetting mechanisms. Figures are based on six large US banks' reported net and gross derivatives assets.

Based on the 'All Derivatives' multiple of **6x,** for each current $1m in derivatives risk-weighted assets (RWAs), banks could face additional $5m in RWAs. Assuming a capital ratio of 8% and a capital cost of 15%, **the resulting cost increase would be $60,000 for each current $1m in derivatives RWAs.**

ISDA membership provides access to legal opinions on the enforceability of derivatives netting, enabling institutions to reduce credit risk and therefore cut capital requirements in many jurisdictions.

ISDA estimates the **cost of a legal netting opinion at approximately $30,000.** A distinct legal opinion would typically be required for each derivative counterparty, and in each jurisdiction.



* Source: CRR Article 194(1) in the European Union.
** Source: 2022 Annual Reports - JP Morgan, Wells Fargo, Goldman Sachs, Citi, Bank of America, Morgan Stanley.

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