

Master agreements and collateral as risk mitigating tools

by Alexander Vogel and Christoph Heiz, meyerlustenberger

COUNTERPARTY OR CREDIT RISK EXISTS WHENEVER A MARKET PARTICIPANT HAS ENTERED INTO A TRANSACTION WITH A COUNTERPARTY WHERE THE LATTER HAS AN OBLIGATION TO MAKE PAYMENTS OR DELIVERIES AT SOME POINT OF TIME IN THE FUTURE. EXCEPT FOR SOME REGULATED ENTITIES LIKE BANKS, SECURITIES DEALERS, INVESTMENT FUNDS OR OTHER COLLECTIVE INVESTMENT SCHEMES AND PENSION FUNDS, WHICH ARE REQUIRED BY LAW TO MONITOR AND LIMIT THEIR COUNTERPARTY EXPOSURE IN GENERAL OR AT LEAST FOR CERTAIN TYPES OF TRANSACTIONS, MARKET PARTICIPANTS ARE IN GENERAL FREE TO ASSUME UNLIMITED COUNTERPARTY RISK AT THEIR DISCRETION, WHETHER UNDER OVER-THE-COUNTER (OTC) DERIVATIVE TRANSACTIONS OR OTHERWISE. THUS, UNLESS MARKET PARTICIPANTS ARE SUBJECT TO SPECIFIC LAWS OR REGULATIONS OR ARE BOUND BY CONTRACTUAL ARRANGEMENTS, THEY ARE FREE TO CHOOSE IF, HOW AND TO WHAT EXTENT THEY WISH TO LIMIT OR MITIGATE THEIR COUNTERPARTY RISKS.

However, as a result of the recent credit crisis, most sophisticated parties wised up to the extent that their trading volume is sufficient to warrant the respective costs – mainly legal expenses associated with the negotiation and maintenance of necessary documentation, operational and technology costs, custody fees and financing costs associated with transferring, receiving and monitoring collateral – opt to enter in a first step into master agreements with their counterparties in order to reduce their exposure to a net amount. In a second step, in order to further reduce the risk that such net amount is lost due to an unexpected insolvency of the counterparty, market participants can obtain credit support in the form of a financial guarantee provided by a financially robust affiliate or, usually more reliable, sufficient collateral posted by the counterparty itself.



Alexander Vogel



Christoph Heiz

Dr. Alexander Vogel, Partner, Head of Corporate Department

tel: +41 44 396 9191

e-mail: a.vogel@meyerlustenberger.ch

Dr. Christoph Heiz, Partner, Head of Capital Markets Team

tel: +41 44 396 9191

e-mail: c.heiz@meyerlustenberger.ch

Risk reduction by entering into master agreements with all relevant counterparties

A first measure to significantly reduce counterparty risk is to consolidate the exposure under the various transactions entered into with a particular counterparty through the use of a close-out netting mechanism. This can be achieved by entering into a master agreement with each counterparty providing for appropriate netting arrangements such as the International Swaps and Derivatives Association (ISDA) Master Agreement, the Swiss Master Agreement for OTC Derivatives or similar international, e.g., the European Master Agreement (EMA) sponsored by the European Banking Federation (EBF), or national master agreements, e.g., the *'Convention-cadre relative aux opérations de marché à terme'* pursuant to French law or the *'Rahmenvertrag für Finanztermingeschäfte'* pursuant to German law. As a result of such netting provisions, if certain events occur which are highly likely to undermine the counterparty's financial health and thus its ability to fulfil its obligations, these agreements provide for the consolidation and conversion of multiple obligations between two parties into a single net obligation.

Structure of contractual framework

Each of the master agreements referred to above consists of a pre-printed body with standard provisions and one or more schedules or annexes. While the body of the master agreement is neither party specific nor transaction specific and therefore the parties are not supposed to change it, they can make certain elections and, if needed, amendments or alterations to any of the provisions contained in the body in the schedule(s). The pre-printed body of the master agreement together with any amendments and further terms, elections and arrangements provided for in the schedule pertaining to the master agreement provide the (abstract) legal framework governing the relationship between the parties – such as payment mechanics, a basic set of representations, warranties and covenants, events of

default and other events or circumstances that give one or both parties the right to terminate all or certain transactions, applicable procedures to terminate transactions and to calculate, convert and set-off termination values – and in addition specify certain credit aspects, but do not refer to any concrete transactions or any economic terms for specific trades. The commercial and any transaction-specific contractual terms for each transaction need to be set forth in a confirmation which refers to, and forms part of, the respective master agreement.

While the parties need to prepare and exchange a confirmation relating to each transaction that they enter into setting forth the agreed commercial terms of that specific trade, confirmations are in general quite short as they will normally incorporate, and make use of, certain standard definitions either provided for – as in the case of the Swiss Master Agreement – in the body or annexes of the master agreement or – as in the case of the ISDA framework – in one or more of the definition booklets published by ISDA which each relate to a specific type of derivatives transaction and contain both definitions as well as mechanical provisions which allow the parties not to reproduce such standard terms in each confirmation. An important aspect of most or even all master agreements is that the master agreement and all the confirmations relating to transactions entered into thereunder form together a single agreement which allows the consolidation of the amounts owed under all such transactions in one net amount owed by one party.

The 1992 and 2002 ISDA Master Agreements

In an international context, OTC derivative transactions are most frequently documented pursuant to a form of master agreement provided by ISDA, either a 1992 ISDA Master Agreement or a 2002 ISDA Master Agreement. The 2002 ISDA Master Agreement had been developed from the 1992 ISDA Master Agreement in the aftermath of the crises that affected the global financial markets in the late nineties (among them the Russian bank crisis and the Asian

currency crisis) and is considered to be more ‘creditor friendly’, as opposed to the 1992 version which was considered as too ‘debtor friendly’ in view of various grace periods which were considerably shortened in the 2002 version. Apart from a large number of smaller changes, the 2002 version introduced an additional termination event for force majeure and changed the process used in case of an early termination of the amount(s) due as a consequence of such termination are calculated to the so called ‘close-out amount’-method. Since its introduction, the 2002 ISDA Agreement has become the most common standard master agreement used by most market participants (in particular in an international context), although the 1992 ISDA Agreement continues to be widely used, but usually with amendments that in effect import some of the new provisions of the 2002 ISDA Agreement.

The pre-printed form of the ISDA Master Agreement contains the body of the agreement with general provisions relating to payment mechanics, general representations and covenants, definitions of events of default and termination events as well as procedures to terminate transactions and to determine and calculate the aggregate net termination value of all transactions. In the schedule, the parties can modify and amend the provisions of the standard master agreement and, among other things address tax issues, list the documents that each party has to deliver as conditions precedent and provide administrative details. Thus, the schedule adapts the standard master agreement to the specific requirements of the parties and therefore needs to be negotiated between the parties, but nevertheless remains an integral part of the master agreement.

meyerylustenberger

YOUR LEGAL EXPERTS

Our team of experts is known as one of the most dedicated and specialized derivatives and structured finance teams in the Swiss market and can draw on the specialist skills and technical expertise of lawyers from the firm’s Tax Department, the Banking and Financial Services Department and the Capital Markets Group. We are renowned for our expertise in complex and challenging transactions and pride ourselves for being innovative and commercially aware of our clients’ needs.

Our derivatives and structured finance team advises Swiss and foreign financial institutions, corporates and special purpose vehicles entering into ISDA master agreements, securities lending and repo transactions and collateral arrangements relating to derivatives transactions.

meyerylustenberger Attorneys at Law
Zurich | Zug | Geneva
Forchstrasse 452 | P.O. Box 1432 | CH-8032 Zurich
P +41 44 396 91 91 | F +41 44 396 91 92
zurich@meyerylustenberger.ch | www.meyerylustenberger.ch

Netting mechanics under the ISDA Master Agreements upon an event of default

The ISDA Master Agreement provides for various events of default (in particular ‘failure to pay or deliver’; ‘breach of agreement’; ‘credit support default’; ‘misrepresentation’; ‘default under specified transaction’; ‘cross default’; ‘bankruptcy’; and ‘merger without assumption’) as well as so called ‘termination events’ (in particular ‘illegality’; ‘tax event’; ‘tax event upon merger’ and ‘credit event upon merger’ and – only in the 2002 Agreement – ‘*force majeure*’). Each event of default and each termination event is defined in detail in the body of the master agreement and – as explained above – such definition can be amended, substituted by another event or even disapplied in its entirety by the parties. The occurrence of an event of default or termination event in respect of a party to a master agreement, in either case, gives one or both parties the right to terminate all transactions that are concluded under the relevant ISDA Master Agreement and therefore form part thereof; except in the case of certain termination events, when only transactions affected by the respective event may be terminated. Where more than one transaction is terminated at the same time, the ISDA Master Agreement provides for the mechanism of close-out netting to apply. The effect of close-out netting is to consolidate all obligations of the parties by substituting the multiple payment and/or delivery obligations under the several transactions between the parties by a single net payment obligation of one party for all transactions that are being terminated.

There are several ways to calculate the individual payments for each transaction that become due as a result of the early termination of all such transactions, but explained in a simplified way, such amount should reflect how much it would cost for a party to enter into a replacement transaction with an independent third party having economical terms identical to the terminated transaction. Under the 1992 ISDA Agreement, parties could (and still can) select between two standard methods to determine such amount: ‘loss’ and ‘market quotation’. The ‘loss’-method allows a party a lot of flexibility when

determining its losses and costs (or gains) incurred as a result of the termination or the replacement of related hedging positions, i.e., it can do so based on internal models and/or, at its election, quotations of dealers in the relevant markets, to the extent it acts reasonably and in good faith. The ‘market quotation’-method, however, provides a more stringent framework which requires the determining party to seek quotations from three or more leading dealers in the relevant market in order to obtain a quote for the amount that would be payable upon entering into replacement transactions economically equivalent to the terminated transactions and then to determine the arithmetic average of such quotes (disregarding the highest and the lowest quote).

The ‘close-out amount’-method introduced in the 2002 ISDA Agreement combines elements from both of the two mentioned approaches and requires in essence a reasonable determination of the losses or gains that would be realised upon entering into replacement transactions economically equivalent to the transactions entered into by the parties and now terminated. The determining party must act in good faith and in general use commercially reasonable procedures to produce a commercially reasonable result. In doing so, the determining party may consider any relevant information including relevant market data from dealers, end-users, information vendors and other sources, as well as information from internal models and third-party quotations, without an absolute requirement to obtain a certain number of quotations and to determine their arithmetic average. However, the determining party must consider any third-party market quotations and relevant market data, unless it reasonably believes in good faith that such quotations or data are either not available within the required time period or would lead to commercially unreasonable results.

In general, ‘close-out amount’-method aims at providing the determining party with more flexibility in making its determinations while preserving a sufficient degree of objectivity and transparency by providing more detailed guidance regarding the procedures and standards to be adhered to in calculating early termination amounts. The market instabilities and partial market disruptions

following the Lehman insolvencies have confirmed the difficulty to obtain market quotations as required under the 'market quotation'-approach of the 1992 ISDA Agreement during periods of market turmoil already experienced during the market crises in the late nineties. Even if the determining party was able to obtain the required number of quotations in the market, in many cases those quotations were immensely diverging, making it difficult to determine if the 'market quotation'-method produced the required commercially reasonable result.

As a result, most major dealers in OTC derivatives entered into bilateral or multilateral contractual arrangements with each other to amend any 1992 ISDA Agreements existing among them to incorporate the 'close-out amount'-method of the 2002 ISDA Agreement. Further, in February 2009, ISDA in cooperation with market participants published the 'ISDA close-out amount protocol' in order to allow parties of existing 1992 ISDA Master Agreements to amend the terms of those agreements on a multilateral basis and to facilitate the adoption of the 'close-out amount'-method without the need for bilateral amendments of existing 1992 ISDA Agreements.

Early termination and automatic early termination

Under an ISDA Master Agreement, the transactions under the master agreement are subject to early termination when an event of default occurs and the non defaulting party serves a default notice to the defaulting party. However, in various jurisdictions it is considered to be necessary to effect the close-out prior to the applicable bankruptcy regime which would otherwise not recognise the close-out and the netting effect the parties want to achieve. In order to mitigate the risk that under the bankruptcy regimes of these jurisdictions, a default notice to the defaulting party by the non defaulting party could be considered to be too late to be effective, the agreement also provides for the option of 'automatic early termination' which usually applies only to events of default related to a bankruptcy or similar procedures. The effect of an automatic early termination is that all transactions

under the agreement are deemed terminated as of a date immediately before any bankruptcy proceedings were instituted against the defaulting party.

Conversely, parties choosing automatic early termination to be applicable are faced with the risk that transactions may be automatically terminated without the non defaulting party's knowledge which can leave the latter with unhedged positions or trades that it would otherwise have unwound or replaced simultaneously with the termination. By the time such non defaulting party becomes aware of the automatic early termination, markets may have already moved adversely against it. Many parties therefore have shown a preference not to elect automatic early termination in order to preserve control over when and whether their transactions will be terminated based on the market prices at such time and considering whether or not as a result of the termination, it would owe an immediate settlement payment to the defaulting party.

Based on the contractual arrangements described above and as an effect of the termination of all outstanding transactions between the parties in case of an event of default or termination event, the mechanism of close-out netting also avoids cherry picking by the defaulting party or its bankruptcy trustee, i.e., the attempt to uphold those transactions that are favourable to the defaulting party while annulling those that are unfavourable. In jurisdictions where close-out netting is enforceable, a party's exposure is therefore effectively limited to any net amount that would be payable to it by its counterparty on the termination of all transactions. At the same time, close-out netting also benefits the non-defaulting party in the converse situation because its obligation to pay gross amounts in respect of any – from its perspective – out-of-the-money transactions is replaced with a single obligation to pay the net amount and the latter is automatically diminished by all amounts the non defaulting party can claim under – from its perspective – in-the-money transactions. As a result thereof, under most applicable accounting rules and capital requirement regulations, the availability of close-out netting allows parties to an ISDA or other recognised master agreement to account for all transactions entered thereunder on a net basis.

The Swiss Master Agreement for OTC derivatives

Similar to the ISDA Master Agreements described previously, the Swiss Master Agreement consists of a pre-printed body with standard provisions, annexes to the latter and confirmations relating to specific transactions. Also, in the case of the Swiss Master Agreement, the body of the agreement is neither party specific nor transaction specific and therefore not intended to be changed by the parties. If the parties intend to amend the body, they have to modify and supplement the standard provisions in an addendum to the master agreement. Certain elections (designation of the calculation agent and threshold amounts for purposes of electing and defining a cross default) can be made in the last clause of the body. The Swiss Master Agreement provides explicitly that the body of the agreement and all the confirmations relating to transactions entered into by the parties thereunder form together a single agreement. The Swiss Master Agreement contains three annexes providing for special provisions for the different types of OTC derivatives. In comparison to an ISDA Master Agreement, the length, language and structure of the Swiss Master Agreement – in particular of its body – is less complex and thus easier to comprehend also for a non lawyer in charge of documenting OTC derivative transactions.

Compared to the standard schedule pertaining to an ISDA Master Agreements, there are much fewer elections provided for as standard elections, since the Swiss Master Agreement either does not provide for such election as a standard election, e.g. the election of ‘Specified Entities’ (i.e., the possibility to tie-in other entities whose defaults would trigger an event of default under the master agreement) or ‘specified transactions’ (allowing to limit a cross default to certain types of transactions) or does not provide for a standard opting-out of certain standard provisions contained in the agreement, e.g., credit event upon merger (which is contained as a standard event of default in Section 5.3 f) of the Swiss Master Agreement and thus can only be disapplied in an addendum to the Swiss Master Agreement). Further, the Swiss Master

Agreement provides Swiss Francs as a default termination currency, since the agreement is primarily intended for transactions between national parties.

The Swiss Master Agreement provides for similar standard events of defaults as provided for in an ISDA Master Agreement (‘failure to pay or deliver’; ‘breach of agreement’; ‘default under specified transaction’ ‘cross default’; ‘bankruptcy’; and ‘credit event upon merger’). The detailed definition of these events of default vary in certain aspects, e.g., the Swiss Master Agreement provides in its standard form that any “failure by a party to perform any obligation under any other agreement entered into between the parties” constitutes an event of default, “if such failure is not remedied on or before the twentieth Banking Day after written notice of such failure is given to the defaulting party” and the event of default relating to a restructuring of the counterparty encompasses any “legal or economic restructuring of a party which results in a material deterioration in its creditworthiness”. If one of these default events occurs, the non-defaulting party may terminate the master agreement - and thus all transactions entered thereunder - by written notice. In such cases, the defaulting party has to compensate the other party for any costs and direct loss – calculated on the basis of replacement transactions – resulting from its default.

Like the ISDA Master Agreement, the Swiss Master Agreement provides for the concept of close-out netting in order to consolidate all obligations of the parties by substituting the multiple payment and/or delivery obligations under the several transactions between the parties by a single net payment obligation of one party to the other for all outstanding transactions that are being terminated. In order to ensure the effect of close-out netting and to prevent any possibility of cherry-picking by a bankruptcy trustee, the Swiss Master Agreement provides for automatic early termination if a party is declared bankrupt; is granted a payment moratorium; if reorganisation measures are approved or if any other insolvency-related event with similar effect occurs in respect of a party. In those cases, the transactions entered into under the agreement are deemed to be terminated immediately prior to the occurrence of such event.

Collateralisation of the net exposure

As discussed previously, a first step of addressing the credit risk arising from derivatives transactions with a specific counterparty is to enter into a master agreement providing for an enforceable close-out netting mechanism which allows to reduce the exposure under each of the outstanding transactions to a net-exposure, i.e., a net amount that one party owes to the other party. Such net-exposure can further be reduced by obtaining credit support in the amount of such exposure, i.e., through financial guarantees by an affiliate, a shareholder or the main financial lender of the contracting entity, or by collateralising the exposure. Each of these methods has its advantages and disadvantages.

Collateralisation usually constitutes an adequate way of risk mitigation if the volume of activity is sufficiently high to warrant the operational and procedural burden and costs related to a reliable collateral process. For derivative parties with infrequent use of derivative instruments – e.g., corporations outside the financial industry – relying on other methods of mitigating the remaining credit risk might be more cost efficient. As the example of Lehman has demonstrated brutally, however, relying on the financial health of a parent company or on the credit rating issued by a rating agency might turn out to be a risky approach and collateralisation might be the – although costlier – safer approach to avoid significant losses in case of the counterparty's unexpected bankruptcy. However, this is providing that such counterparty itself has easy access at reasonable costs to the type of assets (typically cash of a G7 currency or high quality government bonds) required for collateralising bilateral OTC derivatives and is not hindered from pledging assets under the terms of facility agreements with negative pledge clauses that contain no carve out for the collateralisation of OTC derivatives.

Therefore, collateralisation has become the most widely used method to mitigate counterparty credit risk in the OTC derivatives market, and market participants have increased their reliance on collateralisation in the recent past. As demonstrated by the recently published ISDA Margin Survey 2010 Preliminary Results, on average, 78% of all

open derivatives transactions were subject to collateral arrangements. The percentage, however, varies depending on the type of derivative transaction, mostly in function of the riskiness of the derivative type: while the percentage of collateralised credit derivatives (97%) or fixed income derivatives (84%) is substantially higher, the percentage is significantly lower for FX, metals and commodities transactions, since markets such as FX are spot or very short-dated, therefore carry a lower risk that is not practical or economic to mitigate by way of collateralisation.

Agreements typically used to document collateralisation

The type of agreement used to document the providing of collateral depends primarily on the type of master agreement in place between the parties and secondarily on their preference for granting the collateral taker the right to make use of the collateral during the period of collateralisation. If the parties have documented their derivative transactions under an ISDA Master Agreement, collateral is commonly provided pursuant to the 1994 ISDA Credit Support Annex under New York law (the ISDA NY CSA), the 1995 ISDA Credit Support Annex under English law (the ISDA English CSA) or the 1995 ISDA Credit Support Deed (the ISDA CSD). If the parties have entered into a different (national) master agreement, they would typically use the appropriate jurisdiction-specific collateral-agreement, e.g. the French 1998 AFB Collateral Annex or the '*Besicherungsanhang*' pertaining to the German Rahmenvertrag or the Swiss Credit Support Appendix in its current version dated March 26, 2009 pertaining to the Swiss Master Agreement for OTC derivatives. In addition, depending on the particular circumstances, the parties might also use bespoke margin agreements or master margining agreements referring, e.g., to commodity-specific arrangements. Unless amended, most standard credit support documents provide for collateral to be posted on a bilateral basis such that either party may be required to provide or entitled to receive collateral depending on the net exposure under the relevant master agreement on a mark-to-market basis.

Both the ISDA NY CSA and the ISDA CSD create a security interest over the collateral, while the ISDA English CSA provides for an outright transfer of ownership by the collateral provider to the collateral taker, i.e., the former retains no proprietary interest in the collateral itself and full legal and beneficial ownership in the collateral passes to the collateral taker, subject to an obligation on the collateral taker to return 'equivalent' property to the collateral provider. Alternatively, the collateral taker may designate a custodian to whom collateral is to be transferred. As a result, under a ISDA English CSA, the collateral taker has no restrictions as to sell or re-use the collateral until it has to return the collateral to the collateral provider. Also, the ISDA NY CSA permits the collateral taker to sell, rehypothecate or otherwise use or dispose of any posted collateral, unless these rights have been restricted by the parties in the CSA, while the ISDA English CSA does not allow any such re-use of collateral. Further, under the ISDA English CSA in case of an early termination as a result of an event of default, an amount equal to the 'value' (as defined in the CSA) of the posted collateral at that time will be included in the close-out netting calculations of the ISDA Master Agreement and thus, the collateral taker's obligation to return 'equivalent' property to the collateral provider is replaced by the net-amount resulting in the close-out netting.

The provisions of the Swiss Credit Support Appendix provide – similar to the ISDA English CSA – for the full right of title to pass to the other party when transferring collateral to the collateral taker and the latter's right to freely dispose of such collateral, subject to an obligation to deliver back the same quantity, type and quality of collateral. Also, the mechanism to be applied in case of an early termination is similar to that provided in the ISDA English CSA: neither of the parties is obliged any longer to deliver or return collateral and the obligations to deliver or return collateral are replaced by a single monetary obligation to pay a liquidation value, which is calculated by the non-defaulting party in analogy to the provisions provided for in the Swiss Master Agreement. The so calculated liquidation value under the Swiss Credit Support Appendix is then set off against the liquidation

value under the master agreement; any resulting net liquidation value shall be paid by the relevant party to the other.

Remaining risks despite collateralisation

It should be noted, however, that while collateralisation is a very useful means to significantly reduce counterparty risk, it cannot fully eliminate any remaining credit risks relating to the counterparty. In particular, certain risks will remain, mainly due to:

- (i) time lags in reacting to market changes and implementing the appropriate counter measures, e.g., fluctuations in the value of collateral in the form of securities or an increase in exposure, both occurring between the last settled margin call and the counterparty's default or the time of the close-out;
- (ii) voluntarily accepted imprecision of the collateralisation schemes put in place caused by unsecured thresholds or excess collateral requirements; or
- (iii) disparities in negotiation leverage and thus build in over-collateralisation, in particular where one party is obliged to accept, and provide collateral based on an independent amount (as defined in the CSA or the Swiss Credit Support Appendix, i.e., an amount that has to be deposited with the counterparty as a prerequisite for trading with such counterparty, irrespective of any actual exposure of such counterparty).

Contact us:

meyerlustenberger

Forchstrasse 452, P.O.Box 1432, 8032 Zurich,
Switzerland

tel: +41 44 396 9191

web: www.meyerlustenberger.ch

e-mail: zurich@meyerlustenberger.ch