Credit support, amendments and novations

In parts 1 to 3 of this series, **Gary Walker** and **Guy Usher** examined each of the core constituents of ISDA documentation: the Master Agreement, the Schedule, the Confirmation and related Definitions. In this fourth and final part, they turn their attention to some of the technical issues relating to the provision of credit support, the effecting of amendments to existing relationship and/or transaction terms, and the novation of transactions to a third party. Concluding with a summary of the series, they suggest a roadmap for treasurers to follow when next faced with an ISDA negotiation.

Credit support is ISDA-speak for security or collateral. It has been an increasingly common requirement of bank sellers of derivatives seeking to keep credit risk to a minimum (particularly in the context of long-dated, volatile and/or 'mega-notional' transactions) and at the same time to maximise regulatory capital efficiency.

More recently, corporates themselves have insisted on credit support for their own counterparty risk management purposes. Such support sometimes takes the form of guarantees and other forms of conventional security, but more commonly operates under standardised ISDA collateralisation documentation that is sufficiently dynamic to track the mark-to-market under the Master Agreement to which it relates, and also provides for the periodic transfer and retransfer of cash or other liquid assets in amounts that over-collateralise that mark-to-market amount (typically on a net, as opposed to gross, basis). Let's start by considering each type of support in turn.

CREDIT SUPPORT

1. Guarantees Typically, guarantees are expressed to secure "all monies indebtedness" of a given debtor to a given creditor. In the context of a (two-way) swap arrangement, this formulation perhaps needs a rethink.

A guarantor should consider whether its obligations under the guarantee should be restricted to the net (as opposed to gross) out-the-money position under the relevant Master Agreement from time to time.

It should also consider whether, where the debtor is concurrently borrowing from the swap provider (or a related entity) and is net in-the-money at any relevant time, that in-the-money amount should first be set off against the borrowing before a claim is made under the guarantee.

Otherwise, in either instance, the guarantor is effectively and unnecessarily taking a disproportionate slice of the debtor's credit risk.

Figure 1 illustrates the principal methods of structuring guarantees for such arrangements.

2. Conventional security By this we mean debentures, charges over fixed assets and the like. As well as demanding that certain formalities be complied with (such as registration at Companies House in the case of an English registered company), such instruments suffer from the obvious drawback that they are static in nature – that is, they are not dynamic enough to 'move' with the mark-to-market under a Master Agreement. Where, however, they are employed, the points considered at the start of this article in relation to net mark-to-market and pre-claim set-off are equally valid.

3. ISDA credit support documentation ISDA English law credit support documentation takes two forms. The first, the ISDA Credit Support Annex (CSA), operates by way of title transfer. It obliges a net out-the-money party to transfer to its counterparty, at periodic intervals, sufficient liquid assets to over-collateralise the out-the-money amount, subject to an obligation on the counterparty to return equivalent assets if, and to the extent that, the out-the-money position improves.

The CSA itself is expressed to constitute a transaction under the relevant Master Agreement with the intention that, on an early termination of the Master Agreement, amounts posted under the CSA are netted off against the (net) out-the-money position in respect of all non-CSA transactions.

The relative disadvantage of the CSA is that it relies on the enforceability of the netting arrangements within the overlying Master Agreement. While generally this is not an issue for UK-incorporated entities (and while for the UK as well as for other key jurisdictions, ISDA provides opinions confirming such enforceability), corporates should be aware of the legal framework within which the CSA operates.

The CSA has generally been preferred to its cousin, the ISDA Credit Support Deed (CSD), for the simple reason that the CSD operates by way of security 'proper' and has been vulnerable to the argument that it requires registration at UK Companies House in order to be effective against a liquidator of an English registered company. With the advent of the recent Financial Collateral Arrangements (No. 2) Regulations 2003, however, that technical argument has all but disappeared, with the result that the CSD may with time become more prevalent than the CSA.

Whichever document is used, various questions need to be considered by both parties and, where appropriate, reflected in the drafting:

- Will the entry into either document breach applicable negative pledge covenants? Be aware that the CSD obviously creates security and the CSA, perhaps less obviously, synthetic security.
- Is the arrangement to operate unilaterally or bilaterally?
- Has the collateral-taker a right (under the CSD) to use posted collateral while in its possession?
- What thresholds are to operate – initial/independent transfers, minimum transfer amounts, transfer thresholds, etc?
- What is the nature and extent of criteria as to the type and quality of posted assets and corresponding substitution obligations?
- Has the end-user the ability (as both the CSA and the CSD presuppose) to support mark-to-market exposures under the related Master Agreement, either for the purposes of itself making a call or of verifying a called amount? Where the swap-providing bank offers to value

Figure 1. Principal methods of structuring guarantees

Fig. 1(a) Single obligation guarantee structure

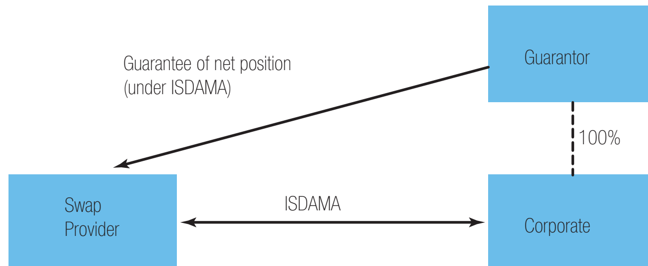
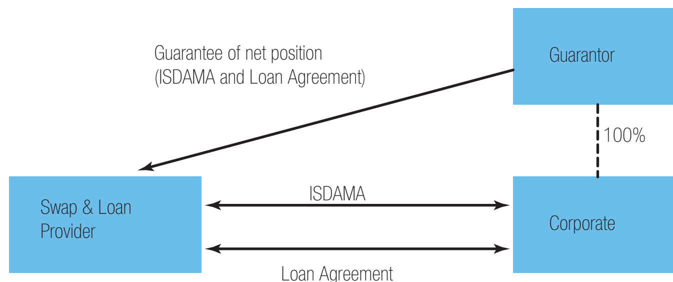


Fig.1(b) Multiple obligation guarantee structure



the exposure on the end-user's behalf, the end-user should note that various changes are recommended to the standard forms of CSA/CSD, both to protect the end-user from the moral hazard implicit in such an arrangement and, mechanically, to achieve the desired 'omni-valuation agent' functionality.

Like the Master Agreements to which they relate, the CSA and CSD are generally sold as standard-form, with the result that unsophisticated or unsuspecting end-users may sign up to collateral arrangements that are inappropriate at best, and covenant breaching at worst.

AMENDMENTS

From time to time, amendments may be required by one or other of the parties to the terms of an ongoing swap relationship. These amendments may be wholesale, migratory or transaction-specific in nature.

1. Wholesale Suppose the automobile industry takes an unexpectedly sharp downturn. Swap provider A is concerned about the long-term credit standing of its car manufacturing corporate swap customer B. So it seeks to introduce a provision that gives it the right to terminate all transactions between it and B in the event of the latter's downgrade. A seeks to introduce the provision by way of formal amendment agreement to the existing Master Agreement between it and B. Assuming that it is agreeable in principle to the provision, B will want to consider among other things the following questions:

- Is the provision intended to operate on new transactions only or on all transactions, existing and future?
- What is the criteria for determining whether a downgrade has occurred – type of debt downgraded, number of notches, designation of rating agencies, etc?
- Can it avoid an early termination on a downgrade by posting collateral or by novating the swaps to an amenable third-party provider?
- To cater for the fact that it may be significantly out-the-money at the relevant time, does it need a standby credit line to meet its obligation?
- Is the provision expressed as an additional termination event or an additional event of default?

In our experience, amendment agreements often turn up on an end-user's doorstep addressing issues such as these in only cursory fashion.

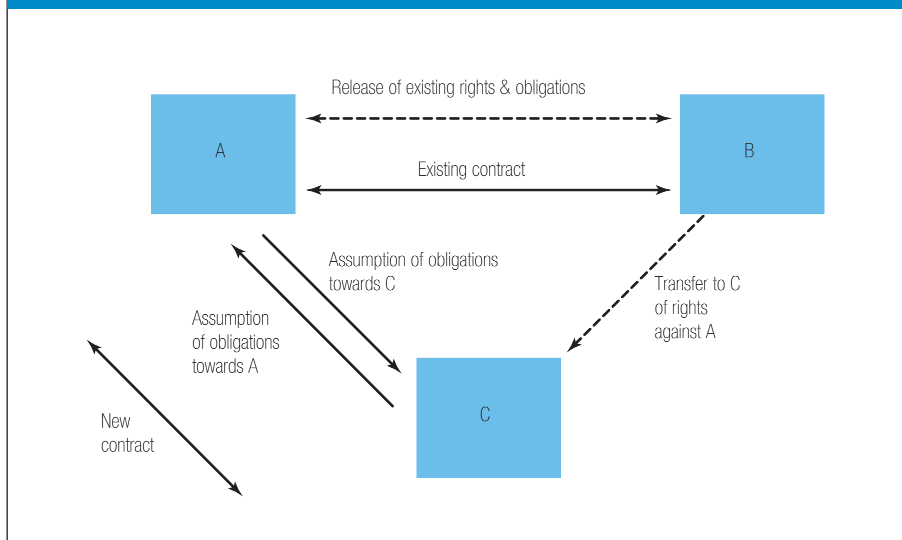
2. Migratory Market practice changes, banks' policies alter, master documentation evolves and swap portfolios change hands. Each necessitates a migration of transactions, whether from one swap provider to another or from one form of Master Agreement to another. Any migratory process that impinges on an end-user will necessarily involve consideration of one or more of the following questions:

- Am I going to have a weaker counterparty post-migration?
- Do the new documents that I am being asked to sign materially increase the risk of my default? The answer, by the way, in the case of a migration from the 1992 to the 2002 ISDA Master Agreement, is almost certainly 'yes'.
- What level of technical 'plumbing' and due diligence do I need to undertake to ensure that the new documents work as intended, do not have unintended consequences in other documents to which I am party, and do not diminish my rights against my counterparty or any credit support provider of that counterparty?
- What consents do I need?
- What consents do I need to see from my counterparty?
- Does the migration expose me to a cost or crystallise a gain?
- If I need to replace my existing swaps in the market, what is the cost to me of doing that?
- What are the tax and accounting consequences of the migration?

Doing nothing is invariably not an option.

3. Transaction-specific Sometimes Confirmations are sent out and signed containing unintended or manifest errors. Sometimes after entering into a transaction but ahead of its contractual maturity, the parties want to change the terms of a certain type (or class) of transaction. In either case, the change will usually be effected by way of restatement of, or formal amendment to, the relevant Confirmations and should not disturb the overlying Master Agreement or related Credit Support arrangements. In any event, the revised terms should be checked to ensure they give effect to what has been agreed.

Figure 2. How novation works



NOVATIONS

A novation is the rewriting of a contract that existed between, say, A and B, such that, post-novation, a new contract exists between, say, A and C (*see Figure 2*). The technique is employed to move entire books of swaps as well as single or limited numbers of transactions.

1. Book novations These are most commonly encountered in a bank-to-bank environment but may occasionally affect a large corporate. On top of the obvious considerations of break cost/gain and related tax and accounting issues, the treatment of accruals needs thought as does the creditworthiness of the transferee/novatee entity. Documentation for novations, while now largely standardised for transactions governed by ISDA Master Agreements, can be technical, particularly to those who are unfamiliar with it.

2. Transaction-specific In an end-user context, transaction-specific novations most often occur where a borrower refinances a loan that is hedged by the lending bank or by an affiliate of that lending bank. Invariably, the original lending bank or its affiliate will not want to keep the swap, not least because doing so will lead to intercreditor complications between it (as the remaining swap provider) and the refinancing bank. So the borrower faces a choice between:

- breaking the swap and being unhedged on the new loan;
- breaking the swap and entering into a new swap with the refinancing bank;
- novating the swap to the refinancing bank; and
- entering into a fixed-rate loan with the refinancing bank (that itself takes the swap over from the borrower).

The technicalities are demanding in each case. Suffice to say that, whatever choice it makes, an out-the-money borrower is inevitably exposed to an immediate break cost, a deferred break cost or an off-market swap/fixed rate, with attendant and disadvantageous cashflow, tax and accounting consequences in each case. Such complexities are commonly not given sufficient advance consideration by end-users.

SUMMARY AND ROADMAP

Looking back over this series of four articles, we find ourselves surprised by the number and complexity of matters to be considered in the context of even 'straightforward' ISDA negotiations, tempting us to conclude that, after all, there is no such thing as a 'straightforward' ISDA negotiation. To summarise:

- ISDA documentation is standardised but not standard.
- The Schedule is not a blank-filling exercise. It demands election-by-election analysis in the context of an end-user's wider banking and commercial arrangements.
- Economically, the Confirmation is key. The more complicated or structured the transaction, the more compelling the argument that it should be independently reviewed; and don't forget that IAS 39 is here to stay.
- A requirement for credit support is increasingly the norm (for both parties). ISDA credit support documents throw up significant operational and commercial issues.
- Even apparently simple amendments and novations demand forward planning and expert scrutiny.

As for a roadmap, try these five suggestions:

- Do read the documents.
- If they do not make sense, get someone else (an expert) to read them for you.
- Do not assume that your swap provider understands your requirements or that it has considered your commercial perspective.
- Do not assume that the last agreement you signed was right and that you can therefore just replicate your thought process for the current one you are looking at.
- Do accept that you are a great corporate treasurer but not so great a derivatives lawyer.

If you still doubt the message, bear in mind that, on signing an ISDA Master Agreement, you will, among other things, be making repeating contractual representations to your swap provider to the effect that:

- You have read the documents.
- You understand what they say and are not relying on your swap provider to tell you what they say.
- You do and will understand the tax, legal, accounting and economic effect of every transaction you enter into under the Master Agreement and have sought appropriate tax, legal, accounting and other specialist advice where necessary.

This article concludes The Treasurer *series on the ISDA swap agreement, covering the Master Agreement (October 2004), the Schedule (December 2004), and the Confirmation (July/August 2005).*

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