The neglected piece of the ISDA puzzle – the Confirmation

In the third of a four-part series on International Swaps and Derivatives Association (ISDA) documentation, **Gary Walker** and **Guy Usher** look at the process of the Confirmation.

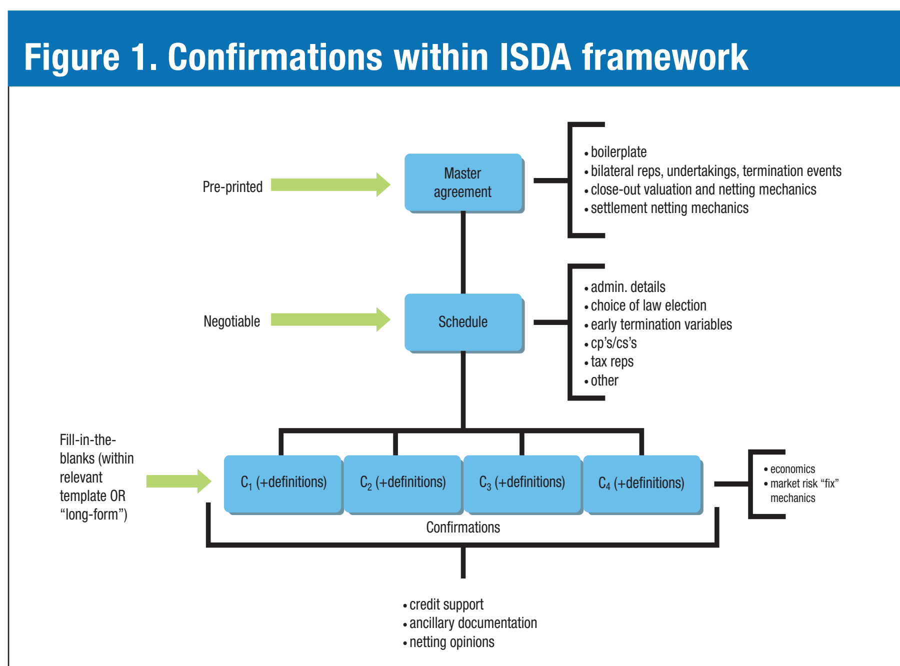
In parts one and two of this series (*The Treasurer* October and December 2004) we looked critically at International Swaps and Derivatives Association (ISDA) documentation and the Schedule. We now turn our attention to perhaps the most neglected piece of the ISDA puzzle, the Confirmation. In the high-volume, automated, skills-intensive world of the inter-bank market, perhaps such neglect is understandable. In the end-user arena, however, the Confirmation is deserving of respect and scrutiny. This article explores some of the complexities.

THE CONFIRMATION – WHO, WHAT, TO WHOM, WHEN The Confirmation sets out the economic terms – the "who pays what, to whom and when" – of individual derivative transactions entered into under any given ISDA Master Agreement. It is not called a "Confirmation" by accident. In most instances, it "confirms" the terms of a pre-existing contract entered into by oral (usually telephonic) agreement between the end-user and the originating bank. Moreover, it structurally "completes the picture" so far as the documentary framework is concerned, being expressed to form part of and supplement an overarching ISDA Master Agreement and related Schedule.

In order that its negotiation and physical length are kept to a minimum, each Confirmation incorporates one or more relevant glossaries of ISDA Definitions that themselves give meaning to various employed terms (such as Notional Amount, LIBOR, Day Count Fraction, etc.) and that further address the manner of dealing with various contingencies, such as disappearance of LIBOR and scheduled payment dates falling on non-business days. Different sets of Definitions exist to assist the documentation of different derivative product types – so interest rate transactions, for example, incorporate ISDA interest rate Definitions; credit derivative transactions, for example, incorporate ISDA credit derivative Definitions; and so on. Most Definitions booklets include, to their rear, template Confirmations that serve as an essential starting point for the documentation of individual transaction types.

UNDERSTANDING AND CHECKING The Definitions themselves do not stand still – they are periodically updated for market events, product

Figure 1. Confirmations within ISDA framework



updates and changes to convention – and it is not unusual to see different banks making use of different sets of Definitions from time to time. The result is that ostensibly identical transactions may, substantively and economically, be very different. For the purposes of understanding and checking even the simplest of derivative transactions, therefore, it is necessary to have to hand (and to cross-refer to) the relevant set(s) of Definitions. Since the Definitions are the intellectual property of ISDA (and since only ISDA members are permitted to use/refer to them in a day-to-day context), it is hard to see how end-users (few of whom are ISDA members) can, under their own steam, properly scrutinise the Confirmations that they are asked to sign.

For new product types – property derivatives are a good example – no Definitions yet exist, with the result that transactions have to be documented under so-called "long-form" Confirmations (that are "longer" simply because there is no market short-hand to facilitate their construction and interpretation). Needless to say, long-form Confirmations are, even with the relevant Definitions to hand, much more difficult to draft and check than their short-form (i.e. ISDA template-based) cousins.

Figure. 1 shows how Confirmations (short-form and long-form) fit into the ISDA framework.

TYPICAL CONTENT All Confirmations contain prefatory as well as closing provisions that are more or less the same whatever the nature of the transaction. The purpose of these provisions is to introduce the transaction, to reference the relevant Master Agreement of which it forms part, to incorporate the relevant set(s) of Definitions and to obtain the agreement and signature of the parties to its terms.

In between sits the economic 'meat' of the transaction. Taking a simple fixed for floating rate interest rate swap as an example: the Confirmation includes the effective date and termination date, the notional amount (and any applicable amortisation profile), the floating rate and spread payable by the floating rate payer, the fixed rate payable by the fixed rate payer, the respective payment and rate reset dates, the chosen currency of payments and the desired day count and business day conventions. For more complex transactions, a whole host of further provisions are required – primarily to deal with key 'what ifs' in relation to the underlying Definitions – that vary from transaction to transaction, that demand specialist knowledge of the underlying as well as the corresponding Definitions and that are beyond the scope of this article.

To complete the picture, the parties insert details of the accounts to which they wish payments in respect of the transaction to be made, the location of the office out of which each is trading and miscellaneous items such as governing law, statements as to regulatory authorisation and time of dealing.

INCONSISTENCIES AND DISCREPANCIES
ISDA documentation is set up so that the terms of the Confirmation prevail over any inconsistent provisions within the Master Agreement or within the relevant set(s) of Definitions. This ordinarily makes sense insofar as it enables the parties, where that is their desire, to achieve transaction-specific deviations from ISDA/market norm with the minimum of fuss. On the other hand, it means that the parties need to take care, when reviewing Confirmations, to ensure that no terms are imported via the Confirmation that unintentionally override entrenched positions within the Master Agreement.

To illustrate the latter point, we recently 'rescued' an end-user that had inadvertently signed up to a series of super-long dated interest rate hedges, the Confirmations relating to which contained provisions that gave the originating bank frequent and periodic break rights. The Master Agreement, on the other hand, provided that the bank could break only on a downgrade of the end-user. Had the provisions in the Confirmations been allowed to remain, they would have prevailed – to the obvious detriment of the end-user – and so they were eventually removed as being inconsistent with what had been agreed during negotiations of the Master Agreement. As to how the confusion arose, the bank had implemented a policy change in relation to long-dated instruments that it had failed to communicate to the end-user; and the end-user had compounded that error by not checking the terms of the Confirmations before it signed them. A salutary lesson all round.

A word of warning is also in order in relation to Confirmations that, as occasionally happens, are entered into prior to negotiation/signature of the Master Agreement. Not only do such "pre-Master Confirmations", as they are known, necessarily increase legal and documentation risk (they must do, since by definition they are contractually incomplete) but they also play havoc with the rules relating to inconsistency considered above. End-users who, for whatever reason, find themselves party to pre-Master Confirmations should ask their advisors to address this issue as part of the relevant Master Agreement negotiations.

Discrepancies may also arise between the terms of the transaction as agreed orally and the terms of the written Confirmation as subsequently received by the end-user from the originating bank. Banks normally record telephone calls for the purposes of resolving disputes as to discrepant terms but that should not prevent the end-user from making its own note of conversations had with the bank's dealing room or from promptly checking the Confirmation and querying any discrepant terms at the point of receipt/prior to signature. End-users should note, additionally, that many banks subject them to standard terms (that do not appear on the face of the Confirmation or anywhere else within the ISDA framework), terms that more often than not provide that Confirmations are binding unless queried within a (very) short period of receipt. Caveat end-user is the lesson here.

ADDITIONAL CONSIDERATIONS IN A MICRO-HEDGING CONTEXT A micro-hedge is a derivative that hedges a specific asset, liability and/or cashflow within an end-users's balance sheet, as opposed to a macro-hedge that provides broad/generic economic protection. Consider, by way of illustration, the difference between a hedge for a floating rate debt instrument of a specific amount, maturity and profile and one that provides protection for an amorphous quantum of

Essential do's and don'ts

What follows is perhaps an unsurprising list of do's and don'ts where Confirmations are concerned:

DO:

- **check that the Confirmation accurately cross-references the relevant Master Agreement.**
- **check key economic terms; ask the originating bank to provide extracts from relevant Definitions booklets for independent verification purposes.**
- **consider whether expert external legal/documentation advice is required, especially in the context of micro-hedges, long-form Confirmations and/or non-vanilla underlyings.**
- **watch for unusual or additional provisions.**
- **ask for and check the signatures of bank officials who sign the Confirmation.**
- **raise promptly any discrepant terms and have the transaction reconfirmed where necessary.**

DO NOT:

- **assume that the documentation of the originating bank is perfect.**
- **sign the Confirmation 'blind'.**
- **transact on a 'pre-Master' basis, unless absolutely necessary.**

LIBOR-based funding. Necessarily, the former demands careful engineering at the economic as well as contractual level to ensure that the hedge moves in synch with the hedged item. Put another way, since "LIBOR" under a given loan agreement does not necessarily mean the same as "LIBOR" under a given swap agreement, the basis risk has to be ironed out contractually i.e. by amendment to one or other of the debt or swap instruments. In relation to most instances of economic asymmetry, it is usually the swap that gives, translating into a necessity for one or more amendments to the relevant Confirmation that would not ordinarily be required in a macro-hedging context.

Micro-hedging has hitherto been a feature of project and/or acquisition financings, where the cashflows of a given Special Purpose Vehicle (SPV) borrower are so sensitive as to demand that basis risk is ironed out to the greatest degree possible. More recently, however, the requirement for "effectiveness" under IAS 39 *Financial Instruments: Recognition and Measurement* demands that corporate hedgers take much more seriously the issue of basis risk between hedges and hedged items. In case it is not obvious, this means the adoption of a much more sophisticated approach when it comes to the terms of individual Confirmations. For a detailed analysis of the issues that arise in a micro-hedging context and their implications for swap documentation generally, see the book *Mastering Finance-linked Swaps*[1].

MOVING OUTSIDE THE VANILLA WORLD While it is fair to say that there is not much that one can 'get wrong' within the context of a Confirmation of a vanilla derivative – particularly a macro-hedge – the same is not true of other types of transaction. The construct and complexity of Confirmations of (and related Definitions for) transactions having as their underlying non-deliverable FX, equities, credit, energy, commodity, inflation and weather – to name but a few – present a significant enough challenge to originating banks and derivatives lawyers. To end-users and other non-cognoscenti, such Confirmations may be unfathomable (particularly when read without access to the relevant Definitions), a fact that does not, in our experience, prevent significant numbers of end-users signing up to them 'blind' or after only the most cursory of internal/external reviews. Our advice is simple – the less vanilla the instrument, the more compelling is the case to have it reviewed by somebody who understands the relevant documentation.

We hope that two key messages emerge from this article. The first is that Confirmations are key – if the Confirmation is not right, then the economics are not right; and if the economics are not right, then the hedge is not doing what it was intended to do. The second is that getting the Confirmation right is not trivial – even, in many cases, if the economic substance of the transaction evidenced by it is. As ever, we return to a conclusion that is thematically consistent with this entire series of articles – pay for advice or, sooner or later, pay for not paying for it.

[1]Gary Walker is author of *Mastering Finance-linked Swaps*, published by Financial Times Prentice Hall in September 2003.

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