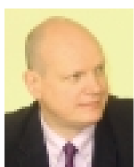
MASTER CLASS IN ISDA



DERIVATIVES EXPERT AND ISDA DOCUMENTATION COMMITTEE MEMBER **GARY WALKER** PROVIDES A 'WARTS AND ALL' OVERVIEW OF THE ISDA 2002 MASTER AGREEMENT.

The ISDA 2002 Master Agreement (the 2002 Master) represents the culmination of a Strategic Documentation Review (SDR) begun by ISDA in late 1999. The aim of SDR was to update the ISDA 1992 Master Agreement (the 1992 Master) to take account of legal developments, changes in risk management practices and practical (as well as, in the case of the Russian debt and Malaysian currency crises and the collapse of Enron, bitter) experiences in the international swap markets. Certainly, all these influences are evident in the 2002 Master.

From a comparative perspective, the number and extent of the revisions heralded by the 2002 Master is unprecedented. Those who recall a similar exercise just over 10 years ago – the transition from the 1987 to the 1992 Master – will know that the number of substantive differences between the then new and then old agreement could be counted on one hand. The 2002 Master, by contrast, reveals in excess of 50 substantive changes over its predecessor.

'THE 2002 MASTER REVEALS IN EXCESS OF 50 SUBSTANTIVE CHANGES OVER ITS PREDECESSOR'

WHAT HAS NOT CHANGED?

Before summarising the changes, it is worth pausing to consider those features of ISDA documentation (good and bad) that SDR has not altered.

ARCHITECTURE, LAYOUT AND OPINIONS. The modular architecture (comprising master, schedule, confirmation(s) and definitions) that characterises ISDA documentation is efficient, malleable and well understood. There was no good reason to alter it as part of SDR and the 2002 Master takes its place within the architecture in the normal way. The layout is similarly unaltered. The 2002 Master comprises 14 sections and a schedule (made up of five parts), all of which, structurally and conceptually, will be familiar to swap-transacting end-users. The process of updating close out netting opinions for the 2002 Master is also underway and is not expected to return any less 'clean' a range of opinions than exists in relation to the 1992 Master.

CROSS DEFAULT ANACHRONISMS. All ISDA master agreements (the 1987, the 1992 and now the 2002) include, for reasons that are beyond the scope of this article, cross default provisions that are both arcane and anachronistic. Two important points for end-users to bear in mind in this context are that

- a default under a derivative entered into between a swap counterparty and an unrelated third party will not, in general, trigger a termination right in favour of the end-user in respect of its own transactions with that counterparty (leaving it vulnerable to a significant degree of counterparty cross default); and
- in respect of a failure by a swap counterparty to repay a deposit (whether the end-user's own or that of a third party), the end-user will not, in general, be able to terminate transactions with that counterparty unless the amount of the deposit exceeds a stated threshold. That threshold, it is suggested, ought to be zero – certainly so far as the end-user's own deposits with the counterparty are concerned.

NECESSITY TO TAILOR. As with the 1992 Master, it is necessary to tailor (through the schedule) the 2002 Master to suit the circumstances of the relationship. As axiomatic as this appears, some end-users remain inclined to sign whatever ISDA documentation they receive from their swap provider, often without reading it or only after a cursory review.

While such an approach may be forgivable in respect of 'portfolio' transactions – that is, transactions entered into for generic balance sheet hedging purposes with a counterparty that otherwise has no relationship with the end-user – it does not make sense where the swap provider is the end-user's relationship

lender and/or where transactions entered into with the swap provider are intended to hedge specific liabilities within the end-user's balance sheet (so called "finance-linked swaps").

At the very least, the early termination provisions of the swap documentation (as elected for in part 1 of the schedule) ought to correspond to their counterparts in the loan documentation and, in a 'finance-linked' context, the relevant confirmation(s) ought additionally to be engineered so that, from a quantum and timing of payment perspective, Libor receivable under the swap(s) corresponds to Libor payable under the related loan(s).

TABLE 1
SHORTENING OF GRACE PERIODS IN 2002 MASTER.

	1992 Master	2002 Master
Failure to pay or deliver	3 local business days after notice of failure	1 local business day after notice of failure
Default under specified transaction (in respect of final payment, delivery or exchange under that specified transaction)	3 local business days after date of final payment, delivery or exchange (if no grace period stipulated in specified transaction documentation)	1 local business day after date of final payment, delivery or exchange (if no grace period stipulated in specified transaction documentation)
Bankruptcy (insolvency or enforcement against assets)	30 days after institution/ enforcement action	15 days after institution/ enforcement action (0 days where institution is voluntary or effected by, eg, lead regulator)

TABLE 2
CHANGES TO CLOSE-OUT METHODOLOGY IN 2002 MASTER.

	1992 Master	2002 Master
Close-out method	Election required between first method (a 'walkaway' provision) and second method (a 'full two-way payments' provision)	No elective: second method applies
Close-out measure	Election required between market quotation and Loss	No elective: 'blended' close-out amount concept applies
Post-termination contractual set-off rights	Typically included as part 5 schedule item	Now integrated as new section 6(f)

WHAT HAS CHANGED?

The changes brought about by the 2002 Master can be divided into four broad areas:

- credit sensitivity;
- force majeure;
- close-out methodology; and
- miscellaneous.

What follows is a summary only and is not a substitute for a detailed review of the new agreement.

CREDIT SENSITIVITY. The 2002 Master displays increases in credit sensitivity that range from the subtle to the conspicuous. Since the subtle are just that – and merely tidy up existing provisions of, or address lacunas within, the 1992 Master – we do not consider them here. It is more interesting to compare how the grace periods applicable to certain events of default (common to both masters) have been shortened. *Table 1* illustrates the key differences.

FORCE MAJEURE AND ILLEGALITY. By way of supplement to the Illegality provisions within the 1992 Master, the 2002 Master introduces 'force majeure' (that is, impossibility of performance) as a new termination event.

Both concepts are further overlaid with a 'waiting period' (effectively a cure window) of up to three local business says (in the case of an Illegality) and up to eight local business says (in the case of a force majeure event).

The overall effect of the provisions is to suspend the occurrence of an event of default (where occasioned by an Illegality- or force majeure event-triggered payment, delivery or other performance failure) for a short time in the hope that the relevant inhibitor will 'go away', enabling the affected party to perform as contractually bound.

CLOSE-OUT METHODOLOGY. The most important feature of the 2002 Master is its revised section 6 (Early Termination: Close-Out Netting). In broad terms, 'first method' has been dispensed with altogether, the 'market quotation' and 'loss' electives have been blended into a new concept – 'close-out amount' – and a contractual set-off provision has been introduced as standard into the main body of the agreement. *Table 2* summarises the differences.

MISCELLANEOUS. Space permits only a brief listing of the numerous other changes brought about by the 2002 Master. As well as amendments to the tax, notice, jurisdiction and 'entire agreement' provisions, the interest and compensation provisions have been overhauled and now differentiate between late, deferred, suspended and defaulted payments.

Most significantly, the suite of ISDA-standardised non-reliance representations (that swap providers have become accustomed to inserting as 'non-negotiable' part 5 schedule items within 1992 Masters) has been moved into the schedule as a Part 5 elective – an overdue acknowledgment by the swap-providing community that non-reliance representations are entirely negotiable and that their inclusion, omission or extent depends not on swap provider policy constraints but on the precise circumstances of the relationship between swap providers and their (in an end-user context, usually less sophisticated) counterparties.

'END-USERS SHOULD TREAT A REQUEST TO MIGRATE TO THE 2002 MASTER WITH A DEGREE OF CIRCUMSPECTION'

MIGRATION ISSUES

There are three alternatives available to end-users in relation to the 2002 Master:

- do nothing, (which may, given what we say below, be a plausible decision);
- by means of ISDA's recently published form of Close-out Amount Amendment Agreement, transplant into existing 1992 Masters the new close-out amount concept (but nothing else); or
- effect a full and formal migration to the 2002 ISDA by way of amendment and restatement agreement.

The latter route involves time and effort, necessitates legal due diligence and has attendant consequences for related credit support documentation.

CONCLUSIONS

How relevant is the 2002 Master to the end-user community? This is an interesting question. Key to answering it lies in the recollection that the new document is, in large part, motivated by recent events and experiences on the international stage.

To give an example, consider the new close-out amount concept. This blends the best of market quotation and loss and at the same time confers a huge amount of discretion and flexibility upon the non-defaulting party (albeit fettered by a duty to act in good faith and an overriding requirement for commerciality) when it comes to valuing terminated transactions.

In the context of a severely disrupted market (Enron is a case in point), that discretion and flexibility (coupled with shortened grace periods in the first place) is enormously helpful. But is it really necessary in the context of a low volume, domestic end-user of vanilla derivative products? The answer is probably not – an interesting point for end-users to bear in mind when their swap providers come-a-knocking.

Although swap providers are likely to counter with a 'competitive inequality' argument – contending that, as a community, they have more to lose (because they have more transactions outstanding) and lose more frequently (because it is end-users, not they, who tend to default) – the lesson is that end-users should treat a request to migrate to the 2002 Master with a degree of circumspection; and in any event should not do so without seeking appropriate legal advice or, in a 'finance-linked' context, considering the degree to which the terms of related credit agreements have a prescriptive influence on the terms of the Master.

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