Keeping to ISDA's schedule

There are many important issues that will require negotiation before accepting the terms of the schedule to an ISDA 1992 master agreement. **Gary Walker** and **Guy Usher** reiterate the point that swap documentation is far from being a standard form that can be automatically accepted.

The documentation for a swap agreement will nearly always end up being intertwined with other contracts for financial assets and liabilities to which the swap user is a party. It is the swap schedule which will govern this inter-relation with other agreements and parties.

THE SCHEDULE – AN OVERVIEW. The five-part schedule is the vehicle through which the parties amend the terms of the master agreement to reflect relative creditworthiness and to address certain operational and structural issues. By and large, bank swap providers send 'standard' schedules to their corporate counterparties. These rarely take into account entrenched/negotiated positions, either between the end-user and the bank, or between the end-user and the banking community in general. Often, such schedules are inaccurate and unsophisticated formulations that are 'sold' to the end-user as market standard and non-negotiable. A review of such schedules invariably reveals glaring defects – particularly in relation to micro-hedging transactions.

PART 1. TERMINATION PROVISIONS. There are three concepts, in particular, within part 1 of the schedule, that are generally misunderstood, but greatly influence the sensitivity of the master agreement to a default by one or other of the parties. These concepts are:

SPECIFIED ENTITY: By designating a specified entity in relation to one of the parties (X) to a master agreement, any financial problems in the specified entity will feed back into deals done under the master agreement. The occurrence of certain events (including cross default and insolvency) will give the other party (Y) the right to terminate all transactions between X and Y.

To illustrate the far-reaching consequences of such a designation, imagine that a bank stipulates, with respect to a corporate customer, 'insolvency of any affiliate' as a termination event. (Note that this is a paraphrase. Typically, the actual provision within the schedule will read: 'specified entity' means, in relation to party X for the purpose of Section 5(a)(vii), any affiliate'. This is hardly a transparent formulation.)

If a relatively insignificant affiliate of the end-user is wound up, the bank can legitimately use this event to terminate all outstanding transactions under the master agreement. If this happens at a time when the end-user is significantly out of money, the end-user will rue the fact that, had it considered the matter, it would have sought to narrow the ambit of the designation. It could have done this either by restricting the meaning of 'specified entity' to certain named affiliates, or by subjecting the definition of 'affiliate' to a 'material net assets' test.

But a lack of transparency within ISDA documentation, coupled with a belief that the documentation itself is standard form and does not merit a read in the first place – as well as endemic reluctance to seek expert external advice – all conspire against the end-user. This can prevent the user from considering the issue at all.

Executive summary

- **In the schedule to an ISDA 1992 master agreement, the parties involved amend terms to reflect creditworthiness and address operational and structural issues.**
- **There are three concepts in part one of the schedule – termination provisions – specified entity, default under specified transaction and cross default. They are generally misunderstood and can make a master agreement more sensitive to default by a party.**
- **A lack of transparency in ISDA documentation, coupled with the belief that it is standard form, combine to prevent end-users from considering termination provisions, such as 'specified entity', in detail.**
- **Banks always require end-users to make tax representations. A breach here can leave the end-user having to gross up for any witholding taxes – but with no right to terminate the agreement.**
- **Requirements to deliver documents in connection with the master agreement should be scrutinised. The end-user should also consider which documents need to be seen from the bank itself.**

DEFAULT UNDER SPECIFIED TRANSACTION. A specified transaction is a derivative transaction between any combination of the parties to the agreement and their respective specified entities and credit support providers. It is broadly defined but excludes derivatives entered into under the master agreement itself. *Figure 2* provides a matrix of specified transactions.

A default under a specified transaction has far-reaching consequences. As an example, suppose a bank designates, with respect to its end-user swap counterparty, 'default by an affiliate of the end-user under a specified transaction' as a termination event. (Note again that this is a paraphrase. Typically, the schedule will read: 'specified entity means, in relation to party X for the purpose of Section 5(a)(v), any affiliate.')

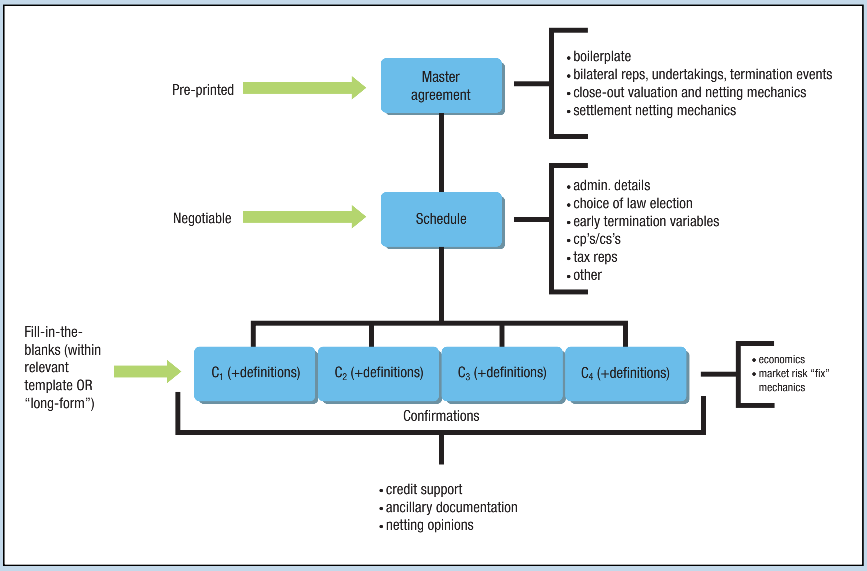
Such a designation will mean that a default by any affiliate of the end-user under a derivative transaction between that affiliate and the bank, or any credit support provider or specified entity of the bank will give the bank a right to terminate all transactions under the master agreement.

The same analysis applies to defaults by the end-user (or by any credit support provider of the end-user) in respect of other specified transactions. It is fair to say that very few end-users appreciate the additional early termination risks inherent in such seemingly innocuous provisions.

CROSS DEFAULT. Cross default is a similar concept to the regime applicable to defaults under specified transactions, but there are differences:

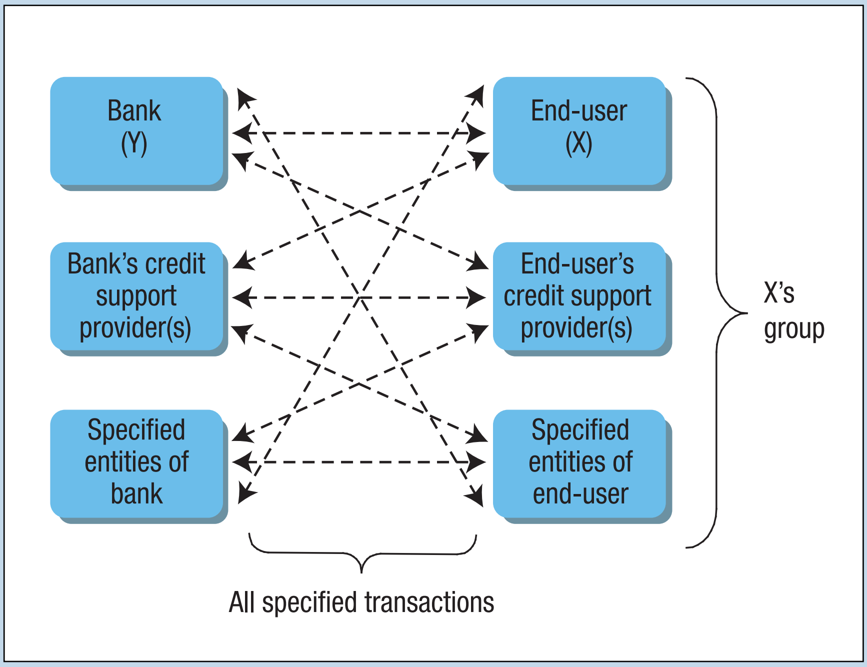
- It bites on specified indebtedness (i.e. obligations in respect of borrowed money) and not on derivative exposures.
- It is subject to a threshold test i.e. the amount of defaulted principal must exceed a given figure before a cross default is triggered.
- It relates to all third-party indebtedness and not just exposure subsisting between the two

Figure 1. The ISDA contractual framework.



The schedule is used to tailor the generic provisions of the master agreement

Figure 2. Matrix of derivative transactions within the specified transactions definition.



parties and a limited guarantor/affiliate network.

- It acts as a cross-default provision 'proper' (and not merely as a cross-acceleration clause) and so is correspondingly more sensitive.

Table 1 compares the two regimes – default under specified transaction and cross default – in detail.

The two regimes are inconsistent *inter se*, incomplete and require thought around the areas of scope of application and thresholds. ISDA acknowledges the existence of these shortcomings, but inexplicably has never sought to address them. However 'savvy' members of the market invariably amend their master documentation to account for them. As always, expert advice is the only way the end-user can ensure signing up to a contract that is both understood and wanted.

At a practical level, it is worth remembering that a corporate's own deposits with a bank will fall within the definition of specified indebtedness for the bank. This is good news for the corporate if ever the depositee bank runs into difficulty as the corporate will be able to terminate transactions outstanding under its master agreement with that bank. However, many banks will carve out deposits for this very reason. Alternatively, it may be that few deposits will ever be large enough to breach the threshold required to trigger a cross default in the first place.

However, there are solutions to these problems and a well-advised corporate will know them. Note that these are only some of the issues that arise in respect of Part 1 of the schedule. There are many others.

Table 1. Cross default vs under specified transactions – in detail.

CROSS DEFAULT

APPLICABLE TO: Specified indebtedness (full universe of debt).
TRIGGER: Cross default or cross acceleration.
THRESHOLD: As agreed between the parties.

DEFAULT UNDER SPECIFIED TRANSACTIONS

APPLICABLE TO: Specified transactions (limited universe of derivative counterparties).
TRIGGER: Cross acceleration only.
THRESHOLD: None applicable.

PART 2 – TAX REPRESENTATIONS. Nearly all of the English incorporated companies transacting vanilla derivatives business with English incorporated banks (or with London offices of foreign incorporated banks) only need to make (and receive in return) the 'standard' payer representations set out at part 2(a) of the schedule. They can safely ignore the payee representations And in all other cases, specialist tax/legal advice should be sought.

It is worth remembering that banks will always require end-user counterparties to make representations of one kind or another, for reasons other than a change in tax law or a failure to provide relevant tax documents. A breach of representations will lead to the end-user having to gross up for any withholding taxes but with no right to terminate.

PART 3 – AGREEMENT TO DELIVER DOCUMENTS. Any requirement on the part of the end-user to deliver documents in connection with the master agreement should be scrutinised. Is the requirement consistent with what the end-user is required to deliver under its committed loan facilities? Does the bank already hold the information? Is the requirement to deliver tax forms logical? Does the bank want a legal opinion and is that reasonable? At the same time, the end-user should think about what documents it requires to see from the bank itself. At the very least, it ought to ask for a copy of the bank's authorised signatory list.

PART 4 – MISCELLANEOUS. For English-law governed master agreements entered into by English incorporated end-users, there are a couple of points worth mentioning. First, a process agent will only be required if the bank counterparty is incorporated overseas. Evidence of the process agent's appointment is a worthwhile stipulation in this regard.

Second, where the bank counterparty is the London office of a foreign bank, the correct structural route is to enter into the master agreement with the overseas head office of the bank. The bank's London office will then have to to be designated under Part 4(d) as a multi-branch office. The (structurally flawed) temptation is for the end-user to enter into the master agreement directly with the London office.

Third, if single-transaction (versus cross-transaction) settlement netting is to apply, it is necessary, to state that the disapplication set out at Part 4(i) will not apply. This wording always seems counter-intuitive.

PART 5 – OTHER PROVISIONS. All provisions inserted into this part of the schedule need careful and considered review. Many are not required and even those that are legitimate are often poorly drafted or have undesirable credit, legal, tax, accounting and other implications. Again, expert external advice is the principled and recommended course of action in each case.

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Note: It is the schedule to the ISDA 1992 master agreement which is being considered here, since the 2002 version has yet to gain widespread acceptance or usage. ■