ISDA documentation – back to basics for corporate treasurers

Corporate treasurers' attitudes towards ISDA documentation is that of a 'seen it all before' nature, but have they? Far from being 'standard form', they might be surprised at what they find if they take a closer look.

Widely perceived as being standard form, largely non-negotiable and simply a matter of filling in a couple of blanks within a schedule to its rear, International Swaps and Derivatives Association (ISDA) documentation, in general, gets pretty short shrift from corporate treasurers who have seen it all before and who scoff at the idea that they might be missing a trick.

There are, however, a number of end-user beliefs which can be seriously questioned. These include:

"ISDA documentation is standard form." While it is highly standardised and adopts a building block approach that is intended to facilitate its use in the context of a wide variety of derivative instruments, ISDA documentation is not standard form. If one 'reduces to standard' a contract that has to deal with volatile two-way credit exposures, skewed credit standings, complicated economics and all manner of market and other disruption events, does it not then follow that those parts of the contract that remain open to negotiation, by reason of the fact they are incapable of being 'reduced to standard', deserve much greater attention? Put another way, while the modularity and standardisation that characterises ISDA documentation takes most of the pain out of negotiations, what is left is 'critical stuff' – and it is this 'critical stuff' that is anything but standard and that needs careful and informed consideration.

"My bank will provide an accurate contract". If only this were true. Time and time again, we are confronted by bank-prepared ISDA documentation that is structurally flawed, economically inconsistent, non-reflective of the bank's relationship with the end-user or simply inaccurate. There are many reasons for this. First, ISDA documentation is drafted primarily with the inter-bank market in mind and many bank-employed negotiators find it difficult to adjust their thinking (let alone redraft the contract) when it comes to preparing documentation for end-users. To be fair, such negotiators are seldom, in our experience, given any information about the end-user or the motivations behind the underlying transaction. Second, many end-user transactions are vanilla, small-ticket and not that profitable for the bank. So there is little desire or economic incentive on the part of the bank to throw resource at the documentation in the first place. Third, albeit out of a desire to execute the documentation as quickly and costlessly as possible, banks implicitly discourage end-users from taking legal advice by playing the "standard form" card. Fourth, many banks still do not fully understand the nuances of ISDA documentation, nuances that are often critical when viewed from an end-user perspective. Fifth and finally, the documentation itself is not perfect to begin with. Needless to say, all of these factors contribute to defective, under or over-sensitive and unreviewed contractual arrangements.

Executive summary

- **Existing beliefs relating to ISDA documentation should be questioned. It is not necessarily "standard form" and banks do not always provide "accurate contracts" suitable for non-bank users.**
- **Beliefs regarding the documentation's logic, and the stability of derivatives law/documentation should also be questioned. A professional legal review is essential in most cases.**
- **A "holistic" approach that takes account of existing relationship/finance documentation between corporates and their banks as well as the swap documentation is recommended.**
- **Structural issues such as the form the documentation takes as well as the extent and scope of collateral arrangements must be considered.**
- **Default sensitivity should also be examined on both sides – that of the corporate and that of the bank.**
- **Corporates should consider their relationships with their banks in terms of borrowings and deposits when drafting the ISDA documentation they enter.**

"My approach to ISDA documentation is logical and reflects that of my peers". This should be analysed from the perspective of documentation for cash, derivative and debt finance transactions. What is the right approach in each case? For cash, you receive a one-page confirmation. In this instance, a short piece of paper for a low risk, short-term transaction is rational. For debt finance (including syndicated and debt capital market) transactions, you invariably instruct your lawyers to review the lengthy facility documentation that you receive from your bank/arranger and then spend hours negotiating the various representations and events of default. Your concern, rightly, is that you do not unnecessarily expose yourself to the risk of your own default (the bank's default not being an issue since you have no rights against it). This again is rational. In the case of derivatives, you have significant rights against (as well as obligations to) the bank, but may have been cajoled into thinking – not only by the bank but also by the form that the documentation takes and by your own preconceptions – that the contract is much simpler than it really is. So you do not negotiate it at all. Your approach, like that of many of your peers, is paradoxical at best; irrational at worst.

"Derivatives law/documentation is settled and does not change". Again, this is not true. One very recently decided case – Enron Australia vs. TXU Electricity – not only goes to the heart of certain key provisions of the ISDA master agreement (and is likely in due course to necessitate an industry-wide amending exercise) but also threatens to further delay IAS 39. The new 2002 ISDA master agreement also looms large and, while many banks argue that this represents light at the end of the tunnel, we – like many commentators – suggest that, for end-users at least, that light is much more likely to signify the front of an oncoming train.

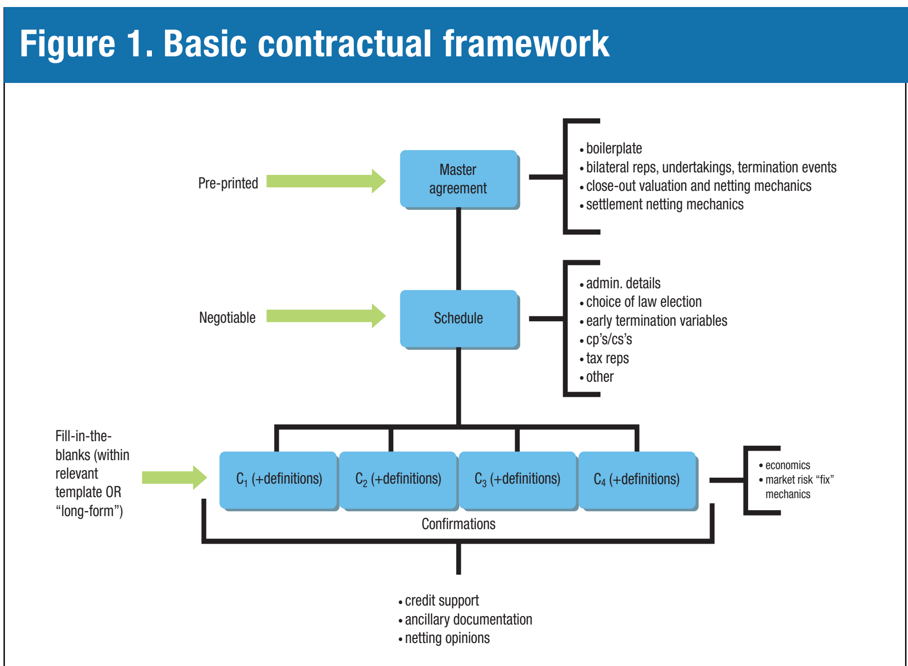
"I do not need/want legal review". You may argue that you fully understand ISDA documentation. Without wishing to be arrogant, we know that you do not. Two serious points do arise, however. The first is that most areas of corporate business are subject to the discipline of an in-house legal function that itself controls the budget for external legal spend. In most cases, the one and obvious exception occurs in relation to the treasury function, where it is not unusual for the treasurer to decide whether, when and whom to instruct and how much to pay when it comes to legal spending. In our experience, many treasurers prefer to do the legwork themselves and 'save' the cash. The second point is that, in almost all cases, the treasurer does not have a full set of documents to begin with. Most notably, he or she does not have to hand the relevant set of ISDA definitions that are incorporated by reference into individual Confirmations. Consequently, they end up reviewing 'blind' a significant – and highly important – part of the contractual framework. How many treasurers, for example, can honestly say that they know the circumstances in which a cash-settled swaption will be automatically exercised under the 1991 or 2000 ISDA Definitions?

"My existing lawyers do not have the capability to advise". This may be true. Outside of the magic circle and a handful of London-based US law firms, there are only a dozen or so legal practices in the UK that truly understand enough about derivatives or ISDA documentation to be able properly to advise you.

KEY NEGOTIATING POINTS. One popular approach towards end-user ISDA documentation is "holistic". This means not looking at the swap documentation in isolation but instead taking account of any existing relationship/finance documents between a bank and a corporate, together with the corporate's relationship with the banking community in general. Other approaches may be considered myopic and lead to unnecessary documentary, credit, economic and other risk.

STRUCTURAL ISSUES. At an organisational level, many UK corporate treasurers enter transactions with the head office of a UK/London bank or with the London office of a foreign bank. In cases other than these, special care is required around the tax representations in Part 2 of the Schedule and the head office liability/multibranch provisions in Part 4 of the Schedule. Other structural issues concern the form the documentation takes (e.g. full ISDA vs. standalone Confirmation vs. ring-fenced ISDA) as well as the extent and scope of any collateral arrangements (cash/other; dynamic/static; one-way/two-way etc.) and the likelihood of obtaining any required waivers of negative pledges.

Figure 1. Basic contractual framework



DEFAULT SENSITIVITY. Few corporates have a system that enables them to track the default events to which they may be subject to, let alone a formal policy aimed at harmonising these events wherever possible. The result is that the 'lowest common denominator syndrome' operates. In other words, since all the credit agreements to which they are party (debt as well as derivative) are inevitably structured to cross-default to each other, a triggering of the most sensitive among them will bring the house down. Nor do many corporates take seriously the possibility that their bank counterparty may itself default. In many cases, they are also unlikely to look overly hard at the new (and much, much more default-sensitive) 2002 ISDA master agreement when, as is inevitable, it confronts them.

ECONOMIC SYMMETRY. A further issue relates to the type of hedge that a corporate treasurer is buying – macro/generic vs. micro/finance-linked. The latter type of transaction requires significantly more engineering than the former – particularly at the confirmation level – if a perfect economic hedge is to be achieved. IAS 39 may itself impose additional disciplinary constraints in this regard.

RELATIONSHIP ISSUES. Finally, corporates need to consider their relationships with their banks. Over and above its swap lines, a corporate needs to ask whether it deposits cash with or borrows money from its bank. And if so, if needs to address the "what ifs" – i.e. "what if I default on the loan?; what if the bank does not repay my deposit?; what does this mean for derivative transactions with the bank?" It also needs to consider the extent to which it is relying on the bank for advice etc. in relation to individual derivatives under contemplation. All these questions inevitably transgress into the contractual arena and ought to influence the drafting of the ISDA documentation entered between a corporate and its bank.

PRELIMINARY CONCLUSIONS. Three generalities must always be considered. First, most corporate treasurers (as well as their lawyers and accountants) need to adopt a significantly more sophisticated and mature approach to the contractual aspects of their derivative relationships.

A formal corporate policy on such matters would be a sensible starting point. Second, many banks have yet to realise that wholesale/inter-bank and end-user transactions are as different as chalk and cheese and that the extent of the divide probably merits a formal bifurcation of approach at both credit and legal/documentation levels. Third, where micro-hedges are concerned, bespoke and ring-fenced documentation is necessary to ensure a perfect economic hedge that both tracks and is tracked by the hedged instrument.

The forthcoming series of articles is intended to provoke debate and encourage progess in all three of these areas.

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