Feature

KEY POINTS
- Lehman and the defaults by the Icelandic banks have provided a wake-up call. Weaknesses in the International Swaps and Derivatives ('ISDA') documentation previously seen as remote, have become a reality.
- Principal major weaknesses in the ISDA Master Agreement include flawed negotiated documentation, harsh termination notice provisions and difficulties in forcing close-out – and in the Credit Support Annex, the confusion surrounding differences in the English and New York forms and re-hypothecation risk.
- The authors recommend that all active derivatives counterparties prepare a battle plan setting out who does what on an event of default and when and how they do it.

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The ISDA Master Agreement and CSA: close-out weaknesses exposed in the banking crisis and suggestions for change

Lehman Brothers Holdings Inc filed for Chapter 11 bankruptcy on 15 September 2008 causing the London arm to fall into administration and the entire Lehman group to begin to topple. Until then the ISDA Master Agreement and its Credit Support Annex ('CSA'), periodically finetuned over the years, had coped admirably with all insolvencies thrown at them.

None of these stress tests though involved the default of a leading financial institution and derivatives market maker. The Lehman and Icelandic bank defaults have bared significant cracks and weaknesses in this documentation and several market practices. In this article Edmund Parker and Aaron McGarry analyse these flaws and argue for changes in the documentation, both from the International Swaps and Derivatives Association ('ISDA') and in the practices of the market in general.

LEHMAN AND THE ICELANDIC BANKS: WEAKNESSES EXPOSED

The derivatives exposure of Lehman entities, Kaupthing, Glitinir and Landsbanki is and was huge. According to its administrators, the London arm of Lehman Brothers alone had roughly 8,000 ISDA Master Agreements in place with around 67,000 open trades under them when it went into administration. The complexity of this market exposure was leveraged by the number of Lehman entities (in multiple jurisdictions) involved. For Lehman's London arm alone, the administrators have produced a 97-page list of counterparties spread across the globe. Close-out on a grand scale has moved from a 'what if' theoretical scenario, into the real world of how massive volumes of derivative trades can be closed out.

We see the principal major weaknesses in the ISDA Master Agreement exposed as (i) flawed negotiated documentation; (ii) harsh and 'easy to fall foul of' termination notice provisions; (iii) difficulties in forcing close-out of a master agreement; (iv) weaknesses in the market quotation mechanisms and fall-backs in a distressed market; (v) lack of agreed level of detail in calculation statements; and (vi) lack of infrastructure for counterparties dealing with defaults.

We see the principal major weaknesses in the Credit Support Annex exposed as (i) confusion surrounding the differences in the English and New York forms; (ii) re-hypothecation risk; (iii) daylight risk (the risk of a movement in mark to market exposure accompanied by a default, prior to the delivery or return of collateral); and (iv) quality of collateral risk.

MASTER AGREEMENT WEAKNESSES

The weaknesses described below apply generally to both the 1992 and 2002 ISDA Master Agreements unless otherwise stated.

Problems triggering a default when the ship is sinking

In the last few years it has not been uncommon for counterparties to enter into a derivatives transaction, deem an ISDA Master Agreement to apply, and never get round to actually negotiating an ISDA Master Agreement. When this happens, language incorporated into the confirmation states that the parties will use reasonable efforts to negotiate a Master Agreement soon; and indeed most ISDA templates provide optional boilerplate language to this effect.

In the recent Lehman bankruptcy we encountered several cases where the relevant Lehman counterparty had been a foreign subsidiary or swap financing vehicle.

Problems arose specifically with Lehman Brothers Special Financing Inc ('LBSFI'), which did not file for bankruptcy until 3 October 2008, three weeks later than its parent. Several non-defaulting parties were left unable to trigger a default until LBSFI finally did file for bankruptcy. In the meantime some of these counterparties were left sitting on a massive exposure, even though the rest of the group had already sunk.

Where a negotiated schedule was already in place, this was unlikely to be a problem. The parties would usually name the parent company as a credit support provider or a specified entity in the schedule, allowing the non-defaulting party to trigger an event of default as soon as that entity filed for bankruptcy.

Although ideally the deemed master agreement practice should cease, we fear that practically the problem will always be with us. We suggest that best practice would be for ISDA to prepare a specific protocol. If incorporated, in addition to providing deemed standard elections, the protocol would also provide that any group parent company or subsidiary issuing or taking on capital markets debt would be deemed to be a specified entity for the purposes of a bankruptcy event of default pursuant to s 5(a)(vii) of the master agreement.

We propose that this should also be a fall-back election in the Master Agreement, with it being left to the parties to dis-apply this in the schedule. This would strengthen the negotiating hand of counterparties negotiating from a weaker position.

Murky areas surrounding termination

Perhaps the biggest weakness in the Master Agreement relates to the confusion, traps for the unwary and lack of options present for a non-defaulting party serving a termination notice on its defaulting counterparty. All of these can lead to a delayed or botched close-out.

Many Master Agreements still in use are based on the 1992 version, which contains the greatest weaknesses. The 2002 version, although correcting several of the 1992 version's flaws (such as flaws relating to the quantum of default interest payable), also contains several problem areas. In general, we recommend that all counterparties use the 2002 version or update any schedule for a 1992 version to include the improvements of the 2002 version.

Notice delivery methods

Notices under an ISDA Master Agreement can be sent in a variety of ways: post, fax, telex, electronic messaging system; and in the 2002 version, by email too. Notice of an event of default though is not valid by fax or email in the 1992 version. In the 2002 version, notice by email is also not permissible, and if by fax must be in legible form and received by a responsible employee of the recipient. The onus of proof is on the sender, effectively ruling it out as a safe form of delivery. Hand delivery of a termination notice is the only secure means of designating an event of default. When a market counterparty has master agreements in place with multiple Lehman entities, the Icelandic banks and others scattered across the globe for example, this can be an onerous requirement.

Anecdotal evidence suggests that many non-defaulting parties have been caught out by these restrictive notice provisions. If a party closed out a master agreement by sending a fax notice under the 1992 agreement, the positions will remain open. The same is true of a notice delivered by email under both agreements. Of course, counterparties should always read the documents. The consequences of an honest mistake though seem to be particularly harsh.

We would suggest that ISDA prepares a general market protocol open to market counterparties to sign up to and/or going forward to incorporate into future agreements. The protocol would allow delivery of a notice of event of default by fax or email to be deemed to be valid if related to bankruptcy of the counterparty, or a specified entity which is a parent company, and a contrary interpretation would be unfair. A more radical proposal would be for ISDA to establish an infrastructure for it to act as a central close-out counterparty, with an email notice of default sent to ISDA triggering a close-out and an electronic notification automatically being sent to the defaulting counterparty.

Effective dates

The Master Agreement provides that a notice not delivered to a defaulting counterparty within 'business hours' is deemed to be delivered the next business day. There is no guidance as to what 'business hours' is. Indeed this may vary not only company to company but also jurisdiction to jurisdiction. The significance of this is that the master agreement provides that an early termination date cannot be earlier than the effective date of the notice of event of default. In the recent run of defaults it has been quite common for non-defaulting counterparties to designate the date of the notice of event of default as the early termination date. How some of the late evening deliveries of these notices could be construed by the courts remains to be seen: it is possible that an early termination date could be ruled invalid (and the calculations carried out on that date), where the effective date of the notice was ruled to be after the designated early termination date. We suggest that the ISDA Master Agreement should be modified to allow the early termination date to be before the date of the notice of early termination in these circumstances, to rule out this potentially harsh interpretation.

I want to live forever: Master Agreements which will not die

On 13 November 2008, Lehman's parent company and its US affiliates in bankruptcy filed a motion requesting that Lehman be allowed to assume, assign or terminate a large proportion of its derivative contracts executed under ISDA Master Agreements. The main driver behind the motion was a realisation that the existing mechanisms within the Master Agreement do not allow the defaulting entity to close out trades where they are 'in the money' and their counterparty has not triggered an event of default or termination event.

To maximise the bankrupt estate, the motion seeks a set of measures allowing effective close-out of existing trades under outstanding Master Agreements by assigning these to third parties willing to make a payment to take these on, without seeking the counterparty's consent.

Though this action is radical it is easy to have sympathy with Lehman. Section 2(a)(iii) provides that a party does not have to fulfil its obligation to pay amounts owed under the Master Agreement if an event of default or potential event of default has occurred and is continuing with respect to its counterparty. The temptation for any non-defaulting 'out of the money' counterparty, therefore, is to sit and wait for the mark-to-market price to move in its favour, before closing out the transaction. Arguably this is 'First Method', through the back door: the non-defaulting party can walk away.

Suspicions that this is occurring seem to have led to the motion. We would suggest inserting a fallback provision in any future version of the Master Agreement moving to automatic termination once one party has become bankrupt after a long stop date has been passed, eg perhaps one month.

Market quotation and the lack of a market

Recently there have been problems in finding reference market-maker banks willing to realistically price transactions following a major default.

The vast majority of Master Agreements elect 'Market Quotation' as the payment measurement for calculating close-out amounts and indeed the 2002 version uses an element of market quotations in its close-out amount definition.

When there is a breakdown in the operation of the market (ie following a major default where all market-makers are concentrating on closing out their own transactions rather than trying to enter new ones), it becomes difficult for a determining party to achieve the minimum three quotes from reference market-maker banks to calculate what the 'Market Quotation' for any transaction is.

The fall back for failing to obtain a market quotation average price is the 'Loss' method with the determining party calculating what their loss is using reasonableness and doing so in good faith. This can bring its own problems and potential disputes between parties as to what the loss reasonably is.

Can it always be said in the midst of such a market breakdown, that prices quoted are indeed a fair reflection of what a party would pay to enter such a transaction? It remains to be seen whether allegations will be made that prices have been quoted on the basis of what would be helpful to that particular party in reaching a replacement cost which is lower (or higher) than it should be depending on its position.

We have been here before. *The Peregrine Fixed Income Limited v Robinson Department Store plc* case (Commercial Court, 2000) showed that Market Quotation could in certain circumstances produce unreasonable results. The introduction in the 2002 ISDA Master Agreement of the Close-out Amount system that sought to combine the best of the Market Quotation and Loss mechanisms should help with this, and indeed the market has been moving towards this. Anecdotal evidence suggests that many banks now prefer to use the 2002 version, although it has not reached wholesale sole use with some participants, including many corporates, still preferring the older 1992 Master Agreement.

In addition to wholesale adoption of the 2002 Master Agreement, a possible solution is for ISDA to hold an auction system, much like they already do for credit defaults, on what market participants believe to be a fair price in a market distress situation. This would be complicated, and for this reason may never happen. A simpler solution though would be to refer to exchange traded prices, if exchange traded interest, foreign exchange and credit derivatives take off.

Calculation Statement: a move to a standardised form

When notifying a defaulting party of the quantum of a termination payment, the non-defaulting party must also deliver a calculation statement as proof of how any amounts were calculated.

In the main such statements are often spreadsheets of figures and prices that mean very little to anyone outside that particular institution and are difficult to follow without adequate explanation.

We believe a template calculation statement would help, and suggest that ISDA prepare a form readily acceptable to the market, after consultation. We believe that the form should contain agreed on and adequate details to verify amounts reached and claimed by the determining party with a separate dispute system built in.

CREDIT SUPPORT ANNEX WEAKNESSES

English and New York form differences causing confusion

Although there is just one form of ISDA Master Agreement that is applicable under both New York and English law, the same is not true of the Credit Support Annex ('CSA'), which has separate formats for these jurisdictions. A lack of market understanding of the key differences between them, particularly in relation to rights in transferred collateral, exacerbated problems in the recent wave of market defaults.

The effect of choosing one form over the other may have a significant effect on the treatment of collateral following a close-out. Under an English law CSA any collateral listed as 'Eligible Collateral' is delivered to the other party, by an outright transfer of title. The collateral taker becomes the outright owner of that collateral free of any interest or liens of a third party, and is free to dispose of it. The collateral taker must give back equivalent collateral, although crucially not the identical collateral, if and when the exposure reduces.

Under a New York law CSA the collateral provider retains a first ranking security interest in transferred collateral; helping to reduce daylight risk where exposure reduces, but collateral has yet to be returned. The effectiveness of this security interest is reduced and often negated by allowing the collateral receiver to re-hypothecate the collateral (see further below).

Each form has its own advantages and disadvantages, the English law CSA transfers title completely and the New York CSA provides an illusory security. The central weakness though is the lack of understanding and previous reluctance to use a third party custodian to hold the posted collateral.

Re-hypothecation

The New York CSA permits re-hypothecation (ie the collateral taker to transfer the collateral to a third party free of encumbrances, to cover its own exposures under separate derivatives agreements). This is despite the first priority interest and lien retained over the collateral by the collateral giver. This is the default position as set out in para 6(c) of the New York CSA.

This exposes the collateral provider to the risk that the collateral taker becomes insolvent and prior to the collateral provider designating an early termination date under the ISDA Master Agreement, the mark-to-market exposure moves back to the collateral provider. The collateral provider may then find that the securities it believed it had a security interest over had previously been transferred to a third party, which can now set these off against its own exposure to

Biog box

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the bankrupt entity. This was a relatively common problem in the Lehman bankruptcy.

We recommend that parties consider the risks of re-hypothecation, and consider dis-applying the provisions in the New York form which make this possible.

Daylight risk

Both the English law CSA and New York law CSA have 'daylight risk'. Both forms provide a grace period for the collateral taker to transfer collateral back to the collateral provider if an exposure has reduced. The regularity with which valuations to assess exposure take place can also magnify 'daylight risk'. Monthly and weekly valuations are not unknown.

We recommend that when negotiating a CSA the grace period for returning collateral is reduced to a minimum and that daily valuations of exposure are carried out. Of course, there may be a cost element to this, and this should be weighed up against the risks involved.

Where this daylight risk becomes crystallised (ie on an early termination date) a counterparty to an English CSA will find itself as an unsecured creditor, and likely to find itself entitled to only a fraction of the value of the collateral it transferred.

With a New York CSA a first ranking security in the collateral at least offers some chance of reclaiming the collateral provided; however transferred cash collateral co-mingled with other funds or re-hypothecated collateral are both likely to leave the collateral provider in the same position as an unsecured creditor.

The recent market defaults have highlighted what were previously thought of as remote risks as genuine weaknesses, and we expect to see revisions of the forms and/or market practice to deal with this in the future.

Quality of collateral: beware toxic waste!

The current woes of valuing and lack of market for asset-backed securities is well known. A further problem has arisen though where these assets have be transferred as 'Eligible Collateral' under a CSA. In the main, collateral that is acceptable under an English CSA tends to be restricted to cash or sovereign bonds of western economies with a suitable haircut.

The New York CSA however offers a broader scope as to what is eligible, and, as such, it is wise for a counterparty to ensure that the quality of collateral receivable is sufficiently liquid, notwithstanding the level of any haircut.

INTERNAL PROCEDURE RECOMMENDATIONS

We recommend several procedures a prudent counterparty should introduce internally to minimise some of the risks discussed above.

Full audit of live Master Agreements and CSAs

Any entity that enters into Master Agreements will have comprehensive records of those that are live and what transactions are taking place under them.

We strongly recommend carrying out a full audit to produce a central populated spreadsheet that lists:

- every trade;
- every counterparty;
- the exposure;
- what role each party has (who is the calculation agent?); and
- the crucial elements elected to in the Schedule to the Master Agreement (including whether Automatic Early Termination applies) and any CSA.

This will allow a counterparty to be fully informed and able to make decisions quickly and decisively if the creditworthiness of a counterparty becomes a source of concern.

Prepare template forms of notices/calculation statements

If a default occurs the non-defaulting party must move quickly to mitigate its risk and close out outstanding transactions efficiently.

We recommend preparing template forms of notices which can easily be populated with the relevant variable details and delivered to the defaulting counterparty within business hours and by hand or courier so as to fully comply with the requirements.

The same idea should be applied for template calculation statements providing as much detail and as clearly as possible in how the final sum was reached to prevent dispute and delay in closing transactions.

Defined roles for personnel

A team should be chosen from among the counterparty's staff to be ready to close out Master Agreements and CSAs, promptly upon a default. Each member of this team should have defined and clear roles.

As an example, the central spreadsheet should be in the hands of one person who constantly updates this as circumstances change. Another team member should be in charge of updating the templates with other members of the team keeping abreast of the collateral provided, collateral returned and the status of current counterparties and their current corporate health.

Battle plan

We recommend that all active derivatives counterparties prepare a battle plan: a step-by-step guide of who does what on an event of default, and when and how they do it. A Master Agreement/CSA close-out committee will then be formed when a default occurs and will be responsible for:

- drafting and sending the final forms of notices to be delivered;
- drafting and starting to calculate the final prices according to the formula elected;
- ensuring the relevant event of default/termination event provisions have been met; and
- managing the whole process.

This division of responsibilities should ensure that nothing is missed and everything is delivered on time.

CONCLUSION

Lehman and the defaults by the Icelandic banks have provided a wake-up call. Whether or not this was a '100-year storm' remains to be seen, but what is clear is that weaknesses in the documentation previously seen as remote have become a reality. We expect to see an active time ahead for the industry in 2009 and 2010 addressing these points. ■