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Derivatives Documentation: Overview of the ISDA Architecture

ISDA Credit Support Annex

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New York

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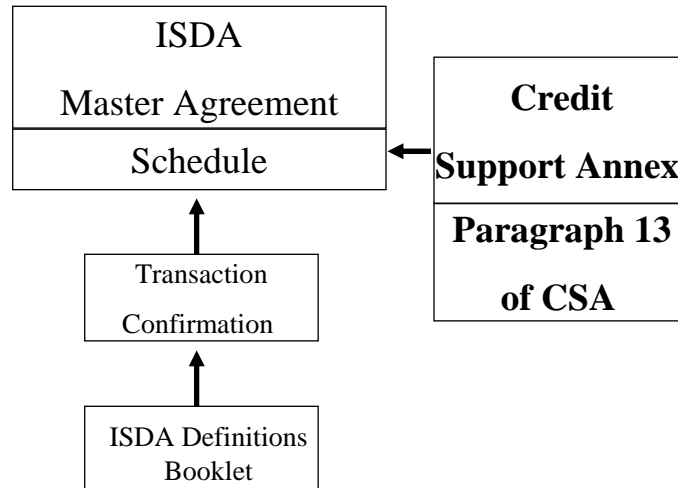
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Benefits of Collateralization

- Counterparty Credit Risk Mitigation
- Market and Regulatory Forces
- Disadvantages of Other Methods - Guarantees, Credit Insurance or Bond, Letter of Credit
- Drawbacks
 - Operational systems and legal support
 - Costs of collateral and infrastructure
 - Legal risk: applicable law and procedures may vary from jurisdiction to jurisdiction



The Credit Support Annex in the ISDA Master Agreement Structure



Introduction to ISDA's Library of Credit Support Documents

- ISDA has published the following:
 - 1994 Credit Support Annex (Security Interest – New York Law)
 - 1995 Credit Support Annex (Transfer – English Law)
 - 1995 Credit Support Deed (Security Interest – English Law)
 - 1995 Credit Support Annex (Security Interest – Japanese Law)
 - 2001 ISDA Margin Provisions
- Parties are free to use other pledge or security agreements; however, the ISDA CSAs are most widely used.

1994 Credit Support Annex (NY CSA): Main Concepts

- Annex to the Schedule to the ISDA Master Agreement
- Credit Support Document under ISDA
- Intended to be governed by New York law
- Grants security interest in posted collateral



CSA – General Purpose

- Bilateral, mark-to-market form
- Includes standard terms regarding:
 - Method for determining a party's "Exposure" to the other
 - Parties' obligations to deliver/release credit support
 - Rights, remedies and duties of parties with respect to credit support supplied
 - Grant of security interest in collateral
- Identifies types of collateral that are eligible
 - E.g., cash, treasury securities are typical; but parties can agree other forms of credit support
- Credit terms can be customized (in Paragraph 13) for each party
 - Thresholds
 - Independent Amounts
 - Minimum Transfer Amounts



Overview of NY Credit Support Annex (pre-printed form)

- Paragraph 1 – Interpretation
- Paragraph 2 – Security Interest
- Paragraph 3 – Credit Support Obligations
- Paragraph 4 – Conditions Precedent, Transfer Timing, Calculations and Substitutions
- Paragraph 5 – Dispute Resolution
- Paragraph 6 – Holding and Using Posted Collateral
- Paragraph 7 – Events of Default
- Paragraph 8 – Certain Rights and Remedies
- Paragraph 9 – Representations
- Paragraph 10 – Expenses
- Paragraph 11 – Miscellaneous
- Paragraph 12 – Definitions
- Paragraph 13 – *Elections and Variables*



Paragraph 3: Credit Support Obligations

- Specifies obligations of parties to deliver/return credit support
- Defines:
 - Delivery Amount (amount to be transferred by Pledgor to Secured Party)
 - Return Amount (amount to be transferred by Secured Party back to Pledgor)
 - Credit Support Amount
- Obligation to deliver/return credit support arises upon appropriate demand by a party on or promptly following a Valuation Date



Paragraph 4: Conditions Precedent, Transfer Timing, Calculations and Substitutions

- Conditions Precedent: A party's obligation to deliver/return credit support is subject to the following conditions:
 - No Event of Default, Potential Event of Default or Specified Condition is continuing with respect to the other party; and
 - No Early Termination Date has been designated with respect to the other party.
- Transfer Timing: If a demand for Credit Support is made:
 - **Before** Notification Time: Transfer required by COB on next LBD.
 - **After** Notification Time: Transfer required by COB on second LBD thereafter.
- Calculations (of Value and Exposure)
 - Made by the Valuation Agent as of the Valuation Time
- Substitutions
 - Posted Credit Support may be exchanged following notice to the Secured Party



Paragraph 5: Dispute Resolution

- Addresses disputes regarding Valuation Agent's calculations of Exposure and Value of Credit Support
 - Undisputed amount must be transferred pending resolution of dispute
 - Specifies methods for resolving disputes
 - Exposure is recalculated by seeking 4 mid-market quotations for Transactions in dispute
 - Value of Credit Support is recalculated using procedures specified in Paragraph 13



Paragraph 6: Holding and Using Posted Collateral

- Care of Posted Collateral
 - Duty of reasonable care to assure safe custody per applicable law
 - Otherwise no duty (e.g., no duty to collect Distributions, enforce rights pertaining to Posted Collateral)
- Eligibility to Hold Posted Collateral; Custodians
 - Secured Party entitled to hold subject to conditions in Para. 13
 - If it fails to satisfy conditions, transfer to Custodian required
- Use of Posted Collateral (“Right to Rehypothecate”)
 - Secured Party may sell, pledge, rehypothecate, invest, use, commingle or otherwise dispose of Posted Collateral (subject to Para. 13 and other conditions)
- Distributions and Interest Amount
 - Secured Party required to transfer Distributions, interest on Cash to Pledgor



Purpose of Paragraph 13 of CSA

- Paragraph 13 (“Elections and Variables”) = negotiated portion of the CSA
- Allows parties to:
 - Specify relationship-specific provisions and elections
 - Amend, add to standard terms of the Credit Support Annex



Anatomy of Paragraph 13

- (a): Security Interest for "Obligations"
- (b): Credit Support Obligations
 - Eligible Collateral, Other Eligible Support
 - Independent Amounts, Thresholds, MTAs, Rounding
- (c): Valuation and Timing
- (d): Conditions Precedent and Secured Party's Rights and Remedies
- (e): Substitution
- (f): Dispute Resolution
- (g): Holding and Using Posted Collateral
- (h): Distributions and Interest Amount
- (i): Additional Representations (if any)
- (j): Other Eligible Support and Other Posted Support
- (k): Demands and Notices under CSA
- (l): Addresses for Transfers
- (m): Other Provisions



Key Lessons from Recent Market Events

- On Collateral: Call Early and Call Often
- Implement Effective Means to Resolve Margin Call Disputes
- Address Routine Over-Collateralization Risk



On Collateral: Call Early and Call Often

- Beware of one-way CSAs!
 - Generally each side should have appropriate rights to call for collateral.
- Establish means/infrastructure (either directly or through third party vendors) to make regular collateral calls.
- Consider whether transfer timing requirements/notification times result in timely transfers.
- Major risk issue here: by holding insufficient collateral or posting excess collateral, a party will likely be a general unsecured creditor for the shortfall if its counterparty goes insolvent.



Implement Effective Means to Resolve Call Disputes

- Existing ISDA Credit Support Annex dispute resolution mechanism has not always been considered practical/efficient by collateral practitioners.
- As a result, industry regulators have encouraged the industry to make improvements in this area.
 - ISDA Collateral Committee committed to develop a better dispute resolution process.
 - ISDA's 2009 Collateral Dispute Resolution Procedures were delivered on September 30, 2009.



Address Routine “Over-Collateralization” Risk

- Buyside/non-dealer firms that are posting “Independent Amounts” one-way to certain counterparties need to consider this risk.
 - Excess collateral held by a failed counterparty = general unsecured creditor claim
- Possible means of reducing over-collateralization risk:
 - Have a third party custodian hold IAs/excess collateral
 - Letters of Credit
 - Deduct IAs from unwinds/final payments
 - Reduce IAs to zero upon credit deterioration of holding party.



Other Issues to Consider

- Nature and location of collateral
- Nature and location of counterparty
- Perfection issues
- Tax issues
- Recharacterization issues
- Collateral Opinion Projects



ISDA Collateral Opinion Projects

- ◆ ISDA has obtained legal opinions relating to creation and perfection of security interests under New York and English law collateral documents, and provides annual updates of these opinions to its membership.

- ◆ Forty-three collateral opinions received from:

Australia	Denmark	Italy	Singapore
Austria	England	Japan	South Africa
Bahamas	Finland	Luxembourg	South Korea
Belgium	France	Malaysia	Spain
Bermuda	Germany	Mexico	Sweden
British Virgin Islands	Greece	The Netherlands	Switzerland
Canada	Hong Kong	New Zealand	Taiwan
Cayman Islands	Hungary	Norway	Thailand
Channel Islands (Guernsey)	Indonesia	Philippines	Turkey
Channel Islands (Jersey)	Ireland	Portugal	U.S.A
Czech Republic	Israel	Scotland	

**New collateral opinion
commissioned for India*