THE BASICS OF COLLATERALIZATION OF DERIVATIVES

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The market disturbances of 1998 (most notably in Russia and the Pacific) presented the first market-wide tests of collateral arrangements in support of over-the-counter derivatives. After these tests, many market participants observed that certain aspects of commonly used collateral agreements could be improved. The International Swaps and Derivatives Association, Inc. ("ISDA"), for example, surveyed the experiences of the collateral management staffs of many of its members. ISDA then published its "1999 Collateral Review", with recommendations spanning the field of collateral management. In the documentation area, the Review generally recommended simplification of documents and greater uniformity of terms. The Review contains numerous more specific recommendations, including among others that parties consider shortening the time cycles for valuation, delivery, substitutions and liquidation of collateral, and that improvements be sought in dispute resolution methodology. The Counterparty Risk Management Policy Group generally endorsed ISDA's proposals in its June 1999 Report, with specific mention of the need to make sure that collateral calls will function on a timely basis and that valuations can be accomplished on a commercially reasonable basis.

In 1999, as part of an effort to revise and improve upon its own collateral provisions, ISDA called upon member practitioners to help draft a new form of collateral document to be used in conjunction with ISDA Master Agreements and other agreements. Under ISDA direction, drafting counsel undertook to reflect in this new document the concerns originally voiced in the 1999 Review. In May of 2001, ISDA completed this project and issued the 2001 Margin Provisions (the "2001 Provisions"). Much like the prior ISDA credit support annexes (including the 1994 New York law Credit Support Annex), the 2001 Provisions provide a framework describing the mechanics and operation of credit support arrangements. In fact, in many respects the 2001 Provisions are identical to the prior annexes. There are, however, notable departures. First, the 2001 Provisions allow the parties to elect, in a single document, either New York, English or in certain cases Japanese law as the governing law for the margin arrangements. The provisions even contemplate situations where parties may wish to elect different governing law for individual margin arrangements under the same Master Agreement. Second, the 2001 Provisions tighten the timing of transfers of margin thereby reducing credit and settlement risk. In addition, the 2001 Provisions provide for the option of excluding individual transactions or groups of transactions from the mark-to-market exposure calculation and establish separate mechanisms for taking supplemental margin either to be included in or excluded from the calculation of margin relative to market exposure. Finally, the 2001 Provisions provide myriad other changes intended to improve credit support management both in the ordinary course and in crisis. A stated goal of the 2001 Provisions drafting group was to "lead the market" by producing a document illustrating practices that might not yet be easily achieved by market participants. Accordingly, though the 2001 Provisions are not yet in common use, certain of their innovations are reported here.

The following outline is intended to provide an introduction to collateralization of derivatives with an emphasis on the 1994 ISDA New York law Credit Support Annex (and indications of some of the major additions and changes contained in the 2001 Provisions). The reader, however, should be mindful that this outline is neither a complete description of the 1994 Annex nor an exhaustive catalogue of the changes introduced in the 2001 Provisions.
Basics of Collateralization of Derivatives

1. Why Consider Collateralization?

(a) Market Forces and Regulatory Forces Are Driving the Effort to Improve the Market's Credit Underpinnings:

(i) Demonstrated Fluctuations in Creditworthiness of Counterparties over Past Years.

- Few Early Credit Triggers in Agreements; Lack of Consensus on Additional Credit Termination Events.

(ii) Uncertain Potential for Accumulation of Risk (market value) in Derivatives.

(iii) Dealers' Need Liquidity (implying need for greater credit lines and more counterparties).

(iv) Regulatory Concern about "Systemic Risk".

(b) Collateralization's Unique Virtues: Transfers of Value Between the Parties, to Reduce Risk Prior to Default and Without Termination of the Related Transactions.

(c) Disadvantages of Other Methodologies:

(i) Guarantees

- Third Party Negotiation
- Require Default to Trigger

(ii) Credit Insurance or Bond

- Third Party Negotiation
- Insurer May Dominate Master Negotiation
- Typically Require Default to Trigger

(iii) Letter of Credit

- Third Party Negotiation
- Cumbersome to Adjust to Fluctuating Risk

(iv) "Triple-A" Subsidiaries

- Expensive to Establish
- Documentation Complexities and Contractual Restrictions for Counterparties
- Support is of Subsidiary's Credit Rating Generally; Does Not Provide Transaction-Specific Support

(v) Clearing Houses

- ???
2. **Drawbacks of Collateralization**

   (a) Collateralization Requires Operational, Systems and Legal Support.

   (b) Costs of Collateral and Support may be Significant.

   (c) Added Overlay of Legal Risk: Applicable Law and Procedure may Vary from Jurisdiction to Jurisdiction.

3. **ISDA's 1994 Mark-to-Market Credit Support Annex**

   (a) Supplements and Forms Part of the Schedule to an ISDA Master Agreement. [2001 MP has a "Supplement" that integrates into other agreements.]

      (i) Has Its Own Body of Definitions, Grace Periods and Remedies.

      (ii) A "Credit Support Document."

      (iii) Statedly Governed by New York Law (but note item 5(b)(i) below). [2001 MP allows for choice among New York, English and in some cases, Japanese law]

   (b) Resolves Basic Legal and Structural Issues, But Leaves Parties Numerous Options.

      (i) Offers fixed language for:

         — creation of security interest
         — calculation and transfer of collateral
         — dispute resolution
         — custodial requirement
         — use of collateral
         — distribution of proceeds
         — special events of default, grace periods and remedies
         — representations
         — expenses

         See item 4(c) below.

      (ii) "Paragraph 13" — a menu of choices and a format for variation of fixed terms similar to the Schedule to an ISDA Master Agreement. [2001 MP has a "Supplement" performing this function.]

   (c) The ISDA Annex Will Not End Negotiation, But It Should Establish a Document Format and Diminish Battles of Forms.

      (i) A Market Eager for Uniformity.

      (ii) ISDA Process Forged Consensus.
4. **Common Collateral Structures and Issues**

(a) **Mark-to-Market Collateralization (adjustable risk protection).**

   (i) The amount of collateral required varies in relation to the market value of transactions (and also may vary according to the parties’ creditworthiness or other factors). [2001 MP allows for exclusion of transactions from calculation.]

   (ii) Distinguish the "true mark-to-market swap", in which the value is bought down and the coupon is reset.

(b) **Types of Collateral.**

   (i) Government securities or cash are typical.
      - They transfer and value readily
      - They are easily liquidated
      - Government securities are more easily held as collateral than is cash (consider: perfection for secured party v. protection of rights of pledgor; return of interest; and costs)

   (ii) ISDA’s document is designed for cash or "readily marketable securities." [2001 MP considered more varied collateral.]

(c) **Frequently Negotiated Variables.**

   (i) Two-way or one-way collateralization?
      - ISDA’s document is two-way (bilateral), but can be readily adapted to one-way. A unilateral ISDA document is not being pursued.

   (ii) Which party is responsible for valuation of transactions and collateral?
      - ISDA’s document, the party making the "call" values, unless otherwise specified.

   (iii) How are valuation disputes resolved?
      - ISDA’s document requires transfer of any undisputed amount, consultation and (in the absence of agreement) recalculation [2001 MP may allow for termination in the presence of unresolved disputes]

   (iv) What is the frequency of valuations and potential calls for collateral?
      - ISDA’s document leaves it to the parties [2001 MP provides for valuation on each Margin Business Day]
      - Typically in the market, at least monthly with more frequent discretionary calls

   (v) Will "cushion" (uncollateralized risk) amounts and de minimis delivery and return standards be used?
      - Uncollateralized risk amounts are used to permit undercollateralization
      - De minimis delivery and return standards prevent overly frequent transfers
      - ISDA’s document permits choice
- ISDA language: "Threshold" means uncollateralized risk amount; "Minimum Transfer Amount" means the de minimis delivery and return standard

(vi) Will Independent Amounts or haircuts be used?
- ISDA’s document permits choice
- Used to effect overcollateralization
- Independent Amount – if elected, a constantly required, basic collateral quantity that does not vary in proportion to the amount at risk (and to which additional risk-related quantities may be added) [2001 MP provides for Additional Margin and Lock-up Margin]
  - In the bilateral situation especially, there is an issue as to whether an Independent Amount is subject to netting [2001 MP - Lock-up Margin is not subject to netting]
- Haircuts – excess percentages applied to amounts of required collateral. Typically designed to guard against collateral valuation volatility and costs of liquidation through overcollateralization

(vii) Will custodians be required?
- A credit/prudence issue: Is the secured party fit and willing to properly hold collateral itself?
- Commingling issues may be intensified by the absence of a custodian
- ISDA’s document permits choice, including an opportunity to establish criteria for judging an entity’s ability to hold collateral

(viii) May the parties commingle or rehypothecate collateral?
- ISDA’s document permits full rights to use and commingle, unless otherwise specified
- See item 5(c) below

(ix) Grace periods and remedies
- Grace periods are in response to Section 5(a)(iii)(1) of the ISDA Master
- ISDA’s document offers 2- and 5-business day categories, and a 30-day category, rejecting a complete analogy to the ISDA Master [2001 MP offers 1- and 5- business day categories and a 30-day category]
- Remedies – for pledgor failure and (in a bilateral document) secured party failure
  - Triggers: Events of Default only? Termination Events (some or all)? – see ISDA document’s "Specified Condition"
  - Set-off Rights
    - See ISDA document’s paragraphs 2 and 8
    - Facilitate proper access to collateral, especially with two-way payments funds flow.
    - Invoke netting/set-off language of FIRREA and Bankruptcy Code
    - Make commingling and rehypothecation rights of a secured party more acceptable to a pledgor
5. Basic Legal Issues

(a) Ability of Parties to Enter into Collateralized Relationships.
   (i) Power and authority issues.
   (ii) Regulatory or audit issues.
   (iii) Contractual conflicts issues.

(b) Enforceability of Collateral Structure (both of security provisions themselves and of each transfer over the life of the relationship (topping up)).
   (i) Choice of Law – Consider:
       - Choice stated in agreement
       - Type of collateral
       - Location of the parties and the collateral
       - Presumed means of perfection
       - See generally UCC Sections
       - See appropriate bankruptcy law jurisdictional, choice of law and comity provisions (e.g. 11 U.S.C. § 304)
   (ii) Commercial law aspects (especially priority and perfection)
   (iii) Bankruptcy law aspects.
       - Enforceability free of stay, preference and fraudulent conveyance issues
       - Section 13 of the Federal Deposit Insurance Act – the "contemporaneous requirement" – does it survive?
       - Bankruptcy Code Section 546(g) – is the collateral agreement adequately linked to the swap agreement to be protected?
       - Note ISDA "Annex" structure ("supplements, forms part of" an ISDA Master)

(c) Effect of rehypothecation and commingling.
   - UCC Section 9-207 establishes rights and duties when the secured party possesses collateral
   - Typical market commingling and rehypothecation is intended to overcome 9-207
   - Risk: Mark-to-market turns to pledgor's benefit before pledgor learns that secured party is not returning collateral. Pledgor loses the opportunity to terminate while still owing a value comparable to that of the collateral posted. The collateral may be lost or subjected to conflicting claims.
   - Reward: Secured parties may derive value from the use of collateral in their businesses.
Bilateral Collateral (Symmetrical)

$3 Million Threshold
$500,000 Minimum Transfer Amount
No Independent Amount

Mark to Market (in $Millions)

5
4
3
2
1
0
1
2
3
4
5

$500,000 in collateral is minimum first call

Collateral Call
First Collateral Call
Party A Posts

$500,000 in collateral is minimum first call

First Collateral Call
Collateral Call
Party B Posts
Bilateral Collateral
With An Independent Amount

Party A - $2 Million Threshold
Party B - No Threshold, $1 Million Independent Amount
Both Parties - $500,000 Minimum Transfer Amount

Assume: Party B is $4 Million In the Money, No Collateral has been Posted, and the Independent Amount is to be Net in the Credit Support Entitlement Calculation.

Mark to Market
(in $millions)
(Party B is in the Money)

4
3.5
3
2
1

First Permitted Call By Party B
Party B is Entitled to $1 Million Collateral

Note: In the example, the Independent Amount and Threshold aggregate in Party A's favor.
Unilateral Collateral
with An Independent Amount

$1 Million Independent Amount
$250,000 Minimum Transfer Amount

Mark to Market Value
(Secured Party is in the Money)

$500,000
Collateral call

$250,000
Collateral call

0
Collateral Posted

Note: Two methods are possible. Collateral posted to satisfy the Independent Amount may remain posted despite any "negative" mark-to-market value (i.e., when the pledgor is in the money) or it may be net against a negative mark-to-market.