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What Risk Managers need to Know about ISDA[®] Negotiation¹

Abigail Harding is Managing Director of Derivatives Documentation Limited, a consultancy and training company established 15 years ago and specialising in OTC derivatives and securities documentation. In this article she provides practical guidance for credit risk officers involved in negotiating ISDA[®] Master Agreements.

When a risk manager is approached for instructions on the terms to include in a draft ISDA Master Agreement Schedule it can be tempting for them to respond “Standard terms”. Unfortunately in the world of ISDA negotiation there is no such thing.

Running a search on “Risk Management and ISDA” on a well-known internet search engine I stumbled across an Australian site for the International Self-Defence Association and I could not help but think that it was rather apt for the two organisations to share an acronym— given that self-defence is arguably the main aim in negotiating an ISDA Master Agreement.

How then can a risk manager use the ISDA Master Agreement to enhance credit protection and pre-empt potential hazards?

Taking the advice of Fraulein Maria in *The Sound of Music* “Let’s start at the very beginning” by asking the simple question - Who is my counterparty?

By focusing on the counterparty type concerned a risk manager can immediately gauge the relative bargaining power of the two sides (e.g. a triple A rated supranational and a lesser rated bank) and differentiate between the terms that are essential (need to have) versus those that are merely desirable (nice to have).

They might then consider who owns or controls the counterparty. If their creditworthiness depends on the continued support of a powerful parent company a risk manager would look at ways to reflect this in the documentation and incorporate possible exit provisions should an adverse change in control or ownership occur. These may take the form of Additional Termination Events covering a downgrade in the parent company’s external credit rating (typically by one or two notches) or the failure to maintain (directly or indirectly) a certain level of ownership – 51% or 75% are commonly chosen trigger levels for this.

If the counterparty is part of a wider group rather than a

standalone entity, it is possible to join other of its group members as “Specified Entities” to certain Events of Default and one Termination Event in the ISDA Master Agreement. This would mean that if a Specified Entity was to be impacted by one or more of these events (e.g. derivatives cross default, debt default, insolvency or financially adverse merger) it would trigger a default under the ISDA Master Agreement even though such an event did not affect the counterparty directly. To determine which group members are to be nominated as Specified Entities (if the catch-all “Affiliates” definition is not used) a risk manager would look at where the group’s assets are located and seek to tie-in asset rich or financially significant subsidiaries.

Alternatively where a third party guarantee is provided, the guarantor can be referenced as a Credit Support Provider in the ISDA Master Agreement Schedule and be joined automatically to many Events of Default and Termination Events.

Once the risk manager’s requirements have been incorporated into the initial draft Schedule they will be reviewed by the counterparty’s negotiator, who will inevitably respond with various changes to the proposed terms.

At this stage the risk manager is likely to be approached again for guidance on the proposed modifications and for this reason it is useful for risk managers to be familiar with commonly negotiated amendments. It may well be the case that many such changes are provided for in an institution’s documentation or credit policy (as they tend to be variations on a theme) but it clearly makes sense for risk managers to understand what a given counterproposal is intended to achieve and any disadvantages that agreeing it would entail.

Examples of credit provisions which may be negotiated include:

Specified Entities: You may have requested all Affiliates but your counterparty may only want to include certain named entities (or none at all!).

Additional Termination Events: For example, with hedge

¹ ISDA[®] is a registered trademark of the International Swaps and Derivatives Association, Inc.

² A very good place to start.

What Risk Managers need to Know about ISDA® Negotiation

funds a decline in net asset value (NAV) termination event may be required but the parties disagree on what level the NAV trigger should be and whether total NAV or NAV per share should be used.

Grace periods for certain Events of Default: You may want shorter grace periods than the ISDA standard and your counterparty may want longer ones.

Cross Default vs. cross acceleration: Whether defaults under other agreements between the parties can lead to a default under your ISDA and the timing of when this Event of Default can be triggered. This can be a major sticking point in some negotiations if the parties want differing terms.

Threshold Amount: This is the trigger at or above which a Non-defaulting Party can terminate all Transactions under the ISDA Master Agreement's Cross Default clause. The level of this is often negotiated and whether it should be measured as a fixed money sum or a percentage of shareholders' equity.

As well as the ISDA Master Agreement itself, you may want to enter into a collateral document - e.g. the ISDA Credit Support Annex under English Law (the "CSA") - to reduce your counterparty risk exposure further. Terms for consideration include whether the CSA is one-way or two-way, the unsecured Threshold you are willing to give your counterparty before trade exposure needs to be

collateralised (i.e. secured), what types of collateral are acceptable to you and whether the parties will be allowed to re-use (or "rehypothecate") the collateral they receive. Over 90% of collateral in the OTC derivatives market is cash in mainstream currencies and G7 government bonds.

So, as you can see, there are many issues to consider when you first review a company which is looking to enter into OTC derivatives under an ISDA Master Agreement and certain points you may need to concede in order to get your "need to haves" in the document. "Standard terms" are a complete myth.

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Ring Leigh Morgan on +44 (0)20 7638 5558 or +1 917 310 1334

For further information please contact:

Dennis Cox – CEO

telephone: +44 (0)20 7638 5558

email: DWC@riskrewardlimited.com

Lisette Mermod – New York

telephone: 1-914-619-5410

email: LM@riskrewardlimited.com

Joanna Kraska – Public Relations

telephone: +44 (0)20 7638 5558

email: JK@riskrewardlimited.com