Negotiating the Credit Support Annex (CSA)--Arms Control for “Financial Instruments of Mass Destruction” *

Warren Davis
Sutherland Asbill & Brennan LLP

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Risks Shared by All OTC Derivatives

- Counterparty Credit Risk
- Liquidity Risk
  - Periodic Payments
  - Early Termination
  - Collateral Requirements

“We try to be alert to any sort of megacatastrophe risk, and that posture may make us unduly apprehensive about the burgeoning quantities of long-term derivatives contracts and the massive amount of uncollateralized receivables that are growing alongside.” (emphasis added)

Recognize the Tension in Addressing both Counterparty Credit and Liquidity Risks in CSA

- Increased collateralization (which diminishes counterparty credit risk) also increases liquidity burden
  - Makes OTC derivatives more like exchange-traded futures where daily margining may result in significant liquidity constraints

- You must think “liquidity risk” as you negotiate counterparty credit risk.
Liquidity Issues Are the Subplot in CSA Negotiations

- Posting collateral requires liquidity
  - Cash
  - Securities (with a haircut)
- There is a cost associated with liquidity
  - Posted collateral ties up liquidity that could be used for other purposes
  - A dealer’s hedge may generate liquidity; an end-user’s hedge may not.
- Beware of the “Specified Condition” trap
“Specified Condition”—One Term, Many Uses

- § 4(a)(i)—condition precedent to transfer is that no Specified Condition (“SC”) exists and is continuing
- § 4(a)(ii)—condition precedent to transfer is no designation of ETD as the result of a SC
- §6(c)—right to rehypothecate collateral tied to SC
- § 8(a)(1) and § 8(a)(2)—Secured Party’s rights and remedies tied to SC with respect to Pledgor
- § 8(b)—Pledgor’s rights and remedies tied to SC with respect to Secured Party

Para. 13(d)— Why One Definition for All Purposes?
The “Specified Condition” Trap

- This can arise where a party triggers an “Additional Termination Event” (the “Affected Party”) but the other party elects not to designate an Early Termination Date.

- In this case, Transactions remain ongoing, but the Non-Affected Party is relieved of its obligation to post collateral if Additional Termination Events are designated as a “Specified Condition” in Para. 13(d).

- See W. Davis Remarks to ISDA Symposium regarding HRO v. Credit Lyonnais case, attached.
How Parties Address Counterparty Credit Risk

- Only do business with financially strong ("rated") counterparties
- Negotiate Additional Termination Events that will permit “pre-bankruptcy” exit
- Obtain guarantees
- Collateralize or over-collateralize counterparty derivative exposures
Caution in Assessing Counterparty Credit Risk

- Enron and WorldCom still had investment grade credit ratings as they plunged into bankruptcy.
- “No matter how financially sophisticated you are, you can’t possibly learn from reading the disclosure documents of a derivatives-intensive company what risks lurk in its positions. Indeed the more you know about derivatives, the less you will feel you can learn from the disclosures normally proffered to you. In Darwin’s words: ‘Ignorance more frequently begets confidence than does knowledge.’”

CSA Negotiating Paradox

- The financially stronger party often dictates the terms of the collateral agreement (e.g., “one way” agreements where only the weaker party posts collateral; asymmetrical “Thresholds”)
- The financially weaker party may actually have less tolerance for counterparty credit risk and liquidity exposure
“Early Termination” Dealer Perspective--“Cut Losses & Move On”

- Avoids default/bankruptcy proceeding
- Hedges are financial and can be generally be unwound quickly
- Generally no accounting or tax problems--transactions are already “marked-to-market” for tax and accounting purposes
- Not a decision taken lightly—customer relations problem and reputation risk
“Early Termination”—Non-Dealer Perspective—“Preserve our Hedge”

- Potential adverse accounting impact under “hedge accounting” rules
- Potential adverse tax consequences depending on whether hedging treatment applies and, if it does, the status of the hedged item
- Reestablishing hedges may be difficult, if not impossible
- Termination payments may stress liquidity
Prioritizing Objectives--Know Yourself and Your Counterparty

- Minimize uncollateralized exposure
- Avoid “early termination”
- Minimize potential demands for collateral
- Maximize utilization of collateral received
Minimize Uncollateralized Exposure

- Low Thresholds
- Low Minimum Transfer Amounts
- Use Independent Amounts
  - “Exposure” determinations, even if done every day, are historic, not prospective, and do not capture current market volatility and potential exposures
  - Independent Amounts can provide the “cushion” you want to avoid future uncollaterized exposures
Avoid “Early Termination”

- Avoid/minimize “Additional Termination Events” in Schedule--e.g., ratings events, NAV decline provisions, etc.
- Convert “Additional Termination Events” into “Collateral Events”
  - Laddered Thresholds
  - Special Collateral Events--add Independent Amount
# Laddered Thresholds

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Minimize Potential Demands for Collateral

- Provide guarantee rather than collateral support
- Maximize collateral “Thresholds” and “Minimum Transfer Amount”
  - Consider “laddered” approach to “Threshold”
  - Avoid “Independent Amounts”
Maximize Utilization of Collateral Received

- Require cash collateral or highly liquid securities (e.g., Treasury bonds and notes)
- Avoid Letters of Credit
- Minimize requirements to hold collateral in separate custodial account
- Make the Paragraph 6(e) election to permit rehypothecation of collateral
Rehypothecation Risk

- When does it arise? Pledgor (“out of the money” party) financially strong; Secured Party financially weak.
- If Secured Party becomes bankrupt and pledged collateral exceeds termination payment to Secured Party, Pledgor becomes unsecured creditor of Secured Party for the excess.
Addressing Rehypothecation Risk

“The provisions of Paragraph 6(c) will apply provided that the party maintains a long term debt rating of at least BBB/Baa2 as determined by S&P and Moody’s, respectively. If a party fails to satisfy the condition of the preceding sentence at a time when it is a Secured Party, then such party shall reacquire any Posted Collateral not in its possession and shall retain such Collateral in its or its Custodian’s possession subject to the provisions of this Annex.”
Determining Exposure/“Close-out Amount” under the CSA

- If you are using the 2002 ISDA Master, you must also use the March 2003 Amendment to the CSA
- Guidance provided by the CSA Amendment is limited
- Amendment calls for determination of Close-out Amount based on “estimates at mid-market of the amounts that would be paid for transactions providing economic equivalent of” material terms of terminated Transactions.
Caution Regarding “Exposure” under the CSA

- Close-out amount is less objective standard than Market Quotation
- For “vanilla transactions” probably few differences; for more complex and illiquid transactions, valuation differences could be material
- Dispute resolution provisions of the CSA do not provide a clear mechanism for resolving differences
Caution Regarding “Exposure” under the CSA (2)

- If Transactions will likely be difficult to value, consider providing:
  - Agreed-upon methodology for Exposure valuations
  - Mechanism for third party determinations if valuation disputes cannot be resolved by parties
Resolving Disputes About Collateral Transfers—A Game of “Ping Pong”

- Key to understanding “Dispute Resolution” under the CSA is appreciating the difference between the “Valuation Agent” under the CSA and the “Calculation Agent” under the ISDA Master Agreement.

- Under Para. 5 of the CSA, the Valuation Agent has the last word. This produces the “ping pong” effect as the role of Valuation Agent shifts back and forth from one party to the other. Care must be taken to ensure that either party can act as Valuation Agent, as is contemplated by the CSA, and that neither party is designated to act as Valuation Agent for the other party in all circumstances.
Summary—Negotiating the CSA

- Know your risk tolerances and go into negotiation with specific credit support objectives—
  - Minimizing early termination risk
  - Avoiding liquidity crunch on credit downgrade
  - Ensuring rehypothecation rights
  - Minimizing credit exposure to a financially weak counterparty

- Consider how your CSA interacts with the terms of your ISDA Schedule, particularly with Termination Events

- Don’t be intimidated by your counterparty and be creative