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THE CREDIT AND LEGAL RISKS OF ENTERING INTO AN ISDA MASTER AGREEMENT

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When a hedge fund decides to enter into derivatives, the first hurdle is a large stack of documents that must be signed with each trading counterparty. This stack will usually include an ISDA Master Agreement published by the International Swaps and Derivatives Association. The ISDA Master Agreement establishes the primary credit and legal terms between the parties. Although the ISDA Master Agreement is signed by the parties without any changes, it is a highly negotiated document that revolves around a 10- to 20-page "Schedule" to the ISDA Master Agreement that sets out all of the modifications, elections and other negotiated provisions. Most of the hedge fund's negotiations with its counterparty (which typically is a derivatives dealer) will center on the instances in which the counterparty can terminate all of the open transactions in place between the parties and when the counterparty can liquidate all of the hedge fund's collateral held under the ISDA Master Agreement.

The Credit Support Annex is another agreement that is usually part of the stack of documents provided with the ISDA Master Agreement. The CSA is a form document published by ISDA and is accepted by the parties in the form it is printed. Elections and modifications to the CSA are set out in a document attached to the CSA that is referred to as the Paragraph 13. Modifications to the CSA are made in a document referred to as the Paragraph 13 because the printed CSA form consists of 12 paragraphs. The CSA and Paragraph 13 set out the collateral terms for derivative transactions under the ISDA Master Agreement, including one-way or two-way collateral agreements.

In this article, I will highlight the structure of the ISDA Master Agreement and cover some of the primary credit and collateral terms that face hedge funds when entering into this necessary agreement.

ISDA MASTER AGREEMENT

Since 1987, several forms of ISDA Master Agreements have been published. When discussing the ISDA Master Agreement in this article I refer to the version of the agreement most commonly used: the 1992 (Multicurrency—Cross Border) form of the ISDA Master Agreement as published by ISDA. Although a newer version of the ISDA Master Agreement was released in 2002, the 1992 form that I discuss in this article remains the form more commonly negotiated in the market today and preferred by end users such as hedge funds. To better address the concerns and issues faced by most hedge funds, I address key issues as they arise under the 1992 form of the Master Agreement. Even though some issues are specific to the 1992 form of the Master Agreement, many of the issues apply equally to both versions.

The ISDA Master Agreement and the Schedule that is made a part of the ISDA Master Agreement establish the legal and credit relationship between the parties. A number of situations under the Master Agreement can give a party the right to terminate the transactions that are subject to the Master Agreement. The Schedule allows the parties to designate the termination events known as additional termination events. Typical additional termination events faced by a hedge fund are declines in net asset value and changes in the investment manager. In this article I address the consequences of three categories of default and termination events under the Master Agreement: default under specified transaction, cross default and additional termination events.

DEFAULT UNDER SPECIFIED TRANSACTION

A critical default provision is the default under specified transaction, which is Section 5(a)(v) of the Master Agreement. The concept underlying this provision is that if a party fails to perform under any derivative transaction (whether or not that derivative is subject to the Master Agreement), the other party will have a right to terminate all transactions under the Master Agreement. Failure to perform under a derivative transaction is a significant credit event, signaling the credit deterioration of the defaulting party. Under this provision the non-defaulting party has the right to choose whether to continue the trading relationship under the Master Agreement. This is obviously an important right.

As specified in the Master Agreement, this provision only is triggered when there are defaults under other derivative transactions similar to those typically be entered into under an ISDA Master Agreement. Some counterparties seek to expand this default provision to include all transactions of any kind between the parties. This is done by expanding the definition of "specified transaction" beyond derivatives to include prime brokerage agreements, repurchase transactions, securities lending transactions, lending agreements, credit agreements and other agreements between the parties. If this expansion is agreed to by the parties, it means that any default by the hedge fund under any of these other agreements with the counterparty can result in an early termination of all transactions subject to the Master Agreement.

Expansion of this default under specified transaction provision poses a number of problems for hedge funds. For example, many prime brokerage agreements are signed by hedge funds without negotiation. Because some hedge funds view their prime brokerage relationships as demand facilities, they do not allocate much of their resources to the review and negotiation of prime brokerage agreements. One problem with accepting a standard from prime brokerage agreement without negotiation is that the agreement typically provides that it is an event of default if the prime broker has grounds for insecurity with respect to the hedge fund's ability to perform. This is only one of a number of default provisions crafted to allow a prime broker to terminate this agreement. By accepting such a prime brokerage form containing provisions such as the grounds for insecurity provision, the prime brokerage agreement can have a ripple effect and also cause the termination of the Master Agreement, which typically contains longer-term transactions that can be very difficult, if not impossible, to replace. If the definition of specified transaction is expanded, the termination of the prime brokerage agreement by reason of default would provide a dealer with the right to terminate the Master Agreement.

Another concern for hedge funds is raised with stock lending and repurchase agreements. Failures to deliver securities are considered defaults under stock lending and repurchase agreements. Although failures to deliver are common occurrences under stock lending and repurchase agreements, they are still technically considered defaults without regard to whether the failing party pays the "buy in" amount resulting from the delivery failure. Whenever a hedge fund fails to deliver securities under a stock lending or repurchase agreement, the other party may have the right to terminate the Master Agreement.

Expanding the definition of specified transaction allows the contract with the easiest default provision to become the lowest common denominator for a hedge fund. Any default under any of the agreements between the hedge fund and its dealer may now give the dealer the right to terminate all of the transactions under the Master Agreement. If a hedge fund agrees to expand this default provision to include its other agreements, it should at a minimum, consider carving out technical defaults under those other agreements. In addition, a hedge fund should evaluate each of its agreements with its Master Agreement counterparty and determine if there are any default provisions under those agreements that are arbitrary or technical. Further, a hedge fund should also consider limiting this default provision to only payment defaults rather than all of the defaults (technical or otherwise) under any of its other agreements.

The 2002 Master contains an expanded default under specified transaction provision that includes a broad range of transactions and trading relationships between the parties. This expanded language, if the parties want to include it, must be added to the 1992 Master Agreement in the schedule that is made a part of the Master Agreement. Although the 2002 Master provides that the agreement governing any defaulted transaction (and all transactions governing such transaction) must be terminated before the default can be used as a reason to terminate the ISDA Master Agreement, this modification does not address the concern of many hedge funds that a counterparty concerned with the hedge fund's creditworthiness or desiring to end the relationship for another reason could use a technical default under another agreement as a way to terminate both that agreement and the 2002 Master.

CROSS DEFAULT

Another default provision under the Master Agreement is the cross default provision set out in Section 5(a)(vi). Cross default specifies that if a party to a Master Agreement defaults in any borrowed money obligations to anyone in excess of an agreed dollar amount, the other party to the Master Agreement can terminate all transactions under the Master Agreement. This cross default provision is broader than the default under specified transaction provision because it looks to the defaults by a party under its other third party agreements as a way to terminate the transactions under the Master Agreement. Under the standard form of the Master Agreement, the cross default provision is limited to borrowed money obligations, such as letters of credit and other lending agreements. If this cross default provision is left as it is defined in the Master Agreement, without modification, most hedge funds are not troubled by this provision because hedge funds do not typically issue debt or borrow money through typical lending arrangements and letters of credits. If this cross default provision were expanded to include all third-party relationships of a hedge fund, a default by the hedge fund under any third-party prime brokerage agreement (including a technical default where the agreement is not terminated) can result in the counterparty's right to terminate the Master Agreement. As a result, if a default occurs under any of a hedge fund's prime brokerage agreements, all of the hedge fund's ISDA Master Agreements containing this expanded cross default provision can also be terminated. For a hedge fund, an expanded cross default provision also results in taking defaults down to the lowest common denominator among default provisions in all of its other agreements with its counterparties. The most loosely crafted default provision under any of its agreements with third parties could trigger a default under a Master Agreement including such an expanded cross default provision.

Typically, hedge funds resist this expansion to include all third-party agreements. If a hedge fund finds that it must agree to the expansion of this cross default provision, it typically carves out technical defaults under its other agreements. A hedge fund may also want to consider limiting any cross default to include only payment defaults instead of all defaults (technical or otherwise) under any of the other agreements. If an expanded cross default provision is proposed, a hedge fund should carefully review its other agreements to evaluate the defaults under these agreements that can trigger a termination under the Master Agreement.

ADDITIONAL TERMINATION EVENTS

Additional termination events are often proposed in ISDA negotiations and are additional triggers that can provide a party with a right to terminate the transactions under the Master Agreement. Additional termination events that are frequently proposed for hedge funds will include reductions in net asset values, key man clauses, changes in investment manager and changes in the hedge fund's trading strategy. Occasionally, changes in the amount of the assets under management by the hedge fund manager are proposed as an additional termination event. Each hedge fund must consider the possible significance of agreeing to any of these additional termination events. In considering net asset value declines proposed by a counterparty, hedge funds typically consider whether to accept NAV declines that are inclusive of or exclusive of redemptions. Hedge funds also consider whether the amounts proposed by the counterparty are appropriate to trigger a termination of the Master Agreement.

Key man clauses typically trigger termination of the Master Agreement if one or more of a number of identified principals of the investment manager cease to be involved in the hedge fund's management. This provision must be carefully considered. For example, if there are two or more principals of the investment manager, this key man provision should be carefully drafted so that both (rather than one of the two) or a majority of the total number of principals named cease to be involved in the management before the termination is triggered. If a hedge fund agrees to a change in the investment manager as an additional termination event, it should carve out those situations where a new investment manager has substantially similar management as the original manager. This carve-out would avoid requiring the hedge fund's to seek consents and waivers from each of its counterparties prior to changing its investment manager (in form rather than substance) for whatever reason.

Hedge funds are often presented with an additional termination event that would trigger a termination of the Master Agreement if there is any material change in the hedge fund's organizational documents. If the hedge fund is willing to add this additional termination event, it typically adds a second prong to this trigger so that the change must materially and adversely affect the hedge fund's ability to perform under the Master Agreement before an additional termination event occurs. This second prong limits changes that can trigger a termination to material changes. Additional termination events can have the same effect under the ISDA Master Agreement as an event of default. Obviously, a hedge fund should carefully consider the requirements of each proposed additional termination event to ensure that it only addresses material events and is reasonable.

CREDIT SUPPORT ANNEX

The 1994 ISDA Credit Support Annex is the document under which most parties document their collateral relationships for derivative transactions subject to the Master Agreement. The CSA addresses the mechanics of collateral transfers (deliveries of collateral and returns of excess collateral), form of acceptable collateral, care given to collateral and other such similar provisions. As with the Master Agreement, the elections and modifications to the CSA are negotiated and documented in a separate document, in this case, the Paragraph 13 to the CSA. The CSA as so modified is incorporated into and made a part of the Master Agreement. Provisions in the CSA that are relevant to a hedge fund include threshold amounts, independent amounts, transfer timing and the right of a party holding the collateral to rehypothecate that collateral.

THRESHOLD UNDER THE CSA

The threshold amount for each party, specified in the Paragraph 13, is the amount of exposure that one party is willing to have to the other party before the other party is required to post collateral. Typically, a hedge fund's threshold is proposed to be set at zero or a fairly small number. This means that such a hedge fund would be required to post collateral in an amount equal to the amount by which the transactions are "in the money" to the dealer counterparty. The hedge fund also should focus on the counterparty's threshold amount, which is the amount by which the positions must move in favor of the hedge fund before the counterparty must post any collateral with the hedge fund. If the counterparty's threshold is set at US$10 million, the hedge fund's positions must move in favor of the hedge fund by more than US$10 million before the counterparty will be required to post any collateral to the hedge fund. Further, the amount of collateral posted by the counterparty will only be the in the money value of the transactions that is in excess of US$10 million. In other words, if the hedge fund's exposure to its counterparty is US$11 million, the counterparty must post only US$1 million in collateral to the hedge fund. If the counterparty's exposure to the hedge fund is US$11 million, the hedge fund must post this entire amount. The higher the counterparty's threshold amount the less likely it is that a hedge fund will ever receive collateral for the "in the money" value of its transactions. If the counterparty's threshold is designated as "infinity" or a very large number (such as US$100 million), the CSA has effectively been modified into a one-way collateral arrangement where only the hedge fund is required to post collateral. If the counterparty's threshold is infinity, it means that the hedge fund will post collateral when its positions are "out of the money" although the hedge fund will never receive collateral from the counterparty when the positions move in the hedge fund's favor. Because of the important effect that threshold amounts have on the release of collateral, hedge funds should carefully consider the amount of each party's threshold and the ramifications of these amounts.

INDEPENDENT AMOUNTS

As a form of additional collateral, one party may require that the other part post an independent amount for transactions subject to the Master Agreement. Typically independent amounts are negotiated on a trade-by-trade basis. Sometimes a party may insist on including a default independent amount for any transaction where the parties did not negotiate a specific independent amount. A common provision is to include a default independent amount of 10% of the notional amount of such transaction. This means that if the parties do not agree on an independent amount at the time a transaction is executed, the hedge fund will be required to post additional collateral equal to 10% of the notional amount of such transactions. Though this number may seem harmless, it maybe an unreasonable amount for some of the transactions that the hedge fund executes with its counterparty. For example, it is very common for interest rate swaps to have notional amounts in the hundreds of millions. Ten percent of the notional amount of an interest rate swap, which must be transferred as collateral within one business day of the execution of the transaction, may cause an unexpected liquidity crunch for a hedge fund. Default independent amounts may also be inappropriate for option transactions or credit derivative transaction where the buyer has already paid the premiums to the other party to enter into the tranasactions. In this situation, a counterparty does not have any risk to the buyer, so there shouldn't be any independent amount. If a hedge fund chooses to accept the proposal of a default independent amount, it should carefully consider each type of derivative transaction that it enters into (or may enter into) to determine if such a default independent amount is appropriate for each transaction type. Though time consuming, this exercise may reduce the unexpected risk of a collateral requirement that can put stress on the liquidity needs of the hedge fund.

TRANSFER REQUIREMENTS UNDER THE CREDIT SUPPORT ANNEX

Under the standard form CSA, collateral must be transferred within one day of demand if the transfer request is made by the notification time (typically at 1 p.m. EST). If the request is made after the notification time, the collateral must be transferred within two days of demand. Counterparties sometimes suggest modifications to the transfer provisions of the CSA to provide that the collateral must be transferred on the same day the call for collateral is made rather than the following day as provided in the CSA. This change may be acceptable to some hedge funds but may be administratively difficult for others. Each hedge fund should carefully consider this modification and provision to determine whether it is able to meet these modified transfer requirements consistently. A failure to transfer collateral when required can lead to the occurrence of a default under the ISDA.

REHYPOTHECATION OF COLLATERAL

In the Paragraph 13, the parties must also make an election with respect to CSA to determine whether each party to the Master Agreement have the right to rehypothecate and use the collateral it is holding. If the provisions of Paragraph 6 (c) of the CSA are applicable to a party without restriction, then that party will have the right to use the collateral that it receives under the Master Agreement. If a hedge fund has this right, it can commingle such collateral with its own funds and use the collateral to meet margin calls under its other trading agreements. If a hedge fund is not able to use the collateral or if there are limitations on the hedge fund's use of collateral, the benefits that a hedge fund receives from holding the collateral are also limited. For example, if a hedge fund cannot use the collateral that it receives unless it is rated above investment grade, the hedge fund will be required to hold the collateral with a custodian. The hedge fund will not be able to use the collateral that it receives to satisfy margin calls under its other trading agreements. In a time when a hedge fund needs liquidity, too many agreements with this limitation may create a liquidity problem that can result in a default under one or more agreements.

Another typical provision that triggers a limitation on hedge fund's ability to use collateral are net asset value declines that turn off the applicability of paragraph 6(c) and prevent a party from rehypothecating the collateral. Typically these triggers are not as low as the additional termination event net asset value triggers, which give a counterparty the right to terminate the Master Agreement. If the annual net asset value for an ATE is set at 40%, the trigger limiting the hedge fund's right to use collateral may be set at an annual drop of 15 or 20 percent. If a hedge fund agreed to such a trigger and its net asset value drops by 15 percent within any 12-month period, the hedge fund will no longer be able to use the collateral that it receives. The argument typically made in favor of these provisions is that even though the counterparty doesn't have the right to terminate the ISDA Master Agreement, the counterparty is no longer be comfortable with the hedge fund's ability to use collateral. A hedge fund should carefully consider this limitation. When a hedge fund's performance has dropped, this may be the time when it most needs the collateral that it receives under the Master Agreement. A trigger limiting the use of collateral can be critical when the fund is experiencing stress.

CONCLUSION

If a hedge fund wants to enter into derivatives it will typically sign an ISDA Master Agreement. Though the Master Agreement is a valuable tool by which parties manage their credit and legal risk, it can also expose a hedge fund to additional and unexpected risks. A few modifications to the Master Agreement can make a big difference in the effect that this agreement can have on a hedge fund's financial stability. A hedge fund should carefully evaluate and negotiate each of these provisions as well as consider the effect that the defaults under its other agreements can have on the Master Agreement. The hedge fund's goal is to ensure that only material events trigger the termination of any of its agreements.