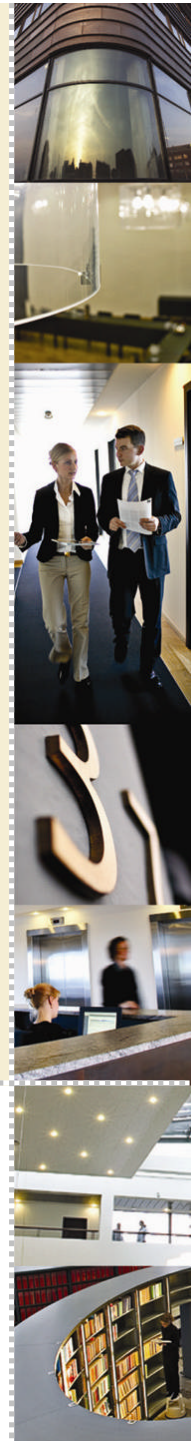


Nordic Capital Markets Forum

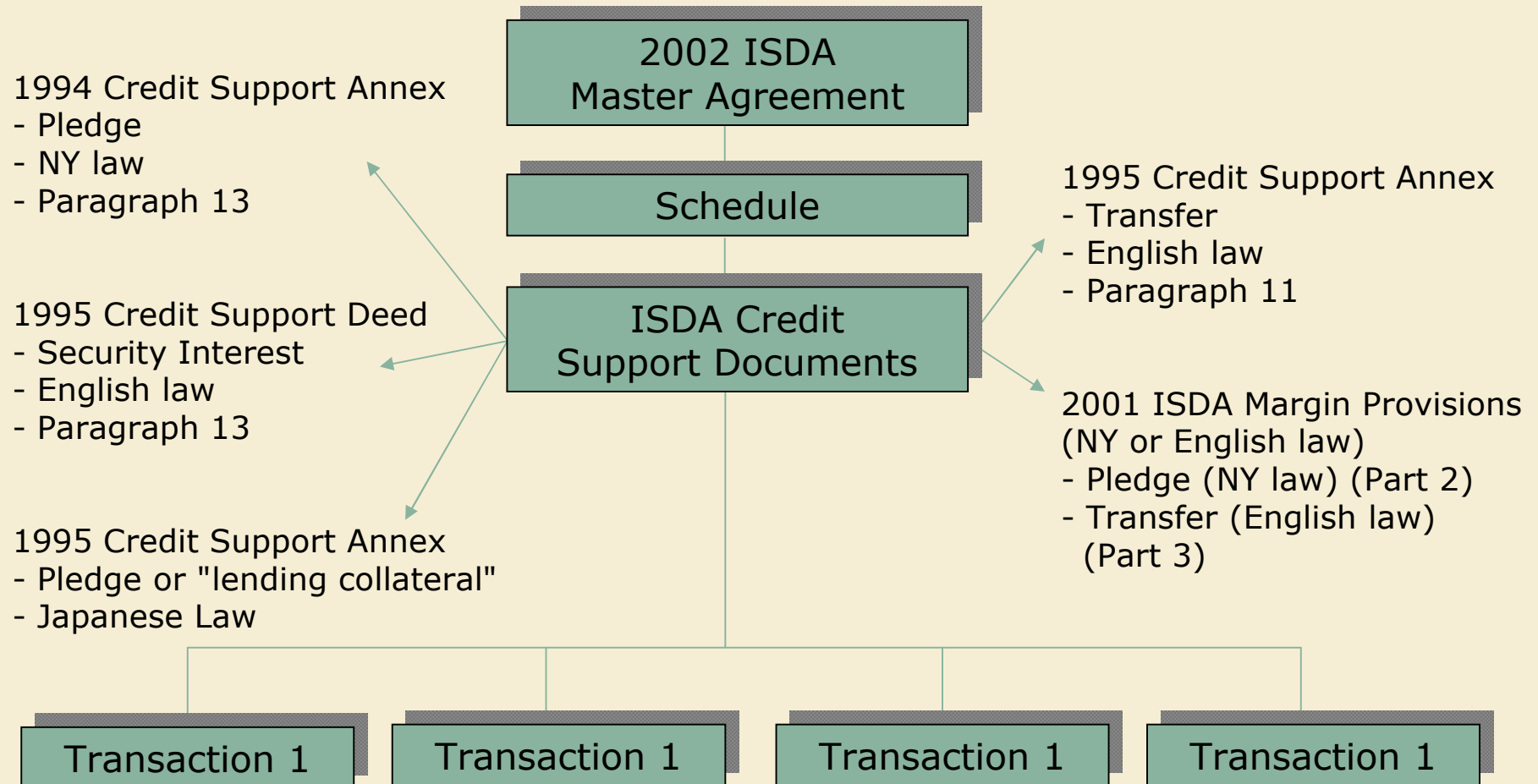
Collateralisation of Derivatives Transactions - legal and documentation issues

Anna Iversen and Catherine Kendal Tholstrup

23rd January 2007
Ingeniørenes Hus, Oslo



ISDA Credit Support Documents



Why enter into one of the ISDA Credit Support documents?



- Mitigation of credit risk
 - reduction of credit exposure
 - management of credit lines allowing more business
- Management of regulatory capital — risk weightings of collateral
- End-user may receive better pricing on transactions if collateralised

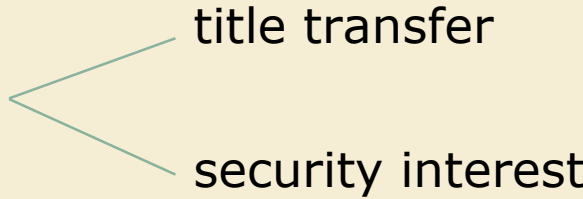
Credit Support Documentation: Issues to consider



- NB: ensure arrangement is properly constructed to avoid legal and operational risk
- Refer to ISDA collateral opinions for enforceability of collateral arrangement upon insolvency of counterparty

ISDA Credit Support Documentation: Basic Notion

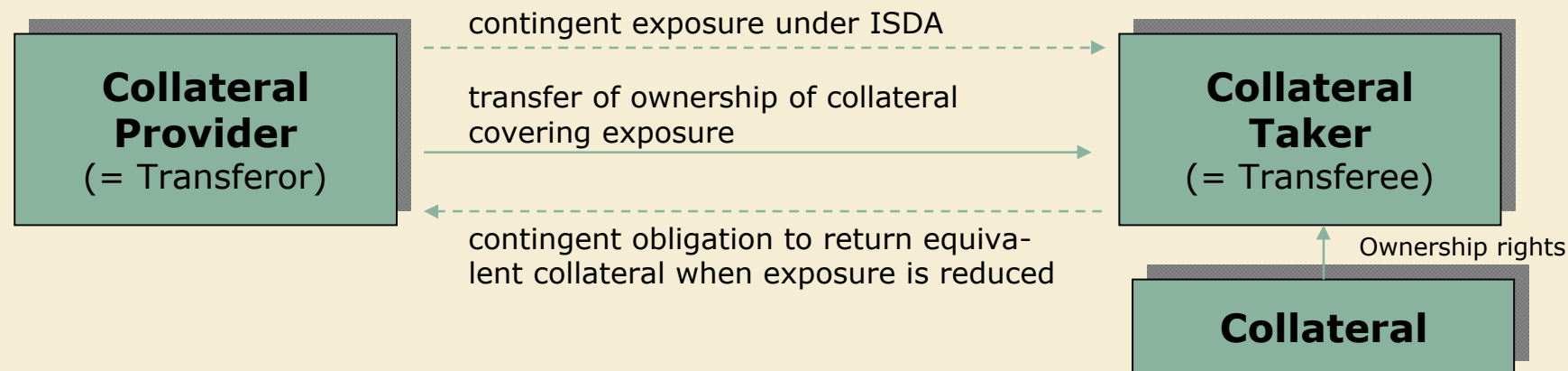


- The delivery of assets (collateral) to be applied against net exposure under the ISDA Master Agreement
- Delivery of collateral 
 - title transfer
 - security interest
- The approach taken will depend on legal due diligence and assessment of which approach is commercially and operationally most optimal
- Collateral arrangements are operationally very intensive

Title Transfer vs Security Interest

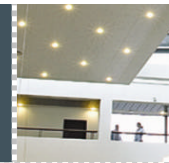


Title Transfer under English law ISDA Credit Support Annex:

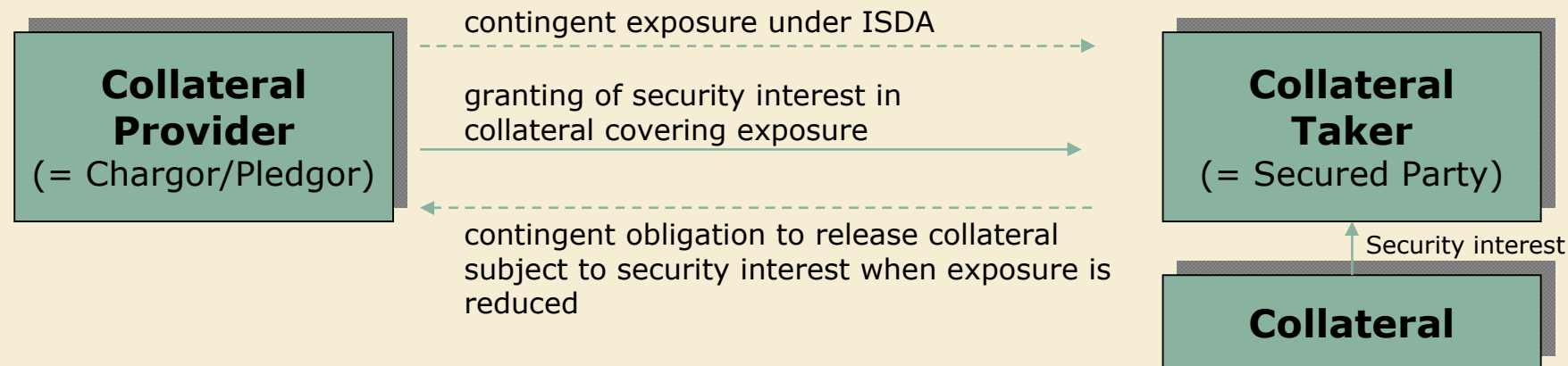


- Collateral Taker has a net contingent exposure to Collateral Provider under the ISDA
- If the Transactions under the ISDA were to be terminated, Collateral Provider would owe a net amount equal to Collateral Taker's exposure under Section 6(e) of the ISDA
- To reduce/eliminate this exposure, Collateral Provider transfers ownership rights in cash or securities (collateral) to Collateral Taker under English law ISDA Credit Support Annex (CSA)
- If the Transactions under the ISDA are terminated early, the net amount due by Collateral Provider to Collateral Taker under Section 6(e) is offset against the value of the collateral transferred under the CSA which is included in the 6(e) calculation as an Unpaid Amount

Title Transfer vs Security Interest

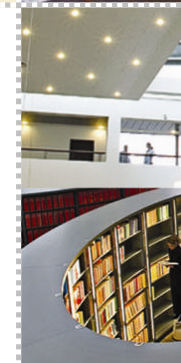
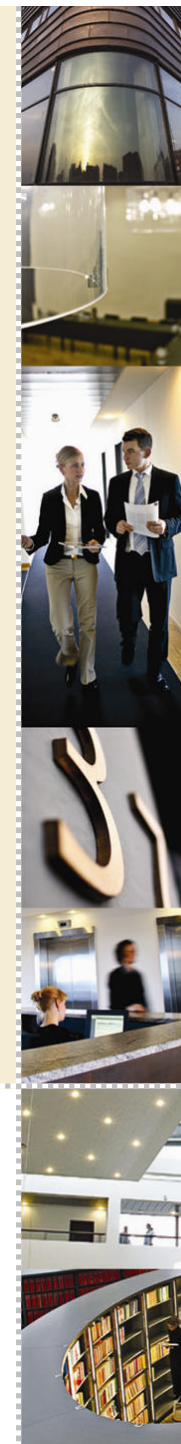


Security Interest under New York law Pledge or English law ISDA Credit Support Deed:



- Collateral Taker has a net contingent exposure to Collateral Provider under the ISDA
- If the Transactions under the ISDA were to be terminated, Collateral Provider would owe a net amount equal to Collateral Taker's exposure under Section 6(e) of the ISDA
- To reduce/eliminate this exposure, Collateral Provider grants a security interest over cash or securities (collateral) to Collateral Taker under English law ISDA Credit Support Deed or NY law ISDA Credit Support Annex
- If the Transactions under the ISDA are terminated early, the Collateral Taker can enforce its security interest (i.e. sell the collateral) and use the proceeds to offset against the net amount Collateral Provider owes it under Section 6(e)

1995 English law Credit Support Annex



English law CSA: Key Concepts



- An annex to the ISDA Master Agreement (cf Credit Support Deed which is a stand-alone document):
 - simpler; fits into the ISDA architecture
 - relies on close-out netting provisions for effectiveness
- No need to specify as Credit Support Document (but note Section 5(a)(iii)(3) if using 1992 ISDA Master Agreement)
- A "Transaction" under the ISDA Master Agreement

English law CSA: Key Concepts



- Outright transfer of ownership rights in collateral — no restrictions on Transferee's use of collateral
- Conditional obligation to redeliver equivalent assets (same type, nominal value, description and amount)
- If Event of Default (not Termination Event) occurs, value of collateral converted to Unpaid Amount, and included in Section 6(e) netting mechanics (NB: adjustment required if using 2002 ISDA Master Agreement)
- Result: the value of collateral transferred under the CSA is off-set against the net value of the Terminated Transactions in a close-out situation

English law CSA: Key concepts



Outright transfer: advantages over security interest

Pros

- Avoids perfection/registration issues
- Can use assets
- May avoid negative pledge
- Avoids restrictions on enforcement

Cons

- Recharacterisation risk
- Relies on enforceability of netting/set-off
- Credit risk to collateral taker (Transferee)
- Tax issues

English law CSA: Key Terms



- Independent Amount
 - Reflection of general credit-worthiness of counterparty
 - Add-on to Exposure to account for volatility of Transactions
 - Timing between Exposure determination dates (Valuation Dates)
 - Timing between Exposure determination and delivery of collateral (take into account settlement cycle plus a bit)
 - May be a fixed amount (per Transaction or overall) or e.g. a percentage of the Notional Amount (per Transaction) or models based, based on Transaction exposure

English law CSA: Key Terms

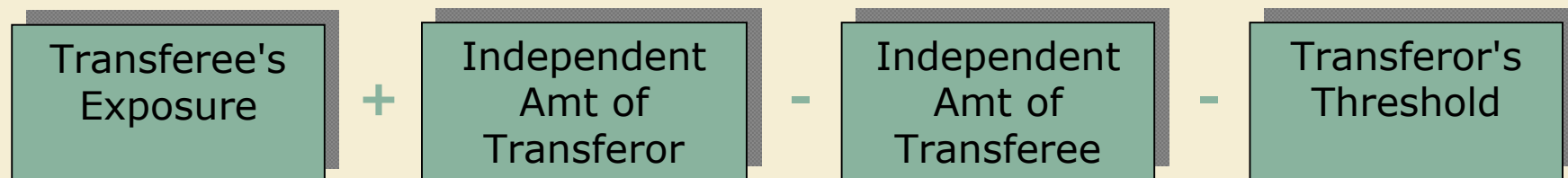


- Threshold
 - Level of acceptable credit exposure, "permitted unsecured risk"
 - Often set according to the credit rating of the party (if downgrade, Threshold increases)
- Minimum Transfer Amount — to avoid de minimis amounts being transferred
- Rounding — to avoid uneven amounts being transferred

Paragraph 2: Credit Support Obligations



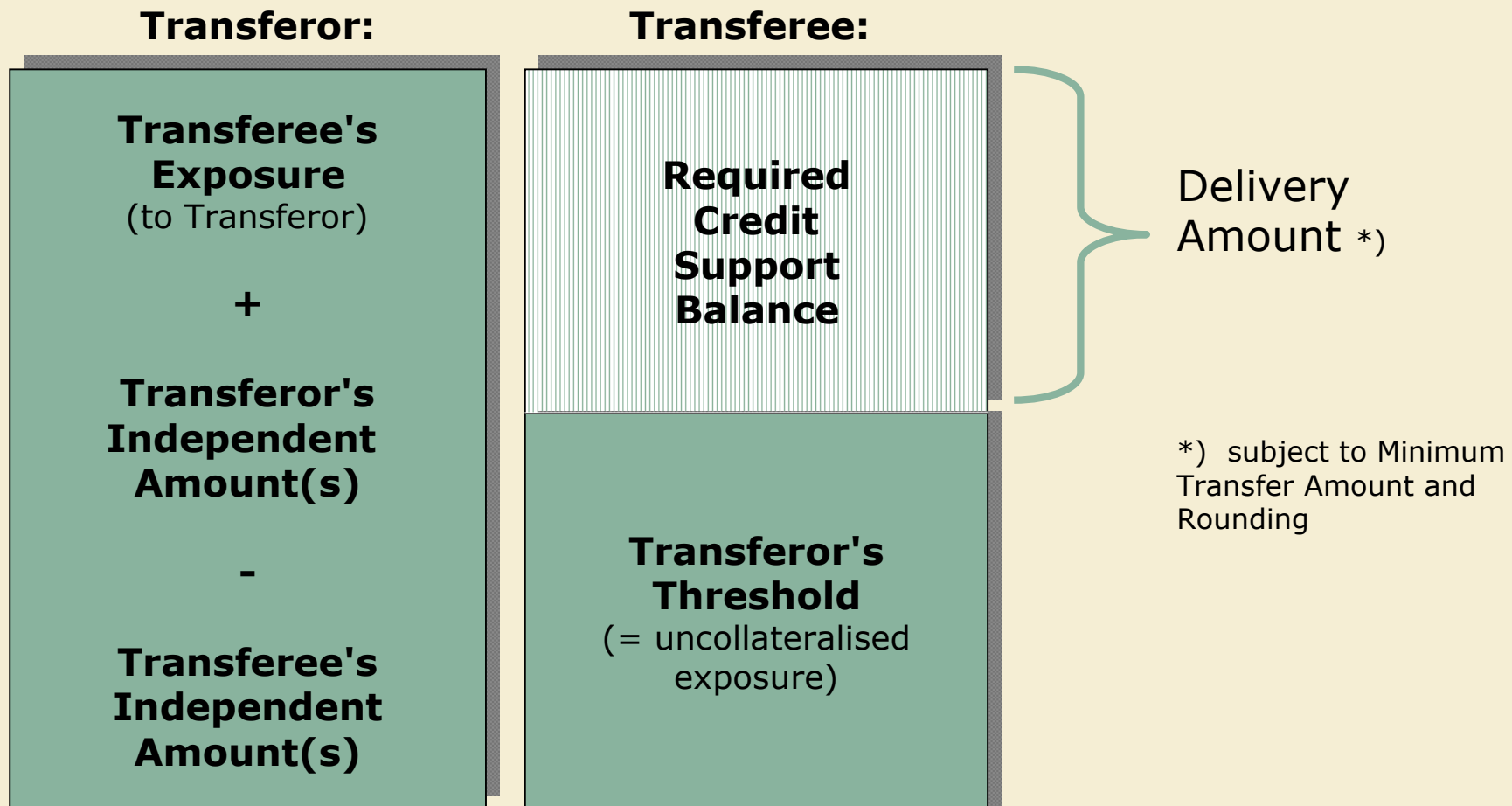
- Credit Support Balance is the value of collateral at hand
- Credit Support Amount is the amount of collateral that the Transferee is entitled to maintain, i.e. the Transferee's exposure to the Transferor, adjusted to reflect Independent Amounts, Thresholds, Minimum Transfer Amounts, etc.



Paragraph 2(a): Delivery Amount



Transferee is exposed to Transferor = Delivery Amount is due from Transferor



Paragraph 2(a): Delivery Amount



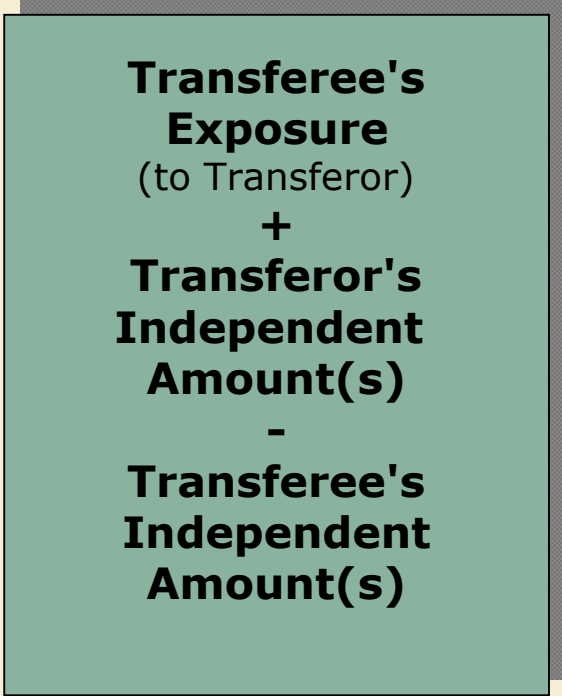
- The amount of collateral or top-up collateral required on a Valuation Date
- Credit Support Amount (adjusted exposure) > Value of Credit Support Balance (collateral at hand)
- Credit Support Amount is adjusted to take into account Transferor's Threshold and parties' Independent Amounts
- Adjusted to reflect prior collateral movements still "in transit"
- Must exceed the Minimum Transfer Amount

Paragraph 2(b): Return Amount

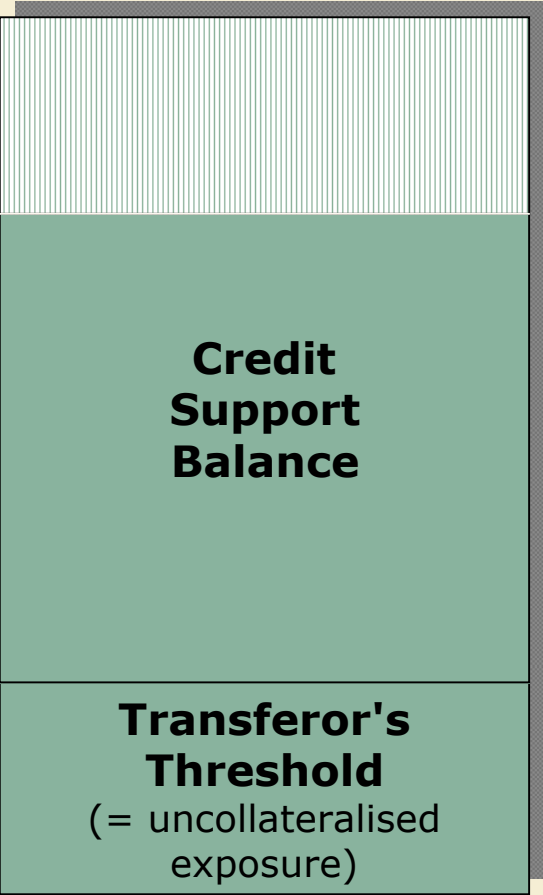


Transferor is exposed to Transferee = Return Amount is due from Transferee

Transferor:



Transferee:



Return Amount *)

*) subject to Minimum Transfer Amount and Rounding

Paragraph 2(b): Return Amount



- The amount of excess collateral to be "returned" on a Valuation Date
- Value of Credit Support Balance (collateral at hand) > Credit Support Amount (adjusted exposure)
- Credit Support Amount is adjusted to take into account Transferor's Threshold and parties' Independent Amounts
- Adjusted to reflect prior collateral movements still "in transit"
- Must exceed the Minimum Transfer Amount

Paragraph 3(b): Calculation of Exposure



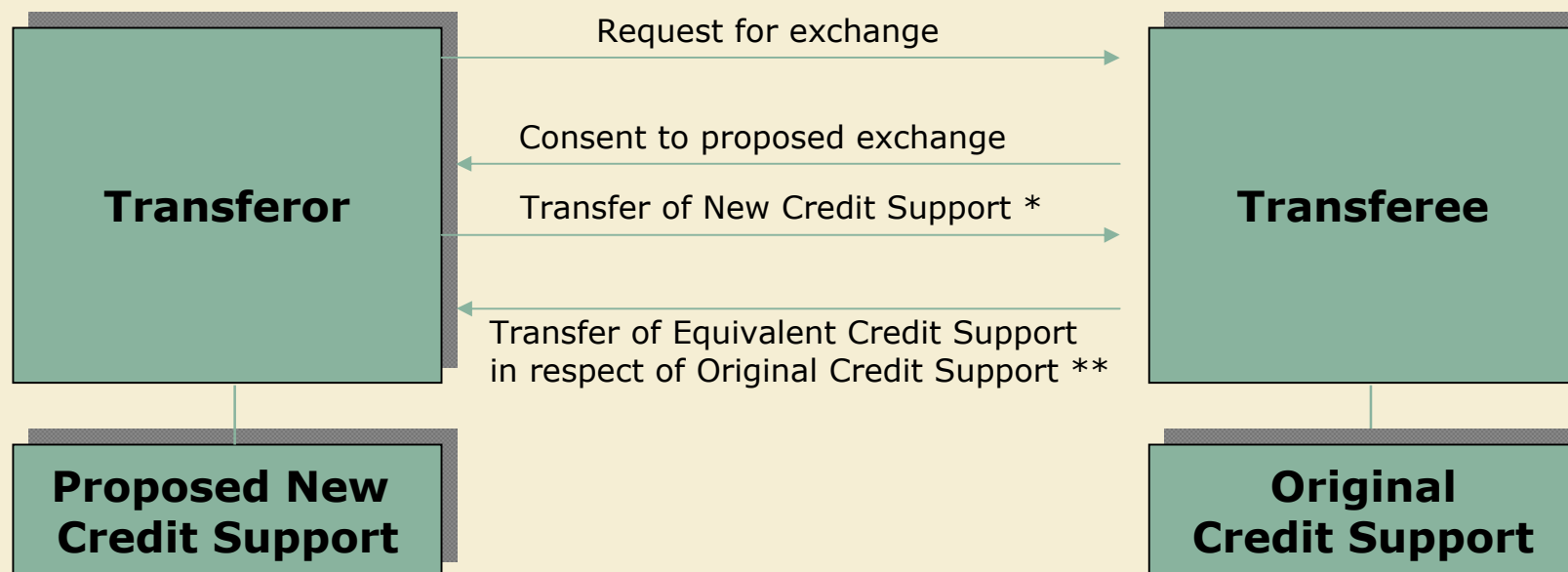
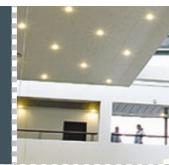
- Amount payable to Transferee as if the Valuation Date were an Early Termination Date
 - Based on mid-market Market Quotations
 - Assume Termination Currency is Base Currency
- Has the definition of Exposure been amended so only part of the derivatives portfolio is collateralised? Problems with this?

Paragraph 3(b): Value of Collateral Held (Credit Support Balance)



- Cash — amount converted to Base Currency x Valuation Percentage (haircut)
 - Securities — bid price x Valuation Percentage (haircut) and converted into Base Currency
- Note: Haircut is applied to account for volatility and liquidity of collateral

Paragraph 3(c): Exchanges

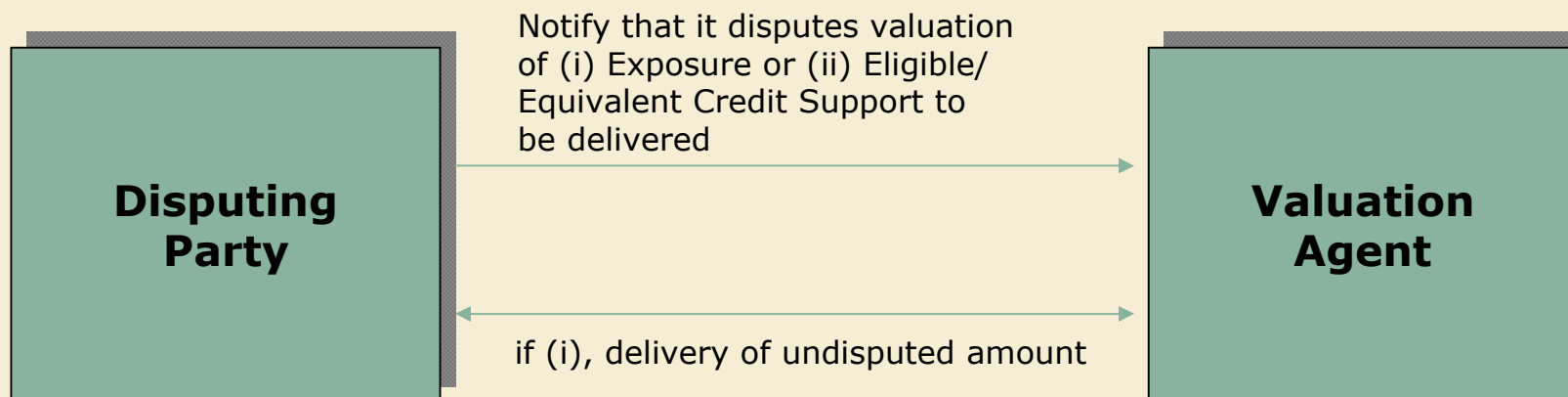
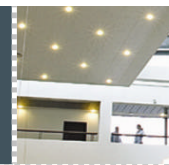


* On first Settlement Day after Transferee has consented

** On first Settlement Day after Transferee receives the New Credit Support

NB: Transferee will be over-collateralised whilst holding Old Credit Support and New Credit Support

Paragraph 4: Dispute Resolution



Dispute can relate to:

- (i) Calculation of Exposure or Credit Support Balance (collateral at hand) (Delivery Amount/Return Amount)
- (ii) Value of Eligible Credit Support/Equivalent Credit Support to be delivered

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