
Collateralization: The International Swaps and Derivatives (ISDA) Structure for Taking Security

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Abstract

The practice of collateral management has existed since the 1980s when Bankers Trust and Salomon Brothers began taking collateral against credit exposure. Derivative collateralization became more prevalent in the 90s, which led to the development of standardized rules by the International Swaps and Derivatives Association in 1994.¹ Credit Support Contracts or collateralization provide protection for the derivative contract itself. By setting aside collateral which is marked to margin, if any of the parties' default, then the collateral becomes protection for the non-defaulting party. This is different from using derivatives to protect from external risks. Collateralization protects the parties from the risk of default of either party to perform their individual contractual obligations. There are different levels of risk protection in derivatives contracts, first is the risk protection from a counterparty's general market exposure (such as interest rate risk or currency risks) and the second is the risk protection against default or bankruptcy of a party or parties flowing from the immediate derivatives transactions. This article does an exposition of the ISDA collateralization structure. It is aimed at ensuring an understanding standard security taking mechanisms adopted in derivatives transactions. The focus of this article is on the 1995 English Law Credit Support Annex and the 1995 English Law Credit Support Deed.

Introduction

Strategic collateral management mitigates current and projected exposures to losses in the event of counterparty default and enhances access to markets through additional counterparties who would otherwise decline to transact on a non-collateral basis. Eligible collateral includes cash, bonds, gold and other company or bank assets.

With the notional amounts of OTC derivatives increasing from \$544 trillion at the end of 2018 to \$640 trillion at the end of June 2019, an increase which registers the highest increase since 2014,² it is important to note that as over the counter (OTC) derivatives transactions increased, so would the collateral arrangements have grown in volume. The use of credit support agreements between counterparties in the over-the-counter (OTC) derivatives market is arguably the most effective and widely used method to mitigate credit risk (the risk of loss resulting from a counterparty's inability to fulfill its obligations as they become due on maturing transaction

¹Ogbonna, S. (2019). Financial Derivatives in Nigeria: Piloting a Safe Risk Management Tool on a Risky Regulatory Framework, *Journal of Law and Global Policy*E-ISSN 2579-051X P-ISSN 2695-2424Vol 4 No 1 Accessed 21st April 2020.

²Bank for International Settlements, Statistical release: OTC derivatives statistics at end-June 2019 (2019) https://www.bis.org/publ/otc_hy1911.pdf Assessed 21st April 2020.

Collateralization.³ The term collateralization is often used by market participants to describe the diverse means of taking security in derivatives transactions.⁴

Collateralization is simply an arrangement structured by a counterparty prepaying all of its future obligations under its derivative transaction either to a third party,⁵ or an outright transfer⁶ of title to a collateral to its counterparty to offset the perceived risk that it would not perform its obligations.⁷

In the case of an outright transfer of title to the secured party, there is a twist to the transfer in that the parties agree that in the event that the party posting collateral defaults or becomes insolvent, then the secured party who by law is the absolute owner would use the collateral to reduce its exposure or risk that it faced as a result of the counterparty's default.⁸

The consequence of collateralization by way of transfer of absolute title however, is that the secured party is under no obligation at law or equity to account to the counterparty or to make any retransfer of the specific transferred property.⁹ In other words, there is no security obligation on the part of the secured party to account for the property, however there may be only a contractual obligation to make a transfer of like kind or equivalent value to the counterparty in the event that the counterparty performs all its obligations.¹⁰ This means that the secured party owes only a personal obligation to transfer property of like kind and value to the counterparty.¹¹

For a derivatives lawyer, it is important to note that collateralization basically involves the effective application of established legal techniques of taking security over commercial contracts to pay money such as the use of trusts, mortgages, charges, pledges, guarantees and indemnities.¹² However, for financial institutions, collateralization allows them to reduce economic capital and credit risk, free up lines of credit, and expand the range of counterparties.¹³

The ISDA Credit Support Documents

There are four main categories of the ISDA Credit Support Documentation and these are (a) the 1995 English Law Credit Support Annex, (b) the 1995 English Law Credit Support Deed,

³Hval, N. Credit Risk Reduction in the International Over-the-Counter Derivatives Market: Collateralizing the Net Exposure with Support Agreements

⁴Hudson, A. (2012). *The Law on Financial Derivatives*. (4 ed.) London: Sweet and Maxwell Ltd.

⁵Such third party would be acting as a trustee of that money/collateral such that the party enforcing its security would be entitled to payments from that trust fund in the event that the counterparty defaults in performing its obligations. Also, the counterparty who deposited the collateral would be entitled to recover from the trust fund any time it successfully performs its obligations under the derivative transaction.

⁶What is obtainable here is that the party requiring security/collateral (secured party) is transferred absolute title in the collateral which will secure its exposure to its counterpart should that counterpart default in its obligations.

⁷Hudson, A. (n 4) 473.

⁸Hudson, A. (n 4) 475.

⁹Hudson, A. (n 4) 474.

¹⁰Hudson, A. (n 4) 476.

¹¹This is merely a contractual obligation because collateralization by way of transfer offers no security against the counterparty's unwillingness to perform its part of the contract. The law of contract will only give the counterparty of enforcement or perhaps a right to damages if performance is rendered impossible for example due to insolvency. See also Hudson, A. (n 4) 476.

¹²Hudson, A. (n 4).

¹³Xia, T. (2012) 'An Economic Examination of Collateralization in Different Financial Markets' MPRA (2012) <www.mpra.ub.uni-muenchen.de/47105/1/MPRA_paper_47105.pdf> Accessed 27th August 2015.

(c) the 1994 New York Law Credit Support Annex and (d) the Japanese Law Credit Support Annex.¹⁴

In order to mitigate counterparty credit risk, parties to derivative contracts enter into a Credit Support Agreement otherwise known as a collateralization agreement which provides a contractual framework for the posting of collateral to secure a party's exposure.¹⁵ The Credit Support Agreement in other words is the documentation that evidences the agreed mode of taking collateral by the parties. The parties ensure that the documents constantly evidences an up to date value of the collateral posted and this is done where the parties to the derivatives contract appoint a valuation date for an evaluation or measurement of the collateral posted in order to ensure that the value of the collateral has not decreased in its ability to protect the secured party from its exposure to its counterparty. It is on this valuation date, that the Credit Support Agreement ordinarily comes into play.

Where the counterparty who posted the collateral successfully performs all its obligations up till the date of measuring the collateral, this means that the risk it poses to the secured party has reduced, and the value of the collateral is now higher than the risk it poses. In this case, it is entitled to the surplus. However, where the value of the collateral after valuation becomes lesser than the secured party's exposure, then this means that the collateral does not match the exposure of the secured party. In this case, the counterparty must add more assets to its collateral. The valuation is often done by a valuation agent appointed by the counterparties or by the secured party. Furthermore, the Credit Support Agreement would also take effect when a counterparty fails to perform its obligations under the derivative contract or where it goes into insolvency. The process of ensuring that the collateral matches the exposure of the counterparty is termed marked to margin.

The focus of this work would be on the English ISDA Credit Support documentation which falls into two main categories: the English ISDA Credit Support Annex and the English Credit Support Deed. While the Credit Support Annex structure deals with personal collateral, the Credit Support Deed deals with security collateral.¹⁶ In practice, the Credit Support Annex is by far the more widely used of the two.¹⁷

A. Credit Support Annex (CSA)

The Credit Support Annex is part of ISDA's continuing efforts to increase efficiency and improve standardization in the OTC derivatives markets by simplifying market processes regarding collateralization and promoting consistent and transparent valuations while making assignment and risk transfer more efficient.¹⁸ A CSA in conjunction with the ISDA Master Agreement will help to reduce legal uncertainty and allow for a reduction of counterparty credit risk through netting of contractual obligations.¹⁹

¹⁴Firth S, (2004) *Derivatives Law and Practice* Sweet & Maxwell.

¹⁵Guylaine Charles, 'The ISDA Master Agreement Part 1: Architecture, Risks and Compliance' (2012) <www.teiglandhunt.com/wp-content/uploads/2013/09/77.pdf> Accessed 16th June 2015.

¹⁶Hudson, A. (n 4).

¹⁷Firth, S. (n 14).

¹⁸ISDA, 'ISDA Publishes 2013 Standard Credit Support Annex (SCSA™)' 2013 <www2.isda.org/news/isda-publishes-2013-standard-credit-support-annex-scsa> Accessed 25th August 2015.

¹⁹Deloitte, (2018) Credit Support Annexure Leveraging CSA for Collateralised Margining, [https://www2.deloitte.com/content/dam/Deloitte/in/Documents/risk/POV_CSA_V11_1067_att_st_Brand\(29-08-18\).pdf](https://www2.deloitte.com/content/dam/Deloitte/in/Documents/risk/POV_CSA_V11_1067_att_st_Brand(29-08-18).pdf) Accessed 21st April 2020.

The Credit Support Annex (CSA) is therefore one of ISDA documents commonly used to define the amount of collateral that must be delivered by one party to the other, or bilaterally between the parties.²⁰ It provides for the movement of collateral between parties during the term of outstanding transactions in order to reduce the net exposure that may result in the event of a trading counterparty's bankruptcy or other default.²¹ The Credit Support Annex does not allow for the transfer security rights in the form of a trust, mortgage or charge to be created over the collateral property.²² Instead, it deals with personal collateral²³ in that it obliges the party posting collateral to transfer outright title to the collateral property to the counterparty or secured party with a contractual agreement that if it performs its obligations, property of like kind or value would be transferred back to the counterparty.²⁴

The 1995 ISDA Credit Support Annex is divided into eleven paragraphs and it is subject to English Law.²⁵ It provides that the annex supplements and forms part of the ISDA master agreement and is subject to the ISDA master Agreement.²⁶ This further sediments the single agreement approach which combines the confirmation agreement, master agreement and credit support agreement as one.²⁷ The ISDA Credit Support Annex has its own terminology particularly applicable to the annex as it provides for those peculiar terms and their interpretations in paragraphs one and ten of the annex.²⁸

Obligations of the Parties under the Credit Support Annex

Paragraph 2(a) of the Credit Support Annex provides that:

Subject to Paragraphs 3 and 4, upon a demand made by the Transferee on or promptly following a Valuation Date, if the Delivery Amount for that Valuation date equals or exceeds the Transferor's Minimum Transfer Amount, then the Transferor will transfer to the Transferee Eligible Credit Support having a Value as of the date of transfer at least equal to the applicable Delivery Amount....²⁹

The above provision is to the effect that where there is a net exposure ("the Credit Support Amount") between the parties following a valuation date, the party who owes the surplus on that net basis (the transferor) is, upon the demand by the transferee obliged to effect an outright transfer of Eligible Credit Support to the Transferee.³⁰

It is important to note here that even when the Credit Support Amount is due, the transferor is under no obligation to make any transfer unless and until the transferee makes a demand for

²⁰Foreign Exchange Committee, 'Tools for Mitigating Credit Risk in Foreign Exchange Transactions' (2010) <www.newyorkfed.org/fxc/2010/creditrisktools.pdf> Accessed 27th August 2015.

²¹Ibid.

²²Hudson, A. (n 4).

²³Personal Collateral refers to the situation in which a secured party receives an outright transfer of assets from its counterparty with only a personal obligation to re-transfer assets of a like kind or of an equivalent value to that counterparty if the counterparty performs its obligations under the derivatives transaction. See also Hudson, A. (n 4) 538.

²⁴Hudson, A. (n 4) 475.

²⁵1995 ISDA Credit Support Annex. Parties who wish to make their Credit Support Annex subject to another Law for example New York Law must indicate appropriately.

²⁶1995 ISDA Credit Support Annex.

²⁷2002 ISDA Master Agreement, Section 1(c)

²⁸1995 ISDA Credit Support Annex.

²⁹1995 ISDA Credit Support Annex.

³⁰1995 ISDA Credit Support Annex. See also Alastair Hudson (n 11) 554.

the transfer.³¹ Furthermore, the transfer is to be made directly to the transferee personally and not a third party.³² This provision shows the fact that the Credit Support Annex purely intends to transfer all rights to the transferee and does not intend to create a trust or security right in the collateral.

Credit Support Annex: A Collateral Document for Transfer of Title

To evidence the fact that the Credit Support Agreement is designed specifically for securing collateral through the medium of transfer, Paragraph 5(a) of the Credit Support Annex provides that:

Each party agrees that all right, title and interest in and to any Eligible Credit Support, Equivalent Credit Support, Equivalent Distributions or Interest Amount which it transfers to the other party under terms of this Annex shall vest in the recipient free and clear of any liens the, claims, charges or encumbrances or any other interest of the transferring party or of any third person...³³

More specifically, paragraph 5(b) hits the nail on the head as it provides that:

Nothing in this Annex is intended to create or does create in favour of either party any mortgage, charge, lien, pledge, encumbrance or other security interest in any cash or other property transferred by one party to the other party under the terms of this Annex.³⁴

The consequences therefore of an outright transfer is that the collateral taker/transferee/secured party is not required to segregate the collateral that is posted from its own assets and neither is the collateral taker/transferee/secured party subject to any restrictions on its use of the collateral.³⁵ Furthermore, as a consequence of transferring “all rights” to the collateral taker, the party that posted the collateral is not entitled to any interest or distributions that accrue on such collateral.³⁶ The collateral taker has the right to use the collateral in whichever manner it deems fit for example, that same collateral can be used by the collateral taker to satisfy its own collateral obligations to another counterparty.³⁷ Because, no security interest was created, the Collateral provider/transferor has no right to determine how and for what purpose the collateral transferred should be used. However, when the collateral provider fully performs its obligations under the contract it is only entitled to an equivalent value (an eligible credit support) of the collateral it transferred and not to the exact same collateral transferred by it.³⁸

(a) Return Amount

Where the collateral has been evaluated on the valuation date, and it is found that the credit exposure posed by the transferor has reduced, this will entitle the transferor to a “Return

³¹1995 ISDA Credit Support Annex. Paragraph 2(a).

³²1995 ISDA Credit Support Annex. Paragraph 2(a).

³³1995 ISDA Credit Support Annex.

³⁴1995 ISDA Credit Support Annex.

³⁵Firth, S. (n 11).

³⁶Firth, S. (n 11).

³⁷Firth, S. (n 11).

³⁸1995 ISDA Credit Support Annex. Paragraph 10. This is referred to as Eligible Credit Support (collateral) of the same type, nominal value, description and amount.

Amount” from the transferee upon a demand made by the transferor.³⁹ The transferor will only be entitled to the “Return Amount” if the amount to be retransferred is sufficiently large.

(b) Eligible Credit Support

Paragraph 2 of the Credit Support Annex provides that the transferor shall transfer to the transferee “Eligible Credit Support”.⁴⁰ Eligible Credit Support is the kind of collateral that the parties are willing to accept as collateral under the agreement. Paragraph 10 provides that Eligible Credit Support includes “...the proceeds of any redemption in whole or in part of such securities by the relevant issuer...”⁴¹ Other “Eligible Credit Support” includes Cash in an eligible currency, Government bonds,⁴² Corporate bonds and other securities the parties decide to include.⁴³

(c) Valuation of Collateral

Paragraph 11(c) provides for the valuation of collateral, time of valuation and the valuation agent.⁴⁴ It provides that the valuation agent shall be the person making the demand for collateral except the parties specify otherwise.⁴⁵ In other words the valuation agent is ordinarily the transferee of the collateral. Valuation date would be as specified by the parties⁴⁶ while valuation time is the close of business on the appropriate date in the market for the collateral property at issue.⁴⁷

(d) Disputes Resulting from Valuation of Collateral

Where disputes arise in connection with the Valuation Agent’s calculation of a Delivery Amount or a Return Amount or the Value of any transfer of Eligible Credit Support or Equivalent Credit Support, the disputing party is required to give notice to the other party and the valuation agent (if the valuation agent is the third party) not later than the close of business day on which the demand is made or transfer is to have been made.⁴⁸

However, as regards the part of the collateral that is undisputed, the transferor is required to transfer the undisputed amount on the settlement day.⁴⁹ On the other hand, as regards the disputed amount, parties are required to consult with each other to attempt to resolve the dispute.⁵⁰ Where the parties still fail to reach an agreement, in the case of a dispute involving a Delivery Amount or Return Amount the valuation agent is required to recalculate the Exposure and the Value of the collateral as of the Recalculation Date.⁵¹ Where the dispute relates to the Value of any transfer of Eligible Credit Support or Equivalent Credit Support, the Valuation Agent will recalculate the Value as of the date of transfer.⁵²

³⁹1995 ISDA Credit Support Annex. Paragraph 2(b).

⁴⁰1995 ISDA Credit Support Annex.

⁴¹1995 ISDA Credit Support Annex.

⁴²1995 ISDA Credit Support Annex. Paragraph 11(ii).

⁴³Hudson, A. (n 4) 555.

⁴⁴1995 ISDA Credit Support Annex.

⁴⁵1995 ISDA Credit Support Annex. Paragraph 11(c) (i). Sometimes, the parties can agree to have an independent valuation agent value the collateral as opposed to the transferee that is the party demanding collateral.

⁴⁶1995 ISDA Credit Support Annex. Paragraph 11(c) (ii).

⁴⁷1995 ISDA Credit Support Annex. Paragraph 11(c) (iii). See also Alastair Hudson (n 11) 557.

⁴⁸ISDA Credit Support Annex, 1995 Paragraph 4(a) (1).

⁴⁹ISDA Credit Support Annex, 1995 Paragraph 4(a)(2).

⁵⁰ISDA Credit Support Annex, 1995 Paragraph 4(a)(3).

⁵¹ISDA Credit Support Annex, 1995 Paragraph 4(a)(4) i.

⁵²ISDA Credit Support Annex, 1995 Paragraph 4(a)(4) ii.

(e) Representations Made by Parties in the Credit Support Annex

Paragraph 7 provides that each party represents to the other party that it is the sole owner of the collateral (Eligible Credit Support) or that it has the right to transfer it to the other party to the credit support annex free and clear of any security interest, lien encumbrance or other restriction.⁵³

...the Secured Party will not have the right to sell, pledge, rehypothecate, assign, invest, use, commingle or otherwise dispose of, or otherwise use in its business any Posted Collateral it holds under this Deed.⁵⁴

Paragraph 6(d) above explicitly prohibits the re-use of the collateral property posted as well prohibits the use of the collateral for any other reason other than that specified under the Credit Support Deed.⁵⁵

B. The ISDA Credit Support Deed (CSD)

Although market participants barely use the Credit Support Deed documentation in their derivatives transactions, it is pertinent to understand the sort of security which this document seeks to create as well as its weaknesses to enable proper usage should the parties seek to create security interest as opposed to creation of personal rights in transfer.

The Credit Support Deed, unlike the Credit Support Annex does not form part of the ISDA master agreement, rather it is a separate security agreement and must be executed as a deed.⁵⁶ Thus parties who intend to use the Credit Support Deed must ensure that they stipulate that in the schedule to the master agreement.

While the Credit Support Annex only involves an absolute transfer of all the rights of the collateral provider/transferor in the collateral property to the collateral taker,⁵⁷ the Credit Support Deed Structure creates security rights in the collateral property by way of charge, mortgage, pledge and transfer.⁵⁸ Thus, the Credit Support Deed is structured so that the collateral provider grants security interest in the collateral property subject to English law.⁵⁹ Paragraph 2(b) provides that:

Each party as the Chargor, as security for the performance of the Obligations: (i) mortgages, charges and pledges and agrees to mortgage, charge and pledge, with full title guarantee, in favour of the Secured Party by way of first fixed legal mortgage all Posted Collateral (other than Posted Collateral in the form of cash), (ii) to the fullest extent permitted by law, charges and agrees to charge, with full title guarantee, in favour of the Secured Party by way of first fixed charge all Posted Collateral in the form of cash; and (iii) assigns and agrees to assign, with full title guarantee, the Assigned Rights to the Secured Party absolutely.⁶⁰

⁵³ISDA Credit Support Annex, 1995.

⁵⁴ISDA Credit Support Deed, 1995 Paragraph 6(d).

⁵⁵Johansson, E. (2009) Property Rights in Investment Securities and the Doctrine of Specificity, (Springer Science and Business Media).

⁵⁶Firth, S. (n 16).

⁵⁷ISDA Credit Support Annex, 1995 Paragraph 5(a) and (b).

⁵⁸ISDA Credit Support Deed. Paragraph 2(b).

⁵⁹Johansson (n 54).

⁶⁰ISDA Credit Support Deed 1995.

By using legal techniques such as charge, mortgage and pledge, the collateral provider under a Credit Support Deed creates security interest in the property it posts as collateral for the purpose of having a certain level of control over the property posted with the collateral taker. Thus unlike a transfer where the collateral giver/transferor transfers “all” right to the collateral taker and has no control on how the posted collateral will be used, by creating a security interest in the property under the Credit Support Deed, the collateral provider can actually restrict the rights of the transferee and hold the transferee accountable where it exceeds its rights.

Paragraph 6(d) provides for the extent of rights which the transferee has under the Credit Support Deed. It provides that: the secured party/transferee should exercise reasonable care to assure the safe custody of the collateral.⁶¹

Although Paragraph 2(b) which provides that each party “...mortgages, charges and pledges...”⁶² seems to want to create some form of security interest in the collateral property, it has however been criticized as contradictory and confusing as to what specific collateralization technique the Credit Support Document intends to create.⁶³ This is because the provision that the relevant party mortgages, charges and pledges is simply doctrinally impossible.⁶⁴ Thus parties to the Credit Support Deed in particular the collateral provider would have to make clear what form of security interest they intend to create to avoid confusion.

Conclusion

Although financial derivatives have always been regarded as complex financial products or instruments that are difficult to understand, this research proves otherwise. A derivatives lawyer must understand first the principles of taking security as set out in the general principles of law when dealing with ISDA credit support documentation structure. In essence, understanding the ISDA documentation structure no doubt is pivotal to ensuring that both the economic and legal interests of the derivatives counterparties are taken into consideration and protected.

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⁶¹ISDA Credit Support Deed, 1995 Paragraph 6(a).

⁶²ISDA Credit Support Deed, 1995 Paragraph 2(b).

⁶³Hudson A (4). See Also S Firth (n 16).

⁶⁴Hudson A (4).

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