Overview

Credit Support Annex

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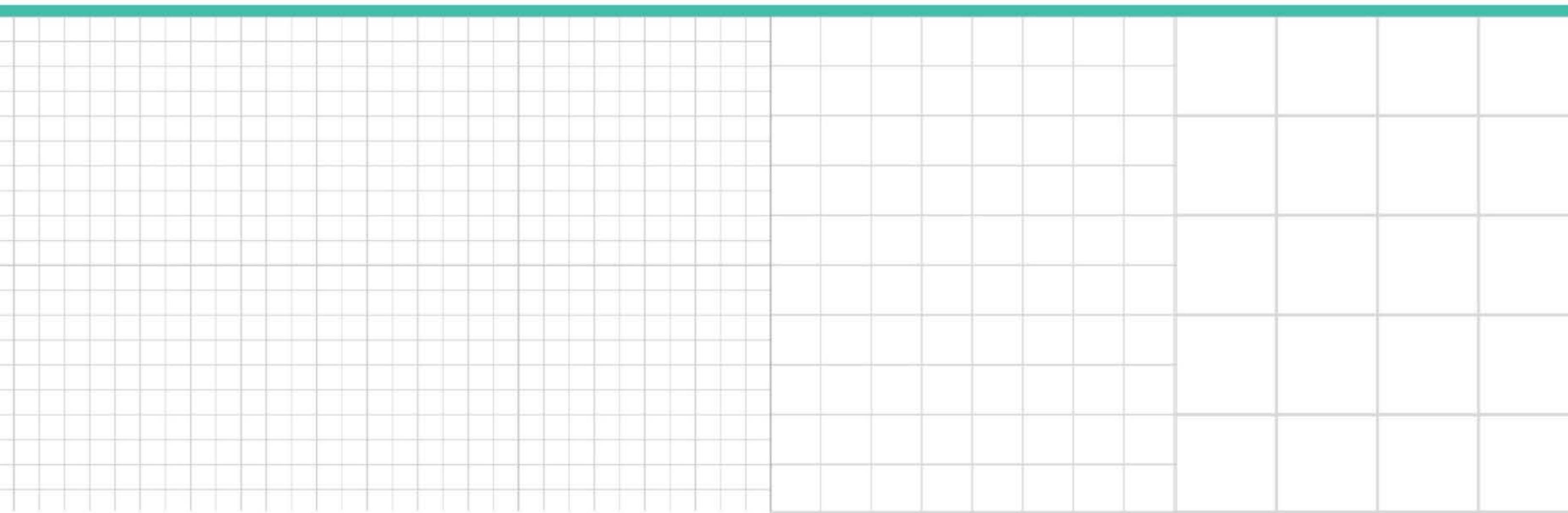

Credit Support Annex

Contributed by GuyLaine Charles of Charles Law PLLC

Introduction

Sophisticated parties wanting to trade over-the-counter ("OTC") derivatives typically do so under the International Swaps and Derivatives Association ("ISDA") Master Agreement (the "Master Agreement"). The Master Agreement offers parties the option of mitigating counterparty credit risk by posting collateral to cover their obligations under the Master Agreement. Counterparty credit risk is the risk that a party will not be able to fulfill its financial obligations under the Master Agreement for any reason ranging from a lack of liquidity to actual insolvency.

This overview discusses voluntary and mandatory credit support documentation between counterparties and the ISDA standard form credit support annexes that provide the contractual framework to facilitate the collateralization of obligations. For further information concerning derivatives, see Bloomberg Law, Portfolio 263: Regulation of Swap and Other Over-the-Counter Derivative Contracts.

Prior to the enactment of Title VII of the Dodd Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), parties could mitigate counterparty credit risk in a number of ways, including by accepting a guarantee from an affiliate of its counterparty with greater creditworthiness, becoming a secured party under security documentation provided to its counterparty's creditors, or entering into standard form credit support documentation published by ISDA.

Codification of Risk Mitigation

Lehman Brothers Holdings Inc. filed a Chapter 11 bankruptcy petition on September 15, 2008 and several affiliated debtors soon followed, ushering in a financial crisis and recession in the U.S. The codification of risk mitigation occurred in the aftermath of the Lehman Brothers crisis, when the U.S. Congress enacted Sections 731 and 764 of the Dodd-Frank Act to address the G20 resolutions to reform the OTC derivatives market. These provisions established, amongst other things, margin requirements with respect to derivatives entered into bilaterally between counterparties and therefore subject to counterparty credit risk ("uncleared OTC derivatives").

Legislators in a number of jurisdictions around the world also responded to the G20 initiative with margin requirements for uncleared OTC derivatives; however, this overview focuses solely on the United States' response and the New York law governed documents created to enable compliance with the laws and regulations implemented in the U.S.

Sections 731 and 764 of the Dodd-Frank Act provide that the Commodity and Futures Trading Commission ("CFTC"), the Security Exchange Commission ("SEC"), and the Prudential Regulators (as defined below) are to establish initial margin ("IM") and variation margin ("VM") requirements on swaps and security-based swaps, as applicable, that are not cleared on a registered derivatives clearing organization. For a description of the difference between swaps and security-based swaps, see Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement;" Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48208 (August 13, 2012).

In response, on November 30, 2015, The Office of the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Association, and the Federal Housing Finance Agency (collectively, the "Prudential Regulators") published rules that set margin requirements for the entities they regulate (the "PR Entities") with respect to uncleared swaps and uncleared security-based swaps (the "PR Rules"). Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74840 (Nov. 30, 2015).

On January 6, 2016, the CFTC published rules that set margin requirements for swap dealers that are not regulated by Prudential Regulators (the "CFTC Entities", the CFTC Entities, the PR Entities together with the Exempted SBSDs (as defined below) will be referred to collectively herein as "Regulated Entities"), with respect to uncleared swaps (the "CFTC Rules"). Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016).

On August 22, 2019, the SEC published margin rules for non-bank security-based swap dealers (the "SEC Entities") with respect to uncleared security-based swaps (the "SEC Rules"). Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers, 81 Fed. Reg. 6359 (Aug. 22, 2019, as corrected on Oct. 21, 2019). The SEC Rules became effective on October 21,

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2019 and have a compliance date of October 6, 2021. The SEC Rules differ in some respects from the CFTC Rules and PR Rules; however the SEC Rules provide that SEC Entities that are not registered broker-dealers, are also registered as swap dealers with the CFTC and have limited security-based swap activity may, rather than comply with the SEC Rules, comply with the CFTC Rules (such entities the "Exempted SBSDs"). Therefore, we will not address the SEC Rules hereunder.

The CFTC Rules and the PR Rules (collectively the "uncleared margin rules" or "UMRs") have made the collateralization of obligations under a Master Agreement for PR Entities, CFTC Entities, SEC Entities as well as financial end-users and financial end-users with material swap exposure (each as defined below). These rules can be divided into two categories: the rules with respect to Variation Margin and the rules with respect to Initial Margin.

Negotiations involving non-financial end-users continue to allow for flexibility as to how parties can mitigate counterparty credit risk. For instance, parties can agree that margining will not be bilateral, i.e., only one party will be entitled to receive collateral if that party is in the money. While the CFTC Rules are not prescriptive with respect to margining by non-financial end-users, the PR Rules provide that the PR Entity collect collateral in an amount and form that addresses the credit risk of its counterparty and the risk of the trade.

Variation Margin

CFTC Entities and PR Entities are now required to post and collect variation margin from other Regulated Entities they transact with and from financial end-users. The rules provide an enumerated list of entities that are considered financial end-users comprised of, broadly speaking, entities whose activities are mostly financial in nature and whose revenues are predominantly generated from financial activities.

There are certain entities that may seem to be financial end-users but are specifically excluded from the definition, including sovereigns, multilateral development banks and certain entities subject to exemptions. For the full list, see CFTC Rules at 696 and 17 CFR Part 23 and PR Rules at 74901.

The Variation Margin rules went into effect for financial end-users in 2017. These rules are based on the concept of Exposure. A party's exposure ("Exposure") is essentially the sum of the positive and negative mid-market valuations of the outstanding transactions under the Master Agreement that are required, or agreed, to be subject to Variation Margin. The change in Exposure from one day to the next represents the mark-to-market change of the transactions in that period. Collateral pledged to cover Exposure is referred to as Variation Margin in the uncleared margin rules.

The rules with respect to Variation Margin require, among other things:

1. bilateral collateral posting;
2. daily calculation of Exposure to determine the collateral to be posted by either party;
3. same day posting of collateral if a call is received by the notification time agreed to between the parties, next day otherwise;
4. that if the parties are not operating under an Eligible Master Netting Agreement (see below), the Regulated Entity is required to collect margin on a gross, rather than net, basis; and
5. that the collateral posted be acceptable under the UMRs and subject to the haircuts mandated in the UMRs.

An Eligible Master Netting Agreement is a master agreement, such as an ISDA Master Agreement, which provides that all transactions entered into thereunder form a single agreement and that, upon termination, all transactions will be valued and netted, so that only the party owing the greater amount will be required to make a payment to the other. Both the CFTC Rules and the PR Rules were amended to modify the definition of Eligible Master Netting Agreement. CFTC Rules are in Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 83 FR 60341 (November 26, 2018), PR Rules are in Margin and Capital Requirements for Covered Swap Entities; Final Rule, 83 FR 50805 (October 10, 2018).

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Initial Margin

Initial Margin is only required if the CFTC Entity or the PR Entity is transacting with another Regulated Entity or a financial end-user with “material swap exposure.” A financial end-user with a material swap exposure is a financial end-user that, at the group level, including consolidated affiliates, has an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps with all of its counterparties for the months of June, July and August of the prior year, that exceeds USD 8 billion.

If a Regulated Entity is facing a financial end-user with material swap exposure, the implementation date for posting and collecting Initial Margin is as follows:

	AANA Threshold	**Implementation Date**
If the financial end-user with material swap exposure has at the group level, including consolidated affiliates, an average daily aggregate notional amount (“AANA”) of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps with all counterparties for the months of March, April and May of the current year that exceeds -	USD 3.0 trillion	1 September 2016
	USD 2.5 trillion	1 September 2017
	USD 1.5 trillion	1 September 2018
	USD 0.75 trillion	1 September 2019
	USD 50 billion	In July 2019 the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) added an additional implementation date of 1 September 2020 for AANAs exceeding $50 billion. However, in light of Covid-19, on April 3, 2020, BCBS IOSCO agreed to extend compliance to 1 September 2021. This extension has yet to be adopted by the CFTC or the Prudential Regulators but they are expected to follow suit.
	All other financial end-users with material swap exposure	Was 1 September 2020 but was extended in July 2019 by BCBS IOSCO, to 1 September 2021. However, in light of Covid-19 on April 3, 2020, BCBS IOSCO agreed to extend compliance further to 1 September 2022. This extension has yet to be adopted by the CFTC or the Prudential Regulators but they are expected to follow suit.

The Initial Margin rules are based on the concept of over-collateralization, what the industry termed the “Independent Amount” in the past, and is now referred to in the UMRs as Initial Margin. The Independent Amount is over-collateralization requested by a party in addition to Exposure. Independent Amounts are negotiated between the parties whereas Initial Margin, which is also over-collateralization, is subject to a regulatory minimum.

The Regulated Entity's requirement to post Initial Margin is a departure from existing industry practice where only the weaker credit would typically post an Independent Amount. The UMRs provide that IM can be calculated based on either (i) a risk-based model that has been approved by the Prudential Regulators, with respect to the PR Rules or with respect to the CFTC Rules, by the CFTC or its delegate, or (ii) a grid methodology specified in the UMRs, which is based on a

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percentage of the derivative notional value. IM is generally to be exchanged by both parties without netting of amounts collected by each party (i.e., on a gross basis).

While segregation of Initial Margin can be a costly proposition, both in terms of the upfront legal and other fees required to set-up the relationship as well as the ongoing fees to the custodian, the UMRs have codified the requirement to segregate Initial Margin with an unaffiliated custodian. This approach is based on lessons learned from the Lehman crisis as, when Lehman (and its affiliated entities) defaulted under a Master Agreement (as a result of its bankruptcy proceedings or that of its credit support provider or specified entity), its counterparties' claims for a return of their Independent Amounts became general unsecured claims.

Transferring the Initial Margin to a bankruptcy remote custodian ensures that the collateral posted is more readily recoverable in the event of the insolvency of the secured party.

Documentation

ISDA has published a number of documents governed by varying governing laws which allow parties to post and collect margin. Initially ISDA's documents were published to facilitate the posting and collection of collateral and subsequently to allow the industry to comply with the UMRs. There are three New York law governed credit support annexes that can be used by all market participants:

1. the 1994 ISDA Credit Support Annex (Security Interest – New York Law) ("1994 NY CSA"), which will be used by counterparties when one of them is a non-financial end-user or by counterparties whose credit support annex must be compliant with the Variation Margin rules, subject to a few amendments which will achieve that goal;

2. the **2016 Credit Support Annex for Variation Margin (Security Interest – New York Law)** (the "2016 NY VM CSA"), which will be used by counterparties whose credit support annex must be compliant with the Variation Margin rules; and the **2018 Credit Support Annex For Initial Margin (Security Interest – New York Law)** (the "2018 NY IM CSA", together with the "1994 NY CSA" and the "2016 VM CSA", the "CSAs") which will be used by counterparties whose credit support annex must be compliant with the Initial Margin rules.

For the posting of Initial Margin, ISDA has also created documents which allow parties to separate the credit support annex into two agreements - the first providing the transfer mechanism and the second granting the security interest. The **2019 Collateral Transfer Agreement for Initial Margin (IM)** will be governed by the law of the Master Agreement and the security agreement will be governed by law of the location of the custodian. The New York law security agreement is the **ISDA 2019 New York Law Security Agreement for Initial Margin (IM)**.

Mitigation of Counterparty Risk

Each CSA can be added to the Master Agreement as an annex to the Schedule to the Master Agreement. The CSAs provide a basic contractual framework enabling parties to decrease counterparty credit risk by establishing the structure for the collateralization or over-collateralization of a party's obligation. They set out the parties' obligations to post and receive credit support, state the assets that will be acceptable as credit support, provide for the granting of a security interest in such assets or otherwise state the receiving party's rights in such assets, and set out the rights, remedies, and duties of the parties with respect to the credit support provided.

Exposure

The 1994 NY CSA and the 2016 NY VM CSA specify a counterparty's duty to post collateral and right to receive collateral based on the concept of Exposure.

These two CSAs provide for daily calculations of Exposure allowing the "in the money" party to make calls for collateral from the "out of the money" party. If the secured party's Exposure exceeds the value of collateral that has been previously posted by the pledgor to the secured party with respect to the transactions entered into under the Master Agreement that are subject to the CSA, then the secured party is entitled to make a collateral call to request additional credit support to cover its increased credit risk. Conversely, if the secured party's Exposure is less than the value of collateral it is holding with respect to the relevant transactions, then the reduced credit risk entitles the pledgor to call for a return of collateral.

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Independent Amount and Initial Margin

The 1994 NY CSA and the 2018 NY IM CSA specify a counterparty's duty to post collateral and right to receive collateral based on the concept of Independent Amount (for the 1994 NY CSA) and Initial Margin (for the 2018 NY IM CSA). The 2016 NY VM CSA does not contemplate the posting of Independent Amount or Initial Margin. Where parties want to collect Independent Amounts from their counterparties and they are not yet subject to the Initial Margin rules, they can amend their 2016 NY VM CSAs with terms from the ISDA-published Independent Amount Provisions (the “IA Amendment”).

The rules effecting the requirement for transfer of Initial Margin are not yet in effect for most financial end- users and while the industry was gearing up for September 2020 which was, prior to the July 2019 BCBS IOSCO compliance delay, to see the requirement to implement almost 7000 new initial margin relationships, the compliance delays suggested by BCBS IOSCO and which the industry excepts all regulators will follow, will allow market participants to take a more deliberate approach to implementation. In the meantime, parties continue to negotiate the 1994 NY CSAs and 2016 NY VM CSAs. For a comparison of these two credit support documents, please see Comparison Table.

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