

Watch Your Swaps And Derivatives Termination Payments

Law360, New York (June 10, 2013, 12:44 PM ET) -- Swaps and derivatives became popular and commonly used financial tools in the 1980s. However, individual dealers developed and adopted different contracts with different terms and conditions, which required lengthy negotiations. As a result, in 1985, dealers and market participants chartered the International Swaps and Derivatives Association. Since its formation, ISDA has published standardized “master agreements” that define the relationship and rights of parties engaging in swaps and derivatives transactions.[1]

ISDA and the 1992 Master Agreement Termination Payment Calculations

The master agreements are designed to allow the parties to engage in multiple transactions under the terms of the master agreement. Parties can supplement and customize the terms of their relationship through a schedule to the master agreement. For example, master agreements and their related schedules define the payment terms and provisions, representations and warranties, events of default, termination rights, and methods to calculate payments on early termination that best suit the parties’ needs. The terms of each individual swap or derivatives transaction are memorialized in a “confirmation” that references the master agreement and specifies the details of each transaction, including, for example, payment dates, the fixed rate and the index/benchmark for the floating rate.

The 1992 Master Agreement is the first master agreement published by ISDA. It specifies two alternative methods, market quotation and loss, to calculate the payment due from one counterparty to the other in the event of an early termination of a swap. In response to a series of crises in the 1990s that tested the strength of existing ISDA documentation, ISDA published the 2002 Master Agreement. In recognition of the issues surrounding the market quotation and loss methods due to the market stress in the 1990s, one of the major changes under the 2002 Master Agreement was to replace the two methods of calculating termination payments with a single method for calculating the termination payment — the “closeout amount.”

Upon the publication of the 2002 Master Agreement, ISDA encouraged counterparties to amend their existing agreements to adopt the provisions of the new agreement. However, many parties chose to continue to operate under the 1992 Master Agreement, as a result of which market quotation and loss continue to be the governing methods to calculate termination payments for a number of swaps and derivatives transactions.

The financial crisis of 2008 has resulted in the termination of a large amount of swaps and derivatives transactions and the calculation of termination payments is undergoing greater scrutiny. Since most disputes are settled out of court through negotiation between the counterparties, case law, especially in

the U.S., is scarce. Each of the methods specified in the 1992 Master Agreement and their relationship with one another is discussed in greater detail below.

Market Quotation

According to the 1992 Master Agreement, in order to calculate a termination payment using the market quotation process, quotations must be taken from dealers serving as Reference Market-Makers (RMMs) in the relevant market for the cost of entering into a transaction “that would have the effect of preserving for such party the economic equivalent of any payment or delivery ... by the parties ... that would, but for the occurrence of the relevant Early Termination Date, have been required after that date.”[2]

To conduct the market quotation process, the party conducting the process[3] (the determining party) contacts four RMMs and asks them to submit quotes representing how much they would expect to pay or receive to enter a replacement transaction with the determining party. The expected payment implies that the swaps are off-market swaps, i.e. they are in-the-money to one counterparty and out-of-the-money to the other. In effect, the market quotation process preserves for the determining party an identical or near identical transaction (i.e. the same notional amounts, and fixed- and floating-rates of the original transactions). The swap is an off-market swap since it is extremely unlikely that interest rates are unchanged from the initiation of the original transactions that are being terminated.

If four RMMs provide quotes, then the highest and lowest quotes are discarded, and the termination payment is based on the average of the two remaining quotes. If exactly three quotes are provided, then, again, the highest and lowest are discarded and the remaining quote provides the basis for the termination amount. In the event that at least three RMMs cannot be found from which to obtain quotes, or if the party seeking the market quotation reasonably determines that the process will not produce a commercially reasonable result, the termination payment method defaults to the loss method.[4]

The advantages of the market quotation process are that the method is objective and based on pricing information from independent third parties (the RMMs). As noted in a 2002 article by Richard Tredgett and John Berry, “The set procedure that underlies the market quotation mechanism has led many market participants to consider it a more objective measure of damages than loss and also a measure that is more susceptible to verification.”[5] The authors go on to note that “Many have also considered market quotation to constitute a valid liquidated damages provision on the basis that it represents, at the time the contract is entered into, a reasonable pre-estimate of damages.”[6] Accordingly, ISDA has endorsed the market quotation process as the preferred method for calculating a termination payment.

The primary disadvantage of the market quotation process is that in times of market stress it may not be possible to obtain quotes from RMMs, or the quotes may lead to commercially unreasonable results. Due to this possibility, the 1992 Master Agreement allows for loss as an alternative method to calculate the termination payment.

Loss

According to the 1992 Master Agreement, “‘loss’ means ... an amount that a party reasonably determines in good faith to be its total losses and costs (or gain, in which case expressed as a negative number) ... including any loss of bargain, cost of funding or, at the election of such party but without duplication, loss or cost incurred as a result of its terminating, liquidating, obtaining or reestablishing

any hedge or related trading position (or any gain resulting from any of them).”[7] The User’s Guide to the 1992 Master Agreements states that loss “is a payment measure in which a party reasonably determines in good faith its total losses (expressed as a positive number) and gains (expressed as a negative number)” in connection with the terminated transactions.[8]

ISDA does not provide specific guidance regarding what constitutes “loss of bargain,” “cost of funding,” or “loss or cost incurred as a result of its terminating, liquidating, obtaining or reestablishing any hedge or related trading position ...” Rather, the determining party is left to calculate its total losses or gains due to the termination. Accordingly, when swaps are terminated due to events of default, practitioners generally understand that loss is “a general indemnification measure of damages and give the Non-defaulting party considerable discretion, subject only to the requirements of reasonableness and good faith.”

The advantage of the loss provision is that it can be used to calculate the termination payment in situations where the market quotation process fails. However, the loss method is inherently subjective, leaving it open to manipulation by the determining party, as well as criticism from the nondetermining party.

The Relationship Between Market Quotation and Loss

Although market quotation and loss are separate methods and seem to be independent of each other, both are subject to certain subjective constraints. The market quotation method must produce commercially reasonable results (although there is little guidance from ISDA as to what constitutes commercial reasonableness), while the loss method is subject to a good faith requirement. Neither method is meant to be punitive to one party and result in a windfall to the other.

Disputes usually arise when the termination payment determined using the market quotation method is significantly different from the value of the swaps or derivatives. This occurs because the RMMs charge new fees for entering into the replacement transaction. These fees can be significant, especially for off-market swaps, as they can include charges to finance the up-front payment required. Often the protection offered by the termination transactions can be replaced with on-market swaps. Under these circumstances, the termination payment calculated using the loss method can be closer to the value of the swaps.

Court opinions on this subject are limited. While there are no court opinions in U.S. courts, there are two opinions issued by courts in England that deal with this subject. In *Peregrine Fixed Income Ltd. v. Robinson Department Store Public Company Ltd.*, the court found that “the market quotation measure and the loss measure are intended to lead to broadly the same result.” The court in *Peregrine* also references *Australia and New Zealand Banking Group Ltd. v. Société Générale*, where members of the court also reached the same conclusion.[9]

However, neither court addressed the issue of how large the difference between the market quotation and loss methods must be in order for the market quotation to be considered commercially unreasonable. Such a determination is to be made on a case-by-case basis, and depends on a number of factors, including the terms and structure of the transaction, as well as the timing of the termination and the market conditions prevalent at that time, among others. For example, because interest rate swaps are OTC instruments, they can contain provisions that substantially affect the fees charged (and therefore the discount to the value) for the swap.

However, it is now generally recognized that the results of market quotation and loss method can be compared to each other. Simon Firth in *Derivatives Law and Practice* states that the decision in *Peregrine* "suggests that the commercial reasonableness of the market quotation provisions must be tested against the result of applying 'loss' whenever they are used"[10] and that "it seems entirely correct to say that market quotation and loss are intended to lead to broadly the same result, so that one should be tested against the other." [11]

Considerations Using the Market Quotation Process

The market quotation process is intended to be more objective than the loss calculation. Due to its reliance on quotes from third parties, it is also believed to be more independent and thus more reliable. This has led to the market quotation process being the preferred method to calculate the amount of the termination payment under the 1992 Master Agreement. However, it is important to understand the assumptions embedded in the market quotation process and its limitations.

Liquidity, Price Discovery and the Market Quotation Process

In order for any market to function reliably, there must be a mechanism to communicate price information to prospective buyers and sellers. Economists refer to this function of markets as "price discovery." [12] It is generally recognized by economists and regulators that price discovery is facilitated by liquid markets containing many buyers and sellers of standardized financial contracts. In periods of financial distress, such markets can "freeze" due to a lack of credit and liquidity, or can exhibit other anomalous behavior that is inconsistent with a well-functioning market that facilitates accurate price discovery.

In essence, the market quotation process is designed to facilitate price discovery under specific conditions, namely, the termination of an over-the-counter derivative contract such as an interest rate swap. However, in an illiquid market, the market quotation process is naturally constrained in this function due to the dearth of buyers and sellers of the particular derivative contract in question. As noted by Weeber, Hoffman and Robson in an article published in the *American Bankruptcy Institute Journal* in 2009, "The market-quotation method assumes a liquid derivatives market that can quickly and efficiently replace any agreements breached by a defaulting counterparty." [13] Likewise, according to Simon Firth in *Derivatives: Law and Practice*:

Market quotation is only suitable ... if representative transactions are available in the market. If the market is very illiquid, any quotations that are available may diverge from each other considerably and so might not accurately reflect the actual loss or gain that has accrued to each party as a result of the closeout. Such a situation might arise if the transactions are complex or exotic or, even in the case of "plain vanilla" transactions, in times of market stress. [14]

Potential Manipulation of the Market Quotation Process

Although the market quotation is considered to be more objective and independent than loss, it can be manipulated by the determining party. The intent of this section is not to undermine the market quotation process, but simply to illustrate that the results of a market quotation process cannot always be taken at face value. The determination of whether or not manipulation has occurred depends on the facts and circumstances surrounding the process in question.

The potential for manipulation arises as the 1992 Master Agreement allows both actionable as well as indicative quotes to be used in the market quotation process. An actionable quote, also referred to as a “firm” or “executable” quote, represents an offer to transact at the quoted price. Actionable quotes represent a contingent commitment of resources in the form of collateral and funding of the prospective payments. These commitments entail actual and opportunity costs to the entity offering the quote and the process of offering an actionable quote involves analyses and approvals from several internal desks or managers, including the credit department.

In contrast, an indicative quote, also referred to as a “soft” or “accommodative” quote, makes no commitments whatsoever, but is simply an indication of the price levels at which the entity would enter into the transaction. Often, the analyses and approvals required to provide an actionable quote are bypassed when providing an indicative quote or require less stringent criteria for approval if the quote to be provided is an indicative quote. RMMs usually do not charge a fee to provide quotes in the market quotation process.

It is common practice for the determining party to seek to reestablish its swaps or derivatives positions using replacement at-market transactions at the same time that it is conducting the market quotation process. Often the same RMMs are requested to provide quotes for the market quotation process as well as the replacement at-market transactions. Under these circumstances, there may be an implicit or explicit quid pro quo agreement between the determining party and the RMM under which the RMM provides an indicative quote for the market quotation process that is beneficial to the determining party and in return is allowed to participate in the replacement at-market swaps. Since indicative quotes do not constitute a commitment to transact, there is no financial penalty for the RMM for providing a mispriced quote. However, the RMMs can earn profits on the replacement at-market swaps.

Additionally, the provision of indicative quotes can result in a market quotation process that would have failed if actionable quotes were required. As previously stated, the market quotation process requires a minimum of three quotations from RMMs. However, the analyses and approvals required to provide an actionable quote are bypassed when providing an indicative quote or require less stringent criteria for approval if the quote to be provided is an indicative quote. Since actionable quotes have higher hurdles for approval, a sufficient number of RMMs may not be able to provide an actionable quote for the market quotation method to be used.

Although the 1992 Master Agreement is silent on the issue, the use of actionable quotes is preferred by regulators and commentators. Alan Greenspan, during his tenure as chairman of the Federal Reserve Board, strongly endorsed the requirement for actionable over indicative quotes in his well-known derivatives address given at the Federal Reserve Bank of Atlanta in 1996:

Transaction prices can be determined only by contacting potential counterparties and soliciting offers to transact. Moreover, when soliciting quotations it is essential that it be made clear to potential counterparties that a transactions price, rather than a fair market value estimate or a nonbinding “indicative” price quotation is desired ...[15]

Simon Firth in *Derivatives: Law and Practice* concludes that in order for the market quotation process to operate in a reliable manner, the quotes provided must be actionable, not indicative:

It is not uncommon for quotations that are provided to be expressed as "indicative quotations." In other words, they are provided for valuation purposes only and do not necessarily represent the price at which a Reference Market-maker is prepared to trade. For example, the Reference Market-maker, knowing the purpose for which the quotation has been requested, may not have analyzed the

economics of the transaction in the same level of detail as in a normal trade. It is questionable, however, whether the use of indicative quotations is permitted by the ISDA Master Agreement if they have not been prepared with sufficient precision. For there to be a "quotation", it is submitted that there has to be a firm statement from the Reference Market-maker of the price at which it would be prepared to deal. An indicative quotation may be no more than a rough guide to this and could probably be challenged if it does not represent a proper trading price.[16]

ISDA issued guidance on the use of indicative and actionable quotes in 2009. At the direction of the ISDA Board of Directors, the ISDA Collateral Committee developed a collateral dispute resolution procedure, publishing the new procedure in 2009.[17] In consultation with the ISDA Product Steering Committee, other industry associations and financial industry regulators, the dispute resolution procedure was viewed as necessary due to the increased occurrence of disputed collateral calls in OTC transactions.[18] According to ISDA, the new Collateral Dispute Resolution Procedure is intended to achieve the following:

- Ensure transparency and engagement in resolving disputes;
- Demonstrate that market-makers are acting as market-makers, and are committed to providing firm executable prices to be used in the resolution of disputes; and
- Establish a clear hierarchy of prices, ensuring that firm executable prices supersede indicative quotes for dispute resolution.[19]

According to ISDA's Outline of the 2009 Protocol for Resolution of Disputed Collateral Calls, the focus on executable prices "is intended to prevent potential abuse of the process by firms that may be tempted to give overly aggressive or overly conservative prices during any kind of polling process, safe in the knowledge that they will never be asked to trade at those levels." [20]

Upon the release of the new Collateral Dispute Resolution Procedure, Matt Cameron wrote an article on Risk.net describing "price firmness," as one of the principles on which the new protocol is based and also noting that "executable prices will be more likely to be accurate than ... indicative prices." [21] One collateral manager quoted in the article stated "... the use of indicative prices [for collateral disputes] was a bit like playing poker with play money." [22]

The outcome of the ISDA review of collateralization practices demonstrates that market participants and regulators wished to impose rigor and reliability into the collateral dispute resolution process through a strong preference for actionable quotations. It is apparent from the commentary above that ISDA and other market participants agree that there is general concern over the incentives to "game" the process in order to achieve a desired outcome. [23]

Conclusion

The calculation of termination payments is undergoing increasing scrutiny as the financial crisis of 2008 has increased the number of transactions being terminated, as well as increased the differences between the value of the transaction and the termination payments. The 1992 Master Agreement allows termination payments to be calculated using two different methods, both of which allow some degree of subjectivity. Other than a finding that both methods should lead to "broadly the same result," there is very little precedent established by case law to determine which method should be used. In spite of being hailed as the more "objective" method, the results of market quotation cannot always be taken at face value. The ultimate determination of commercial reasonableness depends on the facts and circumstances of each case.

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[1] There are different formats of ISDA Master Agreements, such as the Local Currency-Single Jurisdiction version and the Multicurrency-Cross Border version. Users can choose the Master Agreement best suited to the anticipated transactions that they plan to engage in. Additionally, ISDA has revised these Master Agreements over time. For example, the 1992 Master Agreements was revised in 2002 with the publication of the 2002 Master Agreements. See Vrana, Paul E., Enochs, Craig R. and Mwamba, Fundi A. How to Use the ISDA Master Agreement, 28th Annual Ernest E. Smith Oil, Gas and Mineral Law Institute, March 22, 2002, pp.3-6; <http://www.isda.org/press/press010803.html>.

[2] 1992 Master Agreement, §12.

[3] If the swap is being terminated due to an event of default, the non-defaulting party is responsible for determining the amount of the termination payment.

[4] 1992 Master Agreement §12; ISDA, “Market Review of OTC Derivative Bilateral Collateralization Practices”; Release 2.0; March 1, 2010; p.14. See also Gooch, Anthony and Klein, Linda, Documentation for Derivatives, p. 251.

[5] Tredgett, Richard and Berry, John, 2002, “A New Master Agreement for the New Millenium: The Development of the 2002 Master Agreement,” Journal of International Banking & Financial Law, Vol. 1, Issue 5, p. 3.

[6] Tredgett, Richard and Berry, John, 2002, “A New Master Agreement for the New Millenium: The Development of the 2002 Master Agreement,” Journal of International Banking & Financial Law, Vol. 1, Issue 5, p. 3; Section 6(e)(iv) of the 1992 Master Agreement states, “The parties agree that if market quotation applies an amount recoverable under this Section 6(e) is a reasonable pre-estimate of loss and not a penalty.”

[7] 1992 Master Agreement, §12.

[8] ISDA, User’s Guide to the 1992 Master Agreements (1993 Edition), p. 25.

[9] Peregrine Fixed Income Ltd. v. Robinson Department Store Public Co. Ltd., 2000 WL 1027115, at ¶ 30 (Q.B. 2000).

- [10] Firth, Simon, *Derivatives Law and Practice*, Release 15 (Thomson); December 2010; §11-150.
- [11] Firth, Simon, *Derivatives Law and Practice*, Release 15 (Thomson); December 2010; §11-149.
- [12] International Monetary Fund, *Compilation Guide on Financial Soundness Indicators*; Appendix VII, Glossary; 2004.
- [13] Weeber, Phil, Hoffman, Matthew E. and Robson, Edward S. "Market Practices for Settling Derivatives in Bankruptcy: Part I," *American Bankruptcy Institute Journal*; Vol. 28, No. 8; October 2009.
- [14] Firth, Simon, *Derivatives Law and Practice*, Release 15 (Thomson); December 2010; §11-146.
- [15] Greenspan, Alan, "Derivatives Address," Federal Reserve Bank of Atlanta Financial Markets Conference, February 1996. Reprinted in Schwartz, Robert J. and Smith, Clifford W. Jr., eds. *Derivatives Handbook: Risk Management and Control* (John Wiley & Sons, Inc.), 1997, p. 502.
- [16] Firth, Simon, *Derivatives Law and Practice*, Release 15 (Thomson); December 2010; §11-131 [emphasis added].
- [17] ISDA, *Guidelines for Implementation of the ISDA 2009 Collateral Dispute Resolution Procedure*; 2009; p. 3.
- [18] ISDA, *Guidelines for Implementation of the ISDA 2009 Collateral Dispute Resolution Procedure*; 2009; p. 4. Note that the ISDA Credit Support Annex includes a provision for resolving disputes that involves a market quotation process with quotes obtained from RMMs.
- [19] ISDA, *Market Review of OTC Derivative Bilateral Collateralization Practices*, Release 2.0; March 1, 2010; p. 30.
- [20] ISDA, *Outline of the 2009 Protocol for Resolution of Disputed Collateral Calls*; 2009; p. 13 (fn. 15).
- [21] Cameron, Matt, "Conflict's End," *Risk*; August 1, 2009.
- [22] Cameron, Matt, "Conflict's End," *Risk.net*; August 1, 2009.
- [23] In the *Enron Australia Finance v. Integral Energy Australia*, there was evidence that one of the RMMs that provided quotes for the market quotation process had provided Integral with drafts of its quotation for "discussion." See Fernbach, Andrew, 2003, "Court Rules on ISDA Close-Out Calculations," *International Financial Law Review*, Vol. 22, Issue 3, p. 21.
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