

Devil in the Detail: Derivatives Documentation in a New Market Environment

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With the introduction of central clearing for OTC derivatives, financial institutions will have to manage new agreements, with different business rules, in addition to the existing documentation for bilateral trading relationships. In a Q&A, Exari Systems' Paul Nelmes explains how documentation will change within a CCP environment and why financial institutions must implement efficient documentation processing methods to avoid increased legal and operational costs caused by the new market requirements.

Q. How does the introduction of central counterparty clearing (CCP) change the documents used to support OTC derivatives?

The existing Over-the-Counter (OTC) clearing documentation structure between financial institutions and clients or counterparties in the bilateral trade clearing environment, will be supported by the existing International Swaps and Derivatives Association (ISDA) Master Agreement and supplemental documents/annexes such as Credit Support Annex (CSA), trade confirmations.

In the central counterparty clearing (CCP) environment there will be a significant increase in the amount of documentation and overall, the documentation will be more complex. The terms of the agreements with CCPs may be less favorable to the clearing members than their typical bilateral agreement, and commonly will give the CCP power to make unilateral changes by virtue of incorporating its clearing rules (which they decide when and how to change).

Banks trading with many thousands of derivatives counterparties will be compelled by regulators to clear a certain amount of those trades on a central exchange. However, not all OTC trades will be cleared, so anyone dealing in OTC trades that are not standardized will still need bilateral ISDAs or other master agreements in place. The terms of agreements between clearing members and end users (e.g. hedge funds) will need to be amended to include terms that deal specifically with cleared trades (e.g. what happens if a trade is rejected by the CCP?) For OTC trades that do move to clearing, all parties that are clearing members will need master agreements in place with each CCP they deal with, and it remains to be seen how many CCPs will emerge to take advantage of this new wave of clearing.

The overall paper trail is messier compared to bilateral trades, where the ISDA Master Agreement and the trade confirmation are the only documents you need to worry about. With CCP trades, the original trade may be executed bilaterally, and then submitted for clearing. If accepted by the CCP it is replaced by two new agreements, one between the CCP and the buyer and one between the CCP and the seller, on the same economic terms but possibly slightly different netting or collateralization terms.

Financial Institutions will need to enter into supplemental agreements with each counterparty, determining how those trades are communicated, how they are 'given-up' at the exchange, margin terms, etc. There will be some tight deadlines on the clearing of 'vanilla' interest rate swaps on exchange, for example— there is a huge operational challenge and also a huge legal challenge as master agreements will need to be changed, through amended agreements.

To add further complexity there are likely to be significant

differences in regulatory approach in the European Union (EU) and the US. Many financial institutions have expressed concerns with complying with both sets of regulations, especially as there is likely to be inconsistencies between the two territories.

Q. How will financial institutions manage different clearinghouses' rules and other variations in how documentation is managed to support clearing via multiple clearinghouses?

The clearinghouse rules between the client and clearing member changes documentation for OTC trades quite significantly. The inclusion of clearinghouse rules introduces a level of stringency, as opposed to the existing ISDA Bilateral trading environment where there is less restriction.

Clearinghouse rules are generally non-negotiable, whereas the terms between the client and the clearing member are typically negotiated in many areas. For example, while margin terms are specified by the clearinghouse rules, a clearing member may seek a wide discretion to require additional margin from their client.

CCPs rules can change. Therefore, to analyze the documentation, clients will also have to have in place and review the relevant clearinghouse rules (and they may be dealing with many). These rules are likely to have a significant impact on the underlying documentation between the client and the clearing member.

Since there may be multiple CCPs, clearing members may have a choice over which CCP to clear through, and they may find that different terms are imposed on them by different CCPs. This may further complicate the terms that a clearing member has with its end-user counterparties, since they must include the right back-to-back end user terms to suit the CCP through which a deal is cleared.

Q. How will non-general clearing members, such as investment managers, who rely on the clearing services of direct clearing members, have to alter documentation to support these activities?

My understanding is that non-clearing members who are dealing with clearing members will require additional documentation -- at the very least addendums to existing documentation that set out the terms and allow the clearing member to give-up trades for clearing.

There are different rules for different clearinghouses. For example, some clearinghouses have streamlined their rules to remove the need for additional addendums required by CCP, above and beyond the existing documents. Other clearinghouses will require registration agreements between the client and the clearing member that set out the terms of how the CCP works and the rights of the client and their counterparty.

For example, investment managers will need to segregate their activities (and netting) depending on which fund they are trading for and the clearing member must do likewise when dealing with the CCP.

As mentioned above, the European model differs from the US Futures Commission Merchant (FCM) model (where an OTC Addendum to the FCM agreement is the primary agreement that clients will be required to sign). For example, if you wanted to clear interest-rate swaps (IRS) products through LCH.Clearnet, the non-member still enters into these trades on a bilateral basis, governed by the existing ISDA documentation. In addition, there will need to be 'Give-up' Agreements in place between the clearing member and counterparty (to facilitate clearing) – 'Give-up' Agreements are additional agreements to standard bilateral trading environment, as are the agreements between the client and the clearing house.

Q. What are the processing challenges in managing documentation in this mixed environment (both bilateral and centrally cleared transactions)?

The biggest challenges for managing documentation are time, resource, complexity, and risk. Not necessarily complexity in terms of the legal content (this, as already discussed will be relatively straight-forward) but the variation of agreements for differing asset classes, jurisdictions, and differing clearinghouse rules.

In addition to the huge spike in activity required in the CCP environment, these documents will undoubtedly require change as the new environment beds down, and managing this change will add further cost to the legal and documentation functions within firms.

Bilateral transactions will also be managed by the existing ISDA agreements and supplemental documents, such as the CSA.

So, as well as maintaining existing documentation for Bilateral trade relationships, financial institutions will also have to manage new agreements and new business rules.

This is certainly going to add cost to the derivatives business and the challenge for financial institutions is to find ways of reducing that cost whilst not increasing risk.

Q. How can financial institutions improve the processing of documentation to manage a growing volume of documents, use of increasingly complicated financial products whilst also reducing operational risk and cost?

In our experience many financial institutions are turning to software such as document automation and consultancy partners like Document Risk Solutions (DRS) to address this daunting document challenge. There is a real risk that organizations will react by creating masses of documents and templates to support the CCP environment and create a huge 'change management' headache in the future.

Document Automation enables financial institutions to rapidly assemble the new documentation using existing resources and delivers an agile platform that allows them to manage their content in a single source, and introduce new, or change existing, business rules easily as new regulation is introduced.

Q. What are the benefits of automating documentation? What benefits can a firm expect to achieve?

The benefits of document automation for the CCP environment are significant. From a financial perspective, the major benefits are cost avoidance, time savings and risk reduction.

Cost avoidance: the production of new agreements is going to require additional manpower, outsourcing to partners (law firms), or the use of technology. A good document automation solution will allow financial institutions to quickly define the business rules that assemble the document and also share business rules and content

across all documentation. When producing high volumes of new documentation as required by the CCP environment, this time and cost savings is massive.

Time savings: the biggest impact for financial organizations is time. Automation greatly reduces the time it takes to produce documentation for all of their clients and counterparties and increases documentation capabilities of the resources at their disposal.

Risk reduction: the risk is two-fold. Firstly, the risk of producing agreements that exclude key terms and impact the relationship with clients. Secondly, the risk of not producing the agreements in time and suffering delays from trading with clients until that documentation is in place.

From an operational and legal perspective, the value is in the speed of generating documents, the agility to make changes to content or business rules, automatic data capture throughout the document production and negotiation process, and the ability to track the document status during the production, approval, negotiation and acceptance process.

Q. Will there be other factors that may impact derivatives documentation in the coming years for CCP or a bilateral environment?

The 2011 ISDA Equity Derivatives Definitions will adopt quite a different approach than previous ISDA definitions in the way in which trades will be documented. Over time, this will undoubtedly feed through the entire documentation chain both for OTC and centrally cleared transactions.

In addition, there are proposals within current recovery and resolution plan legislation ("Living Wills") that could potentially have a huge impact on the documentation of derivative transactions, specifically in such areas as:

- Payment and delivery obligations
- Close-out netting
- Termination Rights

I think that it is conceivable that these will have a knock-on effect within the CCP area. However, the legislation is at quite an early stage so it's not really possible to say for sure.

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