



# Independent Amounts

October 2009

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## **Independent Amounts**

### Abstract

Collateralization has become a key method of mitigating counterparty credit risk in the derivative markets, both bilateral, privately-negotiated derivatives and exchange-traded, standardized derivatives. In several situations it is common for one party to provide collateral to its counterparty or a clearing house in an amount that exceeds the credit exposure between the two parties at a given point in time. This may occur intentionally; for example, in many (but not all) situations the delivery of Initial Margin or Independent Amount will lead to over-collateralization. It may also occur unintentionally; for example, during the time interval between the exposure between the parties reducing and the relevant amount of excess collateral being recalled. Regardless of underlying cause, any situation in which one party has delivered collateral in excess of the credit exposure borne by the other party may represent additional risk in the event that the other party becomes insolvent. This is, of course, the corollary of the scenario more often considered in collateralization, when the collateral delivered is less than the exposure. But in either case, over-collateralization or under-collateralization, one party is at risk.

This paper is part one of a two-part examination of the risks associated with under-collateralization or over-collateralization associated with Independent Amounts (“IA”) under ISDA Credit Support Annexes (“CSAs”), and the potential alternatives that may be developed by the derivatives market to protect participants.

Although the focus of this paper is the use of IA under CSAs, it will be obvious to readers that many of the same issues and potential alternative methods apply equally to Initial Margin posted under different forms of collateral agreement, including under the rulebooks of organized derivative exchanges, and also the unintentional under or over-collateralization that occurs between exposure reduction due to market fluctuation and the resulting collateral recall.

This paper is being produced jointly by ISDA, MFA and SIFMA. It is one of the deliverables described in the derivative industry letter to the Federal Reserve Bank of New York and other banking supervisors dated June 2, 2009. The first part of this paper (dealing with the use and risks of IA) will be published on October 12, 2009 and the second part (dealing with potential future market practice) will be published later in 2009 for a public comment period.

## Contents

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### **Part I            The Use and Risks of Independent Amounts**

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1. Key Mechanics of the ISDA Credit Support Annex
2. Taxonomy
3. Purpose of Independent Amount
4. Risk to Parties Posting Independent Amounts
5. Third Party and Tri-Party Arrangements for Independent Amounts
6. Cash as Independent Amount
7. Independent Amounts Under Title Transfer Collateral Agreements
8. Appendix

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### **Part II            Alternate Approaches for Independent Amounts**

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*To Be Published Later in 2009*

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#### ***Capitalized Terms***

Except as the context requires otherwise, terms in this paper which are capitalized and have either the meaning defined in the standard ISDA Master Agreement and ISDA Credit Support Annex or are specific taxonomy adopted for this paper and are defined in section 1.

## Part I

# The Use and Risks of Independent Amounts

In Part I of this paper we address the use and the risks of Independent Amounts (IA) from an educational perspective. These sections describe the key terms used in this field, why we have the concept of IA in the market, how the market operates in practice, the risks of IA, and the alternative ways of holding IA. Part I of this paper is intended to be factual and not expressive of any particular viewpoint regarding the use of IA.

Part II of this paper will make recommendations for alternative approaches that may be incorporated into market practice in the use and risk management of IA.

## 1. Key Mechanics of the ISDA Credit Support Annex

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This paper deals with a complex area of collateralization, where several terms have both technically-specific meaning and are also used broadly in a more colloquial fashion by industry practitioners. In this section we describe the key elements of the ISDA Credit Support Annex<sup>1</sup> as it relates to the computation of collateral requirements.

### 1.1 Credit Support Amount

The ISDA Credit Support Annex (CSA) defines<sup>2</sup> the overall amount of collateral that must be delivered between the parties, known as the Credit Support Amount, as:

**(i) the Secured Party's Exposure [...] plus (ii) the aggregate of all Independent Amounts applicable to the Pledgor, if any, minus (iii) all Independent Amounts applicable to the Secured Party, if any, minus (iv) the Pledgor's Threshold**

(Source : 1994 ISDA Credit Support Annex - New York Law version<sup>3</sup>)

The Secured Party is the party that is holding collateral; the Pledgor is the party that has delivered collateral<sup>4</sup>.

### 1.2 Exposure

The term Exposure is defined in a technical manner that in common market usage essentially means the netted mid-market mark-to-market (MTM) value of the transactions in the portfolio between the parties<sup>5</sup>. This term is the core of the Credit Support Amount calculation, and tends to drive the overall collateral requirement between the parties, except in situations where portfolios are small (and therefore often have small MTM) in relation to any applicable Independent Amounts or Thresholds. The commercial reason for basing the collateral requirement around the Exposure is that this represents an approximation of the amount of credit default loss that would occur between the parties if one were to default. Note that, in common with all derivatives, OTC or exchange-traded, this can only ever be an estimate because the MTM of positions varies through time. It should also be noted that Exposure is calculated at mid-market levels so as not to penalize one party or the other (i.e., by calculating Exposure on one party's side of the market). Upon default close-out, valuations will often reflect the replacement cost of transactions calculated at the terminating party's bid or offer side of the market, and will often

take into account the creditworthiness of the terminating party. The amount of collateral held to secure Exposure may be more or less than the termination payment determined upon a close-out.

### 1.3 Independent Amount

The term Independent Amount is defined in the elections and variables section of the CSA<sup>6</sup>, or in the confirmation for individual transactions. It can be any amount that the parties agree, but typically is expressed as a fixed currency amount, a percentage of the notional principal amount, or a computation of value-at-risk. Independent Amount can be defined at the level of the portfolio of transactions between two parties, or can be defined uniquely for each individual transaction; it can be zero of course. As can be seen from the definition of Credit Support Amount set out earlier, the Independent Amount will increase the overall amount of collateral that a party is required to deliver - it makes the Credit Support Amount from that party's perspective larger. The underlying commercial reason behind Independent Amounts is the desire to create a "cushion" of additional collateral to protect against certain risks - we shall discuss these in more detail later in this paper.

### 1.4 Threshold<sup>7</sup>

The term Threshold is defined in the elections and variables section of the document, or (rarely) in the confirmation for individual transactions. It can be zero, but otherwise will typically be defined as either a fixed currency amount or a variable currency amount that changes in response to changes in the credit rating of the party concerned. In context of the expression for Credit Support Amount, any non-zero Threshold will decrease the overall amount of collateral that a party is required to deliver - it makes the Credit Support Amount from that party's perspective smaller. The underlying commercial reason behind Thresholds is that often parties will be willing to take a certain amount of credit risk to each other unsecured (equal to the Threshold), before then requiring collateral to cover any additional risk.

### 1.5 Interaction Between The Elements of Credit Support Amount

When considering the operation of the CSA in practice, three points are critical to remember:

- As can be readily seen, Independent Amounts and Thresholds tend to work in opposition to one another in relation to any specific party under an agreement, which is why a particular CSA will typically employ one or the other in relation to each party.<sup>8</sup>
- In respect of Independent Amounts, it is also obvious that if both parties are subject to an Independent Amount they will tend to cancel each other out, which is why a particular CSA will typically require Independent Amount from neither party or one party, but rarely both parties.
- Exposure and Independent Amounts are simply two of several terms netted together in the expression that yields the overall Credit Support Amount. This has an important practical consequence that although some market practitioners may sometimes think of two separate pools of collateral (one covering the Exposure and one covering the Independent Amount), under the ISDA CSA there is technically just a single pool of collateral, and the elements that make up that pool are generally not held separately. The issue addressed in this paper is whether Independent Amounts should be maintained separately so that they will be better protected from risk of loss upon a default by the party entitled to the Independent Amounts.<sup>9</sup>

## 2. Taxonomy

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In this highly technical area of collateralization some terms sound similar but are different, and others appear different but carry equivalent meanings. In this section we lay out a consistent taxonomy that will be adopted in this paper and also relate these terms to others in market usage.

### 2.1 Taxonomy Employed in This Paper

For clarity we will adopt a consistent taxonomy in this paper:

**Independent Amount** or IA will have the definition given in the Credit Support Annex and as the context requires will also refer to that element of the overall Credit Support Amount that is related to the IA.

**Variation Margin** or VM will refer to the element of the overall Credit Support Amount that is related to the Exposure as defined in the Credit Support Annex.

**Dealer** will refer to the party that is receiving IA from the other party.

**End User** will refer to the party that is delivering IA to the other party.

It is important to point out that any type of counterparty could be subject to an IA requirement, including banks in some circumstances. The adoption of the Dealer and End User taxonomy set out above reflects the fact that historically the posting of IA has generally been associated with end users transacting OTC derivatives with dealers. However, this is not necessarily so in all cases and this paper should be read with this potential diversity in mind.

### 2.2 Other Similar Terms Used In The Market

Initial Margin is a term often used interchangeably with Independent Amount, but it is not actually a term used in industry-standard OTC derivative documentation at all; it comes from exchange rulebooks that set out the collateral required to be pledged by exchange members to the exchange clearing house.

Initial margin is typically an additional amount of collateral that must be posted to the clearing house in excess of the variation margin which reflects the market value of the exchange-traded contracts. Thus in generalized terms the initial margin on an exchange can be seen as equivalent to the IA term that goes into the computation of Credit Support Amount under an ISDA CSA.

Exchange variation margin is likewise analogous to the collateral that covers the Exposure term used in the CSA computation of Credit Support Amount. The CSA does not actually give us a convenient term by which to refer to this collateral; common market vocabulary has adopted the term Variation Margin from the exchange-traded derivative world to refer to this concept.

Various other terms (such as Original Margin and Lock-Up Margin) have developed in certain parts of the market to refer to concepts that are broadly similar to IA, although with some variations. To avoid confusion in this paper we will not use these terms further.

### 3. Purpose of Independent Amount

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Unless otherwise established by contract, official rules, or statute, there is no obligation on any party that any OTC derivative transaction be collateralized. If the parties elect to collateralize, there is no requirement that IA be posted. These are credit risk management decisions subject to negotiation between the parties.

The use of Independent Amounts originated in the earliest days of the collateralized OTC derivative market, which date back to the late 1980s. IA has typically been a one-way obligation for an End User (typically a hedge fund) to post additional collateral to a Dealer, primarily as a cushion to guard against the residual credit risk that may exist even under a collateralized trading agreement. Such residual credit risk may arise in four principal ways:

- When mark-to-market fluctuations occur there is a delay before the new collateral amount can be computed, called and settled
- When a counterparty defaults, no more collateral movements will occur but credit exposure may continue to increase until the non-defaulting party closes out the relevant risk positions
- Collateral agreements typically contain structural features designed to ensure that effort and cost are not wasted in moving *de minimus* amounts of collateral between the parties<sup>10</sup>
- Collateral transfers under the CSA are based on mid-market values of the underlying derivative contracts, whereas a party's loss upon default of the other party may be realized at either the bid or offer side of the market<sup>11</sup>. Thus, some disparity between collateral and exposure is always to be expected, and this may be significant where spreads for a product are particularly wide<sup>12</sup>.

It is noted that both parties are subject to these residual credit risks, however, only the Dealer is protected against these risks by IAs, whereas the End User remains subject to these risks on an unsecured basis (in addition to the risk of non recovery of IAs). This market practice developed based on the role Dealers play in derivatives trades and their relative credit standing.

The decision to require posting of IA is based on a number of factors, including, but not limited to:

- The credit quality of the End User<sup>13</sup> and the nature of their relationship with the Dealer
- The type of account or vehicle that is entering into the derivative transactions (e.g. whether or not leverage is being used, the percentage of liquid assets held in relation to swap notional value, etc.)
- The type of underlying exposure being taken - the riskier the exposure, the greater the Independent Amount requirement will be
- The volatility of a particular transaction or the derivatives portfolio.

### 4. Risks to Parties Posting Independent Amounts

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While a Dealer receiving IA will benefit from the resulting buffer of additional collateral the End User may assume added risk of loss in the event the Dealer becomes insolvent.

In a Dealer insolvency, if an End User delivered IA directly to such Dealer and such IA was rehypothecated or commingled with such Dealer assets, and such Dealer is overcollateralized by virtue of such IA, then the End User will have a general unsecured claim for the recovery of such IA and would be entitled to a pro rata distribution along with all other general unsecured creditors.

This type of claim ranks behind other creditor claims of higher priority, and thus in many insolvencies general unsecured creditors get paid less than 100% of their claim amount<sup>14</sup>.

As recent events demonstrate, this is not merely a hypothetical risk. In the case of Lehman Brothers, many investors may be exposed to significant losses<sup>15</sup> in part because they had effectively over-collateralized Lehman through the provision of IA<sup>16</sup>. These IAs were generally delivered directly to Lehman, with the right of rehypothecation<sup>17</sup>. This meant that the IAs were permitted to be freely used by Lehman, and were not segregated or afforded any client asset protections. Therefore, following Lehman's bankruptcy filing, claims for the return of cash and securities posted to meet IA requirements were treated as general unsecured claims on the debtor's estate. These are given the same priority as claims of other general creditors, meaning in this particular case that counterparties will likely only recover a small percentage of the value of any IA posted.

However, as further discussed throughout this paper, steps may be taken to mitigate or eliminate losses of IA in a Dealer insolvency. While collateral agreements are most commonly setup with direct holding of the collateral with the right of rehypothecation and/or commingling of assets, leading to the characterization of these amounts as general unsecured claims, this need not be the case. It should be noted that there is a selection of various forms of collateral documentation with different degrees of risk and complexity - for example, tri-party custodial arrangements or the ISDA Credit Support Deed for UK Dealers—which would afford certain “client money” protections<sup>18</sup>.

The Lehman experience has led to an increased awareness of the risks associated with posting IA. It has translated into a strong desire on the part of certain End Users to ensure that IA posted to a Dealer is held in a manner that ensures it is remote from the bankruptcy of the Dealer counterparty and immediately recoverable (i.e. “portable”) upon the occurrence of such an event.

In this context there is industry-wide focus on considering alternate approaches to handling Independent Amounts that:

- In the event of default by the End User, permit the Dealer to perform close out calculations and if a net amount is owing to the Dealer, to reliably and rapidly seize and liquidate collateral (including IA) under the CSA<sup>19</sup>.
- In the event of default by the Dealer, permit the End-User to regain control of the IA once close out of the underlying portfolio has occurred and any liability to the estate of Dealer has been discharged, while still being operationally feasible, cost-effective, and sufficiently protected within the laws of the relevant jurisdictions for both parties, notwithstanding the previous points above.

## **5. Third Party and Tri-Party Arrangements for Independent Amounts**

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*The following discussion applies IA in the form of securities collateral pledged under a security interest form of collateral agreement. Please see Section 6 for a discussion of cash pledged as IA under a security interest form of collateral agreement. Section 7 addresses cash and securities delivered as IA under a title transfer form of collateral agreement.*

There are essentially three ways in which a party may hold IA posted to it:

- Direct holding, in which the IA is delivered by the End User to the Dealer, and the Dealer holds the IA themselves or through an affiliate entity.

- Third Party custody, in which an unaffiliated bank, broker-dealer or other party<sup>20</sup> operates under agreement with one of the two counterparties and simply provides typical custody and safekeeping services.
- Tri-Party custody, in which an unaffiliated bank or other party providing tri-party custodial services operates under a three-way contract between it and the two derivative counterparties. Among other duties, the tri-party agent releases collateral to each of the counterparties subject to pre-defined conditions.

The terms “Third Party” and “Tri-Party” therefore connote significantly different custodial arrangements that may be used in connection with a collateral agreement.

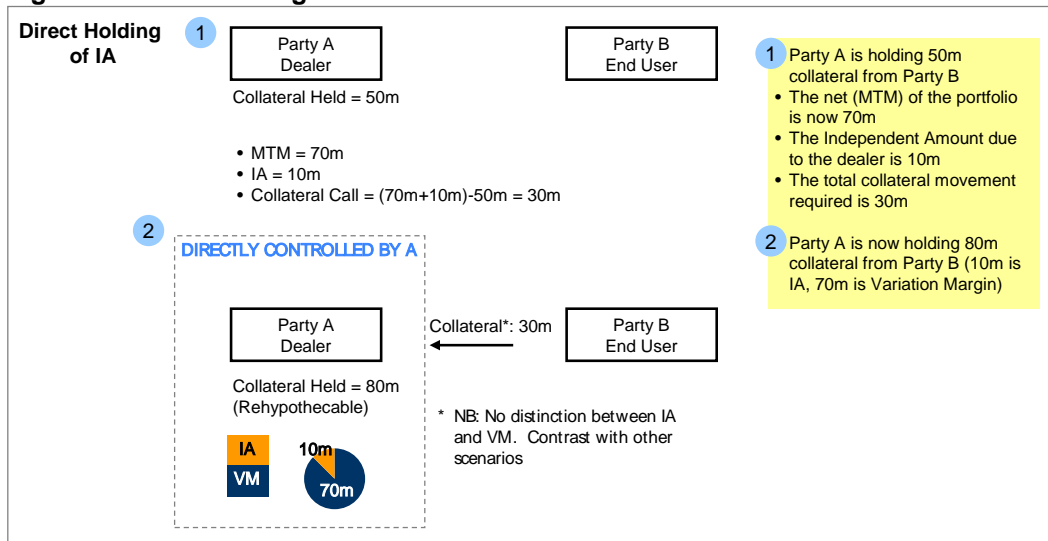
Third Party and Tri-Party agreements will always require additional documentation between one or both parties and the custodial entity, and will likely entail amendment to the CSA documents between the parties.

### 5.1 Direct Holding of IA

Where IA is delivered directly from the End User to the Dealer with rehypothecation rights and there are no formalized arrangements for the collateral to be segregated in some manner, it becomes impossible to distinguish between the IA and the other assets of the Dealer. In the event of the insolvency of the Dealer, the IA will likely be afforded no special protection and will form a part of the estate of the debtor. Claims for recovery will likely be treated as general unsecured creditor claims.

Where the Dealer takes IA that was delivered directly to it and passes it over to an affiliate to hold, much will depend on the status of the affiliate and the legal arrangement governing the holding of collateral by that affiliate. If the affiliate is a *bona fide* custodial bank and is a separate bankruptcy-remote legal entity to the affiliated derivative counterparty entity<sup>21</sup>, then it may be possible, with the proper documentation and regulatory regime, to consider this situation as a third party custody arrangement as discussed below. Generally, however, with direct holding of IA in the name of a secured party (whether held directly or with an affiliate), it will be difficult to robustly establish any degree of bankruptcy remoteness.

**Figure 1. Direct Holding of IA Illustrated**



## 5.2 Third Party Custody Holding of IA

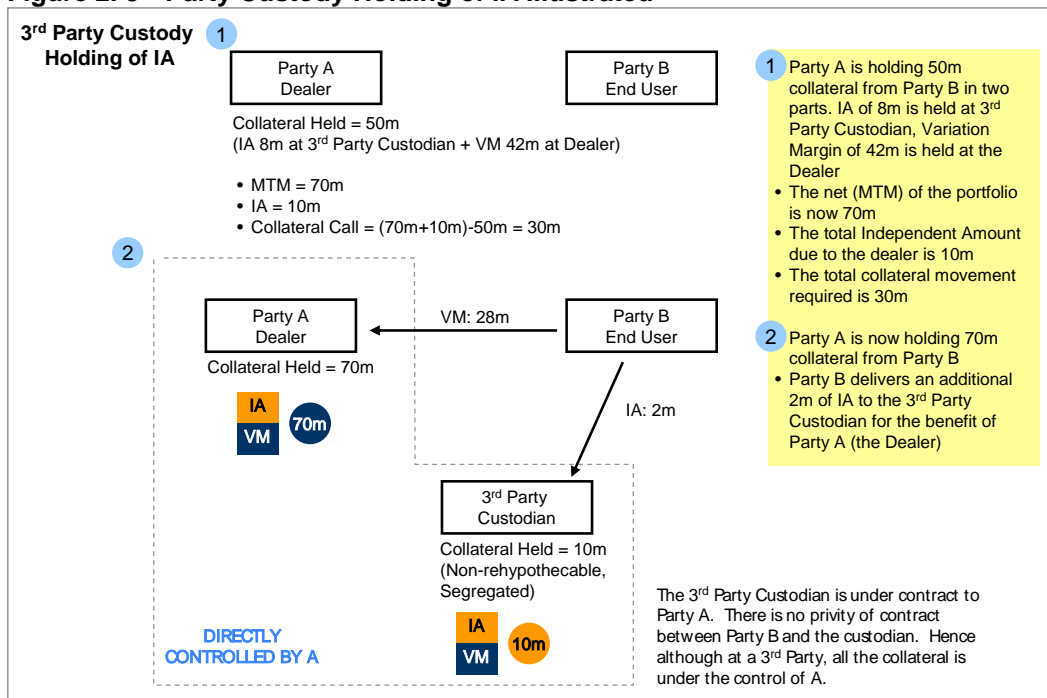
Where a Dealer receives IA from an End User, places it with a third party custodian and does not rehypothecate the collateral it will be relatively easy to distinguish between the IA and the other assets of the Dealer.

In this situation there is no privity of contract between the End User and the third party custodian, but nevertheless strong traceability of assets is afforded. This is particularly so if the Dealer is obligated by its contract with the End User to hold the IA in this third party, segregated manner, and the End User is in possession of identifying details such as the custodian name and address, the relevant account number, etc. The End User may have no control or contractual rights over the account containing the IA, but in the event of the insolvency of the Dealer, the End User can explicitly and uniquely identify the IA it had posted.

In fact, under the customer asset protection rules in several jurisdictions, holding of IA that follow the pattern set out above may enjoy certain statutory protections. For example, under the UK FSA's CASS 3 and CASS 6 rules<sup>22</sup>, in certain cases securities collateral delivered to a counterparty that is not rehypothecated and is held segregated with a solvent custodian will enjoy the full range of customer asset protections. Certain other protections under FDIA and SIPA<sup>23</sup> may apply in the United States, with parallel rules in other countries.

The foregoing assumes that the secured party holds collateral with a third party custodian, subject to a bilateral contract between the two, and furthermore that the collateral is not rehypothecated. Where a third party is used but collateral is rehypothecated, it may be more difficult to establish strong traceability of assets; customer asset protection rules will not apply. This case is therefore similar to direct holding of collateral for these purposes.

**Figure 2. 3<sup>rd</sup> Party Custody Holding of IA Illustrated**



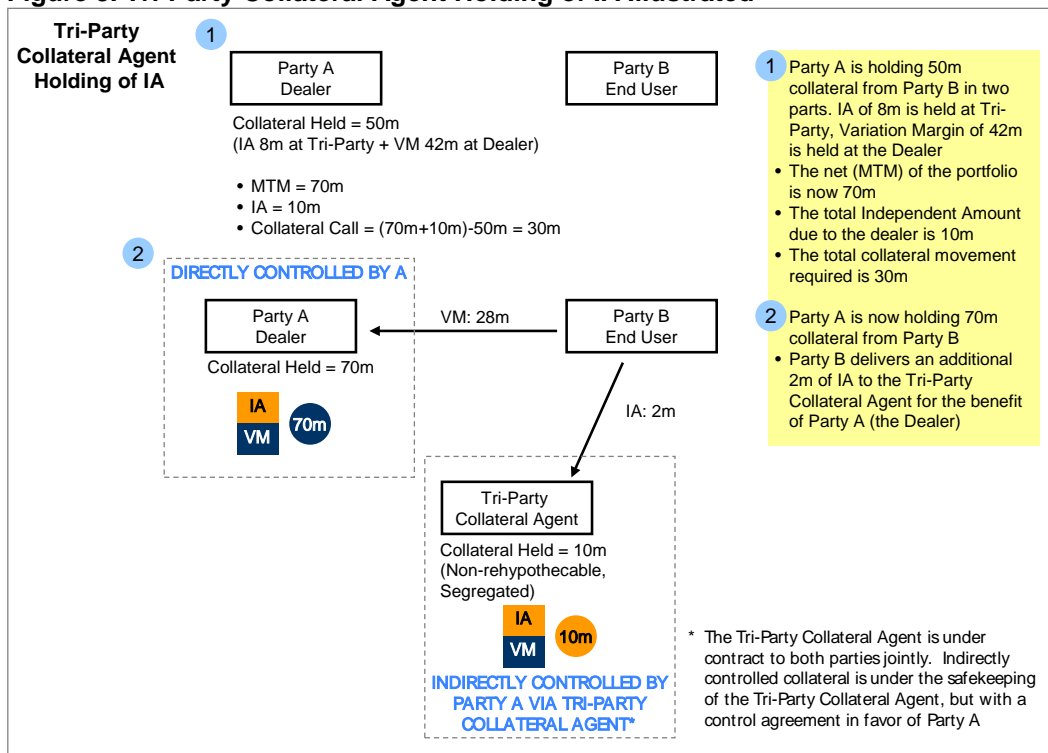
### 5.3 Tri-Party Collateral Agent Holding of IA<sup>24</sup>

In a tri-party holding arrangement of IA there is a three-way agreement between the custody bank (sometimes also called the collateral agent) and the two derivative counterparties. The End User delivers IA to the collateral agent for the benefit of the Dealer.

The End User and the Dealer are both in direct privity of contract with the collateral agent, and therefore each can enforce its rights by giving notice to the collateral agent following the default of the other. While direct privity exists between the three parties, it is important to note that the tri-party custodian is not the Dealer's "Custodian" for purposes of Paragraph 6 of the New York CSA.

In this, as in all other holding models for collateral, the secured party must ensure that it obtains and continues to have a perfected security interest in the collateral. The method of perfection of a security interest differs by jurisdiction and collateral type, but in many cases it is predicated on some notion of the secured party having "control" over the assets<sup>25</sup>. In the tri-party holding model this is slightly more complicated than in other models, because of the existence of the third party and the three-way contract. The collateral agent provides certain undertakings to the Dealer, most particularly that they will follow the instructions of the Dealer at all times, except when the Dealer is in default under the relevant agreements. Generally, tri-party agreements also provide for a party to issue a "Notice of Exclusive Control" under certain circumstances; this is helpful in that it formally eliminates any rights of the defaulting party to attempt to instruct movement of the collateral. These measures are intended to establish the necessary degree of control to achieve a perfected security interest. Whether such a perfected position is accomplished is typically a question of local law and may depend upon the respective rights of all parties under the tri-party agreement.

**Figure 3. Tri-Party Collateral Agent Holding of IA Illustrated**



## 6. Cash as Independent Amount

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*This section considers cash pledged under a security interest form of collateral agreement.*

Cash has the inherent property of fungibility. Therefore, cash delivered to a counterparty or to a custodian will be difficult to effectively segregate on the balance sheet of the entity concerned - it will effectively be an unsecured claim on the party holding it.

This issue may be possible to avoid in circumstances where cash is held with a third party custodian in a defined segregated account and not invested or re-used in any way; the pledgor would likely not earn a return on cash sequestered in this way. If the third party offers an investment of segregated cash collateral, it may have only limited and low-yielding investment options.

To avoid this investment return issue, sometimes cash is delivered as collateral with an accompanying or standing instruction to invest that cash in a defined range of instruments. These typically include mutual fund investment units and short term liquid paper, although any investment could be instructed in this way in theory. In these circumstances, it is not always clear what asset the secured party actually has a security interest in. For example, if cash was delivered as IA for the benefit of the Dealer to the custodian who had instructions to purchase money market funds with the cash, does the Dealer have a security interest in the cash or the money market fund units? Overnight cash sweep products also present similar challenges, since at the close of business on a day D and the opening of business on day D+1 a party may clearly be holding cash collateral, but in the intervening overnight hours the cash may have been swept to an offshore jurisdiction and invested in securities or other assets to earn a return.

In general, it may be preferable to use cash collateral only where the receiving party has unfettered rights of use, and therefore can both generate an appropriate investment return on the cash and avoid ambiguity as to what the collateral actually is; by contrast, where collateral will be segregated it should be delivered in the form of a debt or equity security, or instrument such as a money market fund unit, that is well-characterized and has a defined return to the pledging party.

In either case, careful drafting of documentation is needed to ensure that the secured party has a security interest in the collateral at all stages and in all forms of holding, whether it is in the form of cash or some investment holding purchased or financed with the cash.

## 7. Independent Amounts Under Title Transfer Collateral Agreements

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*This section considers both cash and securities delivered under a title transfer form of collateral agreement.*

IA can be a feature of both the New York Law Credit Support Annex (security interest form of collateralization) and the English Law Credit Support Annex (title transfer form of collateralization). The legal mechanisms underpinning these otherwise essentially similar documents are very different. The idea of segregating IA into non-rehypotheable accounts is really applicable only to the security interest forms of documentation<sup>26</sup>.

Under the English Law CSA, the Transferor becomes an unsecured creditor once it delivers (by outright transfer of title) excess collateral. Regardless of what the Transferee does with those assets (subject to not behaving in a way that risks re-characterization of the delivery), the risk to the Transferor does not change. The assets belong to the Transferee at the point of delivery. When the Transferee uses those assets, it is using its own assets and not rehypotheating. By

contrast, under the NY CSA when the Pledgor delivers assets, the Pledgor retains a title in those assets which may be effectively extinguished when/if the assets are commingled or rehypothecated.

Under a title transfer collateral agreement, a transfer of assets inherently creates an unsecured claim for the return of those assets, subject to common law set off rights in respect of other amounts owing between the parties. This is the basis for around half of the collateralized OTC derivative market, in addition to the repo markets.

In fact, if one were to segregate IA (or any collateral) under a title transfer collateral agreement, it would create a high degree of recharacterization risk. Under a title transfer agreement, the recipient of collateral becomes the legal holder of title to the asset concerned - the recipient owns the assets outright. If they were to segregate those assets and treat them in a manner different to that in which they generally treat their own assets, then it invites recharacterization of the agreement as not being a title transfer at all, but in fact being a security interest form of collateral arrangement, but one for which the necessary steps to perfect a security interest might not have taken place.

Therefore, as distinct from the three patterns of holding collateral under a security interest agreement discussed in Section 5, under a title transfer agreement there really is only one method of holding collateral, which is for the secured party to hold it directly.

There has been some significant amendment of the legislation relating to the perfection of security interest arrangements within the European market pursuant to the terms of the Financial Collateral Directive. This may go some way towards allaying this concern about recharacterization risk. However, the Directive has not been implemented in a consistent way across the different jurisdictions within the European Economic Area so it is unlikely that a generic solution will be feasible.

It should be noted that the title-transfer based English Law Credit Support Annex has a parallel security interest based companion document, the English Law Credit Support Deed. In addition, the ISDA 2001 Margin Provisions document contains both title transfer and security interest mechanisms for taking collateral. It may be feasible to create a situation where the VM element of the overall collateral pool is subject to title transfer (freely useable) and the IA element is subject to security interest (segregated) by using either the English Law CSA and CSD in conjunction, or by using the Margin Provisions.

## 8. Appendix

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Expanding upon the references made in Section 5.2 and footnote 20, below we reproduce in relevant parts the Client Asset rules from the UK FSA Handbook. For the complete reference material, please see FSA Handbook, Client Assets (CASS) section, found at <http://fsahandbook.info/FSA/html/handbook/CASS>. Text below in bold is quoted from the FSA Handbook; other text is provided to assist the reader with context.

CASS 3 ("Collateral") establishes that collateral received with no rehypothecation rights falls under the custody or client money rules:

- **CASS 3.1.3 - This chapter does not apply to a firm that has only a bare security interest (without rights to hypothecate) in the client's asset. In such circumstances, the firm must comply with the custody rules or client money rules as appropriate.**

CASS 3.1.5 – 3.1.7 provide further guidance on this section.

In addition, collateral with rehypothecation rights that are not exercised is also covered:

- **CASS 3.2.3** – If the firm has the right to use the client’s assets under a “right to use arrangement” but has not yet exercised its right to treat the asset as its own, the client money rules or the custody rules will continue to apply as appropriate until such time as the firm exercises its right [...]

CASS 6 (“Custody Rules”) sets out the requirements for assets considered to be under the custody rules. It excludes title transfer collateral assets from its scope:

- **CASS 6.1.6** - The custody rules do not apply where a client transfers full ownership of a safe custody asset to a firm for the purpose of securing or otherwise covering present or future, actual, contingent or prospective obligations.

CASS 6 then goes on to explicitly require a firm holding client assets to preserve the client’s ownership rights, including upon insolvency of the firm:

- **CASS 6.2.1** - A firm must, when holding safe custody assets belonging to clients, make adequate arrangements so as to safeguard clients’ ownership rights, especially in the event of the firm’s insolvency, and to prevent the use of safe custody assets belonging to a client on the firm’s own account except with the client’s express consent.

It further articulates how this protection may be accomplished, including the non-mandatory use of a third party service, and the requirement to establish segregation between the assets of the firm and the client (and indeed the third party, if one is used):

- **CASS 6.3.1**
  - (1) A firm may deposit safe custody assets held by it on behalf of its clients into an account or accounts opened with a third party, but only if it exercises all due skill, care and diligence in the selection, appointment and periodic review of the third party and of the arrangements for the holding and safekeeping of those safe custody assets.
  - (1A) A firm which arranges the registration of a safe custody investment through a third party must exercise all due skill, care and diligence in the selection and appointment of the third party.
  - (2) A firm must take the necessary steps to ensure that any client’s safe custody assets deposited with a third party, in accordance with this rule are identifiable separately from the applicable assets belonging to the firm and from the applicable assets belonging to that third party, by means of differently titled accounts on the books of the third party or other equivalent measures that achieve the same level of protection.

Readers are advised that this is only a brief survey of the relevant provisions of the FSA’s Client Asset (CASS) rules. Review of the complete CASS text is recommended, and firms may wish to take advice from qualified legal practitioners.

TO BE CONTINUED IN PART II

## **Alternate Approaches for Independent Amounts**

DUE FOR PUBLICATION LATER IN 2009

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**NOTES**

- <sup>1</sup> Independent Amounts can be used under any of the ISDA Credit Support Annexes. For illustration purposes, in this document we will mainly refer to the 1994 version according to New York law, except as otherwise stated.
- <sup>2</sup> It should be noted that this definition of Credit Support Amount is the standard one provided in the boilerplate CSA language. Counterparties occasionally modify the language bilaterally, including one type of modification that causes the Pledgor to deliver no less than the sum of all Independent Amounts; this differs from the standard formulation above by removing the so-called “netting” effect whereby an increasingly negative exposure for the Secured Party (i.e. the Secured Party is out-of-the-money on the underlying derivative contracts) reduces and then eventually eliminates the need for the Pledgor to deliver Independent Amounts. The alternative formulation is set out in Appendix C to the User’s Guide to the 1994 ISDA Credit Support Annex. It is used on some occasions where a Dealer requires to hold IA amounts even where the net mark-to-market of the portfolio is negative, which under the standard boilerplate CSA terms would reduce, eventually to zero, the IA posted by the End User. Under the CSA standard netting approach, the End User’s entitlement to require a Dealer to post collateral to cover Exposure when the Dealer is out-of-the-money is reduced by the End User’s IA - so the End User ends up holding an insufficient amount of collateral to cover Exposure by an amount equal to the End User’s IA.
- <sup>3</sup> The equivalent definition under the 1995 ISDA Credit Support Annex English Law version is: “(i) the Transferee’s Exposure plus (ii) all Independent Amounts applicable to the Transferor, if any, minus (iii) all Independent Amounts applicable to the Transferee, if any, minus (iv) the Transferor’s Threshold”.
- <sup>4</sup> For these purposes we ignore certain esoteric scenarios where both parties may be Secured Party and Pledgor at the same time, and also scenarios where no collateral has yet moved under the agreement. Note also that under the English Law version of the CSA the term “Secured Party” is replaced by “Transferee”, and “Pledgor” becomes “Transferor”.
- <sup>5</sup> Technically the definition of Exposure refers to the amount, if any, that would be payable to a party that is the Secured Party by the other party (expressed as a positive number) or by a party that is the Secured Party to the other party (expressed as a negative number)... as if all Transactions (or Swap Transactions) were being terminated as of the relevant Valuation Time; ... using estimates at mid-market of the amounts that would be paid for Replacement Transactions. Where termination of the portfolio occurs and neither party is the affected party, that means that the values ascribed to trades being terminated are those measured at the mid-point of the market, in other words half-way between the bid and the offer values that would be used if one of the parties were the affected party (i.e. in default). Interestingly, the definition of Exposure also includes any due but unpaid amounts between the parties - these would be part of the termination calculation, of course. This would include both payments ordinarily in transit between the parties, and also failed payments past due and currently unsettled. General market practice is currently not to include unpaid amounts in collateral calculations, although this topic has been raised within industry forums and market practice may be amended in the future.
- <sup>6</sup> Paragraph 13 in the NY law CSA; or Paragraph 11 in the English law CSA.
- <sup>7</sup> For completeness, it should be noted that the CSA contains another term in the collateral computation, known as the Minimum Transfer Amount or MTA. The parties may agree any level of MTA, which sets a lower limit on the amount of collateral that will be transferred between the parties at any point in time. The purpose is to allow the parties to prevent the movements of small amounts of collateral that are of *de minimus* credit risk protection benefit but of high operational risk and nuisance value. Generally MTAs are small compared to thresholds, and they can be zero where the parties’ intent is to move every dollar of collateral every day. The CSA also contains a Rounding term, which is of even smaller effect typically, and used to round collateral movements to the nearest sensible size of unit (often the nearest \$1,000 or \$10,000). Neither MTA nor Rounding are further considered in this paper.
- <sup>8</sup> The provision for IAs can be found in confirmations or the Credit Support Annex to the ISDA Master Agreement.
- <sup>9</sup> As discussed below, the portion of collateral representing Exposure is often not subject to the same risk of loss upon a default by the party holding such collateral (assuming Exposure has been determined accurately and market prices do not move significantly against the defaulting party following default).
- <sup>10</sup> These terms include Minimum Transfer Amount and Rounding amount in the CSA documents.
- <sup>11</sup> It is important to note that the determination of the Settlement Amount upon the declaration of any Early Termination Date under the ISDA Master Agreement may also require that mid-market valuations be used, for example upon the occurrence of a Termination Event where both parties are “Affected Parties”.

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- <sup>12</sup> It is noted that both parties are subject to these risks, regardless of the type of party or whether or not IA is posted.
- <sup>13</sup> If the End User is significantly more creditworthy than the Dealer, the Independent Amount may be paid by the Dealer to the End User, although this is rare. Independent Amounts are rarely if ever used between Dealers.
- <sup>14</sup> Notwithstanding challenges as to validity or common law or contractual set off with amounts due elsewhere between the insolvent party and the counterparty
- <sup>15</sup> Strictly speaking the Lehman case remains on-going so it is not definitively known what losses, if any, will have been suffered by counterparties. However, at the time of writing unsecured general creditor claims against the Lehman estate were trading at under 20 cents on the dollar, implying significant losses will be realized when the final distribution to creditors eventually occurs.
- <sup>16</sup> It is possible that the IA posted to a Dealer that becomes insolvent may not all be excess collateral. For example, there may be unreconciled or unconfirmed deals between the parties or there may be operational issues on any given day that mean the VM called is inaccurate.
- <sup>17</sup> Rehypothecation rights are included in the standard ISDA CSA documents according to New York law in Paragraph 6(c), and are either given effect or disappplied according to the election of the parties made in Paragraph 13(g)(ii). Under the English law version of the documents, there is no such grant of rehypothecation rights because the document is fundamentally based on the transfer of title occurring when collateral is delivered. Unlike rehypothecation rights under Paragraph 6(c) of the New York law document, the title transfer underpinning the English law CSA cannot be disappplied. This presents particular issues with IAs delivered under an English law CSA, which are dealt with in Section 6 of this paper.
- <sup>18</sup> The ISDA Credit Support Deed (an English law security interest form of collateral document) contemplates that collateral shall not be rehypothecated and that it will be held in a segregated account. Under the UK FSA rules on Client Assets (CASS 6), where the secured party does not have the right to rehypothecate collateral subject to a security interest, the secured party is obliged to hold the assets as if they are client assets, and thus the collateral is subject to a wide range of protections not applicable to collateral delivered under a title transfer agreement or a security interest with rehypothecation rights agreement.
- <sup>19</sup> The close out sequence under the ISDA Master Agreement is that (a) the agreement is terminated, (b) the termination payment is calculated according to the procedures set forth in the Master Agreement, (c) any termination payment and other amounts (i.e. unpaid amounts) are netted against posted collateral (noting that the entire pool of collateral is available for this purpose – IA and VM are not separately distinguished for this purpose), and then (d) after netting and any applicable common law set off rights have been exercised a determination is made whether any amount is owed or owing and by which party. However, it should be noted that where the Secured Party is the Defaulting/ Affected Party, the Defaulting/ Affected Party is required to immediately return collateral to the non-defaulting Party. See Para 8(b) of the New York Law CSA.
- <sup>20</sup> Custodians and tri-party collateral agents are generally banks, either commercial banks or the underlying bank entities that operate central securities depositories. There may, however, be other non-bank entities that now or in the future operate such services. It should be noted that additional protection may exist when utilizing bank provided solutions, e.g. FDIC insurance (subject to the limits on such protection). Further due diligence is required to provide assurances that affiliated regulated custodians provide the same protection to End Users as unaffiliated regulated custodians.
- <sup>21</sup> This could be established via a legal opinion from an independent law firm supporting non-consolidation of the trading counterparty entity and the affiliated custodian, for example based on the fact pattern that the custodian is a regulated entity subject to a separate insolvency regime.
- <sup>22</sup> The FSA Handbook sections 3 and 6 (Client Asset or CASS) includes several provisions that can provide protection for firms posting IA. See Appendix 1 for more information.
- <sup>23</sup> The Securities Investor Protection Act (SIPA) is codified in Title 15 of the United States Code at Sections 78aaa - 111. The SIPA created the SIPC, a nonprofit, private membership corporation to which most registered brokers and dealers are required to belong. 15 U.S.C. § 78ccc. The SIPC fund, which constitutes an insurance program, is authorized under 15 U.S.C. § 78ddd(a), and assessments against members are authorized by 15 U.S.C. §§ 78ddd(c) and (d). The fund is designed to protect the customers of brokers or dealers subject to the SIPA from loss in case of financial failure of the member. The fund is supported by assessments upon its members. If the fund should become inadequate, the SIPA authorizes borrowing against the U.S. Treasury. An analogy could be made to the role of the Federal Deposit Insurance Corporation in the banking industry. The insurance coverage provided in this manner is strictly limited in size and does not apply to all dealers (e.g. foreign dealers).
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- <sup>24</sup> Tri-party collateral agent holding of OTC derivative collateral and the well-established Tri-party repo market have some similarities but a comparative analysis of the two markets is beyond the scope of this paper. One crucial difference is the legal nature of the collateral arrangement under-pinning the repo market, which is title transfer. There is also no equivalent IA term in the repo market, instead the parties agree to “haircuts” on the purchase prices, which take into account volatility in the underlying securities being sold in the repurchase transactions. Because of these conceptual differences in the repo market, it is difficult to draw comparisons to the OTC derivative market.
- <sup>25</sup> Under the Uniform Commercial Code (articles 8 and 9) adopted by most states in the USA and applicable to most types of counterparty, the essential step of perfecting a security interest is to take control over the collateral. In other jurisdictions there may additionally be filings or registrations that must be made to accomplish a perfected security interest. This is a highly complex area of law and readers are advised to take appropriate legal advice from qualified counsel.
- <sup>26</sup> Primarily this would be the Credit Support Annex under New York Law. It also includes the Credit Support Deed under English law, although this document is very rarely used in practice.