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Interest Rate Hedging Transactions: Selected Concepts and Issues for End-User Counterparties

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Many corporations, issuers, public investment companies, hedge funds, real estate investment companies and other entities that have or are about to incur floating rate debt obligations understand that current financial market conditions are particularly favorable for hedging interest rate risk on those obligations. By entering into bilateral over-the-counter (OTC) derivatives transactions such as, for example, interest rate swaps and interest rate caps, an end-user counterparty can effectively convert its floating rate debt obligations, such as a loan owing by the counterparty that bears interest based on a floating interest rate index (such as LIBOR) to a fixed rate obligation.[1]

To take advantage of existing market conditions, an end-user counterparty that desires to hedge interest rate risk using OTC derivatives transactions will need to establish relationships with one or more banks or other hedge providers and determine what type or types of derivatives transactions are most suitable based on its needs and the underlying debt obligations. A counterparty will also need to negotiate and enter into agreements that will govern its relationship with the hedge provider and the OTC derivatives transactions that it enters into with the hedge provider. The structuring, negotiation and completion of these agreements, and the selection, structuring and execution of OTC interest rate hedging transactions, involve a number of concepts and issues that a counterparty should evaluate and understand at the outset of establishing any relationship with a potential hedge provider.[2]

Interest Rate Hedging Transactions

An end-user counterparty should focus on the following concepts when selecting and structuring a proposed OTC interest rate hedging transaction with a potential hedge provider:

what type of OTC interest rate hedging transaction would be optimal for the counterparty and the underlying debt obligation to be hedged by the transaction;

will the proposed transaction by its terms effectively hedge the interest rate risk arising from the underlying debt obligation to be hedged (in terms of specifying the correct floating rate index, calculation periods, payment dates, amortization dates (if applicable) and other material structuring terms);

do the counterparty and the hedge provider have a "meeting of the minds" as to the primary economic terms of the proposed transaction (the counterparty can request a "transaction term sheet" from the hedge provider to facilitate same);

- is the proposed transaction competitively priced from the counterparty's perspective (the counterparty can structure a proposed transaction and present it to multiple hedge providers in order to get the best pricing for the transaction); and
- does the counterparty believe, after consulting with its advisors, that the proposed transaction will receive the intended hedge accounting treatment.

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Interest Rate Hedging Agreements

The primary agreement that hedge providers will commonly require end-user counterparties to enter into as a basis for entering into OTC interest rate hedging transactions is a Master Agreement in one of the forms published by the International Swaps and Derivatives Association, Inc. ("ISDA") - the so-called "ISDA Master Agreement".[3] The ISDA Master Agreement provides the fundamental contractual parameters for the hedging relationship - it applies to the parties generally and to all transactions that are subject to its terms.

The ISDA Master Agreement contains, among other things, the following sets of material provisions: (a) conditions precedent for the payment or performance of obligations, (b) representations, (c) covenants, (d) events of default, (e) termination events, and (f) provisions addressing the early termination of transactions following the occurrence of an event of default or termination event and the financial obligations of the parties after any such early termination.

The parties to an ISDA Master Agreement will also make elections relating to, and will further amend and supplement, its terms by negotiating and entering into a separate Schedule to the ISDA Master Agreement - the so-called "ISDA Schedule". The ISDA Schedule addresses, among other things, the following:

- which parties (in addition to the counterparty and the hedge provider) will the events of default, termination events, or other provisions of the ISDA Master Agreement cover;
- which indebtedness and other transactions of the counterparty, hedge provider and other parties will the cross-default provisions of the ISDA Master Agreement cover and when and under what circumstances will a cross-default occur;
- how and when will the counterparty and hedge provider determine their financial obligations upon early termination of transactions under the ISDA Master Agreement;
- which parties are or may in the future be required to provide collateral or other credit support for the payment and/or performance of the counterparty's or the hedge provider's obligations under the ISDA Master Agreement, and how, when and under what circumstances will the parties satisfy such collateral and/or other credit support obligations;
- what representations, covenants, events of default, and termination events will apply to the parties in addition to those already set forth in the ISDA Master Agreement;
- what additional provisions, if any, relating to specific transactions or types of transactions that the parties expect to enter into are to be included in the ISDA Master Agreement; and
- when and under what circumstances the obligations of the parties under the ISDA Master Agreement will be subject to netting and set-off.

If an end-user counterparty is or may in the future be required to provide collateral or other credit support for the payment and/or performance of its obligations under the ISDA Master Agreement, these arrangements are often implemented through a separate Credit Support Annex to the Schedule to ISDA Master Agreement - the so-called "ISDA Credit Support Annex" or "CSA". The ISDA Credit Support Annex is designed to accommodate various types of collateral (including cash and eligible securities) and other credit support arrangements (including letters of credit). In addition, the ISDA Credit Support Annex specifies, among other things, when, under what circumstances and in what amounts a party must provide such collateral or other credit support to the other party; when and under what circumstances the secured party or a third party custodian may hold collateral pledged by either party; and when and under what circumstances either party can exercise rights and remedies with respect to any such collateral and other credit support.

By structuring, negotiating and finalizing the ISDA Master Agreement (including the ISDA Schedule and, if applicable, the ISDA Credit Support Annex) and any other necessary collateral and credit support agreements, instruments and documents, a counterparty can effectively establish a customized interest rate hedging relationship with a hedge provider that governs the interaction between the parties generally and provides a framework for the specific types of OTC interest rate hedging transactions that the parties may enter into from time to time.

End-user counterparties and hedge providers will frequently enter into interest rate hedging transactions under an ISDA Master Agreement orally over the telephone and subsequently exchange written letter agreements known as "confirmations" in order to evidence the transactions. The confirmation, which is typically prepared and delivered by the hedge provider to the counterparty, specifies the material economic and other terms of the related interest rate hedging transaction and is deemed to be a part of a single agreement that includes the ISDA Master Agreement. The confirmation will also incorporate by reference and specify that a set of definitions published by ISDA, such as the 2006 ISDA Definitions (the "ISDA Definitions"), apply to the related transaction. The ISDA Definitions, which are published in a separate booklet and are amended and supplemented by ISDA from time to time, simplify the confirmation process by providing, among other things, uniform and well-understood explanations of the terms and conventions that are common to interest rate hedging transactions. When taken together with the specific provisions of the related confirmation, the ISDA Definitions set forth in detail the complete understanding and obligations of the parties with respect to the related transaction. The ISDA Definitions are a very important component of an interest rate hedging transaction entered into under an ISDA Master Agreement and, by the terms of the related confirmation, effectively become part of the binding terms of the transaction. The counterparty should be prepared to review and evaluate the confirmation and to alert the hedge provider of any inaccuracy in the confirmation very quickly (such as within one or two business days following its receipt of the confirmation).

The ISDA Master Agreement (with the ISDA Schedule and, if applicable, the ISDA Credit Support Annex), transaction confirmations, the ISDA Definitions and any other applicable collateral and/or credit support agreements, instruments and documents, collectively form an intricate web of terms and provisions which govern an end-user counterparty's and hedge provider's relationship and OTC interest rate hedging transactions.

Selected End-User Counterparty Concepts and Issues

Some key concepts and issues that any end-user counterparty should understand and evaluate before entering into an ISDA Master Agreement with a hedge provider are set forth below (but are not necessarily set forth in order of priority):

- **Cross-Defaults.** The counterparty should review its existing debt and other financial obligations to determine when and under what circumstances its default under an agreement relating to such debt or other financial obligations (including any agreement evidencing the debt being hedged by the proposed transaction) could cause an event of default or a termination event to occur under the ISDA Master Agreement. A number of different approaches can be taken by the counterparty to limit opportunities for cross-defaults to occur, such as limiting the amount or type of debt or financial obligations subject to cross-default or conditioning the occurrence of a cross-default on the existence of specific types of underlying events of default or the exercise of rights and remedies following any such event of default.
- **Scope of Coverage.** The counterparty should determine, in consultation with counsel, when and under what circumstances would it be appropriate for the ISDA Master Agreement to cover the actions or omissions of a third party. The representations, covenants, events of default and termination event provisions in an ISDA Master Agreement, together with related elections and amendments in the related ISDA Schedule, may apply to a wide range of third parties, including present and future affiliates of the counterparty. A comprehensive evaluation of the application of the ISDA Master Agreement to third parties will ultimately help the counterparty avoid potentially devastating unintended future consequences. For example: Should a default by a third party credit support provider of the counterparty under its hedging transactions or its loan facility cause an event of default to occur under the counterparty's ISDA Master Agreement? If an affiliate of the counterparty files for bankruptcy, should that bankruptcy filing constitute an event of default under the counterpartys' ISDA Master Agreement? If the merger of a third party credit support provider of the counterparty with and into another entity results in the surviving entity being "materially weaker" from a creditworthiness perspective, should that merger constitute a termination event with respect to the counterparty and any transactions under the counterparty's ISDA Master Agreement?
- **Other Agreements.** The counterparty should conduct thorough due diligence to determine what other existing or contemplated agreements of the counterparty or its credit support providers or other related entities may be violated or otherwise affected if (i) the counterparty enters into an ISDA Master Agreement and any OTC interest rate hedging transactions, (ii) the counterparty becomes the subject of an event of default or a termination event under an ISDA Master Agreement, or (iii) the counterparty or its credit support providers or other related entities provide collateral or other credit support to the hedge provider to secure or support the counterparty's obligations under an ISDA Master Agreement.
- **Collateral and Credit Support Matters.** The counterparty should determine when and under what circumstances it or any other entity should be required to provide collateral or other credit support to the hedge provider to secure or support the counterparty's obligations under an ISDA Master Agreement, and vice-versa, and how to appropriately document these collateral and credit support arrangements. There are many different circumstances under which the counterparty or other parties may provide collateral or other credit support to the hedge provider in connection with an ISDA Master Agreement, including (i) cash or securities pledged by the counterparty under an ISDA Credit Support Annex, (ii) collateral pledged or guarantees made by third parties, (iii) letters of credit issued for the account of the counterparty or a third party for the benefit of the hedge provider (which if issued for the account of the counterparty may also be governed in part by an ISDA Credit Support Annex), or (iv) property that also constitutes collateral securing the obligations of the counterparty or other entities to a single lender or to a lender group under a loan facility and/or to other hedge providers ("shared collateral"). With respect to shared collateral, the hedge provider will want to obtain rights as a secured party in shared collateral and the right to receive proceeds of shared collateral following exercise of remedies in connection with an event of default and potentially one or more termination events under the loan facility and/or the ISDA Master Agreement. These collateral and credit support arrangements can raise a number of issues that the counterparty should consider with its administrative agent, collateral agent, lender or lenders (as applicable) and hedge provider(s) when structuring and negotiating the loan facility documents and the ISDA Master Agreement. For instance: If a hedge provider is at any time not a lender or an affiliate of a lender under the counterparty's loan facility, should that hedge provider have rights in the lender collateral? If not, how much and what type of collateral or other credit support should

the counterparty be permitted to provide to such hedge provider under the loan facility documents? When should an event of default under the counterparty's loan facility documents result in an event of default under the ISDA Master Agreement, and vice versa?

- **Consequences of Early Termination.** If an event of default occurs with respect to the counterparty, or if a termination event occurs with respect to the counterparty or a particular transaction under an ISDA Master Agreement, the hedge provider will have the right following notice to early terminate some or all of the transactions in effect under the agreement. Under the ISDA Master Agreement, the early termination of transactions will effectively result in an obligation for one party to make an aggregate net early termination payment to the other party. The process for determining the amount of this net payment depends upon the form of ISDA Master Agreement used by the parties and, if applicable, the determination methodology selected by the parties in the related ISDA Schedule. The counterparty should understand how each early termination process works and the advantages and disadvantages of each process (including with respect to particular types of transactions). The counterparty should also understand how early termination payment amounts determined under each process may change over time, based on different scenarios involving changes in interest rates, transaction amounts, events of default versus termination events, and other variables. In addition, the counterparty should understand these concepts both for circumstances involving a counterparty-related event of default or termination event and involving a hedge provider-related event of default or termination event. Although the counterparty may assume that the likelihood of a hedge provider-related event of default or termination event occurring is remote, the Bear Stearns, Lehman and MF Global matters provide stark reminders that such assumptions may be incorrect, and as such the counterparty should be prepared to quickly and effectively work through any such scenario.
- **Payment of Underlying Debt Obligations.** The counterparty should consider the risks and consequences arising with respect to an interest rate hedging transaction when the underlying debt obligation being hedged by such transaction is paid in full or in part. Both the counterparty and the hedge provider have an interest in ensuring that the counterparty is not as a result of entering into an interest rate hedging transaction "overhedged" in connection with any such underlying debt obligation as and when the related underlying debt obligation is paid. As such, it is quite common for hedge providers to require, in the ISDA Schedule or in the confirmation evidencing an interest rate hedging transaction, that the payment or prepayment in full of the debt obligation relating to such interest rate hedging transaction (with or without any associated fee, make-whole payment or penalty) result in the occurrence of a termination event with respect to such interest rate hedging transaction with the counterparty as the sole affected party and in all likelihood the early termination of such hedging transaction. As noted above, the early termination of an interest rate hedging transaction can result in either the hedge provider or the counterparty being required to make an early termination payment to the other party. As such, it is possible that a counterparty, in paying or prepaying the hedged debt obligation in full, may be required under such circumstances to make a substantial early termination payment to the hedge provider in connection with the termination of the related interest rate hedging transaction. In addition, if an underlying debt obligation to be hedged by an interest rate hedging transaction is prepaid in part, the hedge provider and/or the counterparty should consider whether any portion of such related interest rate hedging transaction should also automatically terminate in part such that the notional amount of the hedging transaction is equal to or less than the outstanding principal or other amount of the partially paid underlying debt obligation. If so, again it is possible that a counterparty, in paying or prepaying the hedged debt obligation in part, may be required under such circumstances to make a substantial partial early termination payment to the hedge provider in connection with the partial early termination of the related interest rate hedging transaction. If the counterparty decides to include or address any such partial early termination in the related ISDA Schedule or interest rate hedging transaction confirmation, the counterparty should further consider whether any specific provisions relating to the process to be used for determining the amount of the partial early termination payment should be included in the ISDA Schedule or confirmation, as appropriate.

In conclusion, establishing relationships with hedge providers is an important and complex step for an end-user counterparty to take in connection with managing interest rate risk on its debt or other financial obligations. While the process and documentation can be complex, current market conditions provide an excellent opportunity for an end-user counterparty to establish these relationships and manage these risks in short order and at reasonable cost. The selection and structuring by a counterparty of its desired OTC interest rate hedging transactions, and the focus and effort of a counterparty and its counsel in structuring and negotiating the ISDA Master Agreement and related agreements, instruments and documents, will directly correlate with the value and benefits that the counterparty obtains from any particular hedging relationship. Any counterparty desiring to enter into OTC interest rate hedging transactions would be well advised to thoroughly understand and evaluate its options with respect to different types of transactions, its rights and remedies under the ISDA Master Agreement, the ISDA Definitions, and related agreements and documents, and to obtain the advice of counsel with expertise in these matters for assistance in this process.

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[1] An interest rate swap is a transaction in which two parties agree to exchange interest-related payments, at specified times and for a specified period, based on a specified notional amount. Although the notional amount of an interest rate swap need not relate to any specific underlying obligation, where the swap is used for hedging purposes the notional amount is typically structured to match the principal amount of the hedging party's underlying obligation. As a result, the hedging party's floating interest payments on its underlying obligation effectively change to fixed rate payments (or vice versa) or from payments based on one floating interest rate to a different floating interest rate. An interest rate cap is an option transaction in which the purchaser of the cap agrees to pay one or more fixed amounts to receive payments from the seller of the cap, at specified times and for a specified period, based on a specified notional amount of underlying obligation, based upon the percentage by which a specified floating interest rate index (such as LIBOR) exceeds an agreed upon fixed interest rate or "strike rate".

[2] This article is intended to provide a general overview of selected concepts and issues for end-user counterparties to consider in connection with structuring and entering into OTC interest rate hedging transactions. There may be a number of additional concepts and issues that any particular counterparty (such as a hedge fund) should consider in connection with an OTC interest rate hedging relationship based on the type of the counterparty or hedge provider, other obligations of the counterparty, the laws and regulations applicable to the counterparty, and the types of derivatives transactions desired to be entered into by the counterparty.

[3] ISDA is the leading trade organization for the OTC derivatives industry. ISDA has published several different forms of Master Agreements.