The basics of Loan-Linked ISDA Master Agreements

Nowadays many ISDA® Master Agreements are loan-linked whether the loans are on a bilateral, club or syndicated basis. Typically banks will require all or a large proportion of the loan exposure to be hedged by interest-rate swaps until its maturity although in these times of low interest rates they may be less strict on this.

There are several things to investigate when preparing a loan-linked ISDA Master Agreement Schedule:

- Is there a hedging letter?
- The treatment of Events of Default;
- The treatment of pre-payments;
- Is the hedging to share in the security package under the Loan Agreement and, if so, to what extent?
- The relationship among the ISDA Master Agreement, Loan Agreement and any Intercreditor Deed; and
- Is the loan to be pre-hedged, simultaneously hedged or post hedged?

Hedging Letter

With club and syndicated loans it is quite common to have a hedging letter which the borrower and the facility agent will sign. This is usually between one and four pages long and states the purpose of the hedging, the minimum percentage of the loan that is to be hedged and possibly some of the main terms which may feature in the ISDA Schedule e.g. Market Quotation and Second Method to apply in a 1992 ISDA Master Agreement. ISDA negotiators need to take heed of the contents of the hedging letter to ensure that its requirements are covered in the Agreement.

The treatment of Events of Default

In Section 5(a) of the ISDA Master Agreement there are eight Events of Default:

- 5(a)(i) Failure to Pay or Deliver;
- 5(a)(ii) Breach of Agreement;
- 5(a)(iii) Credit Support Default;
- 5(a)(iv) Misrepresentation;
- 5(a)(v) Default Under Specified Transaction;
- 5(a)(vi) Cross Default;
- 5(a)(vii) Bankruptcy; and
- 5(a)(viii) Merger Without Assumption;

Typically all of these are in the Loan Agreement, except for Default Under Specified Transaction (derivatives cross default) and Merger Without Assumption.
This is not usually a problem as Default Under Specified Transaction is unlikely to apply because the bank or banks will probably not have existing OTC derivatives transactions with the borrower outside the ISDA Master Agreement, and the Loan Agreement may well include a no merger covenant on the borrower which would render Merger Without Assumption unnecessary.

There are two treatments of Events of Default in loan-linked ISDA Schedules seen in the market.

The more common one is to disapply all the Events of Default except Failure to Pay or Deliver on the borrower until the loan is fully repaid or prepaid and import the Loan Agreement Events of Default wholesale into the ISDA Master Agreement in their place. As there are typically more than eight Events of Default in a Loan Agreement, this provides more potential triggers for early termination of all Transactions under the ISDA Master Agreement. This is, however, usually counterbalanced in a club or syndicated loan by a requirement for the Facility Agent only to accelerate the loan on the instructions of Majority Banks (typically those representing 66 2/3% or more of loan exposure or commitments.)

The alternative way of doing this is to retain all the ISDA Master Agreement Events of Default and import all those in the Loan Agreement too with a provision stating that if there is any clash in their terms, those in the Loan Agreement will prevail. The advantage of this approach is that it avoids any gaps which may arise between Event of Default coverage in the two documents caused by the deletion of Events of Default in the ISDA Master Agreement which may already have been modified by the requirements of bank credit officers.

**Treatment of Pre-Payments**

Prepayments under Loan Agreements can be mandatory or voluntary and be for the whole or part of the loan. They are normally partial and need to be at or above a minimum monetary figure.

To allow loan prepayments without regard to the interest-rate swap will result in unnecessary and costly over-hedging because the notional amount of the swap normally matches the principal amount of the loan or the percentage required to be hedged. It is normal to include a clause in the ISDA Schedule providing for a matching reduction in the notional amount of the swap following a prepayment of part of the loan. The ISDA Schedule provision will also describe the mechanics of this.

**Sharing in the Security Package**

There is normally a security package of some sort under these types of loans. With a bilateral loan, the security is directly created for the benefit of the lending bank. With club and syndicated loans there may be a Security Agent or Security Trustee who holds the security on behalf of the banks.
With a club or syndicated loan there is usually an Accession Deed which the hedging bank needs to complete, sign and lodge with the Facility Agent before it can finally share in the security package. As mentioned above, in a bilateral loan the security will vest directly in the lending bank.

If a club or syndicated loan has senior, mezzanine and revolving credit facilities, it is important for the ISDA negotiator to find out if the security package covers all or only some of these facilities and which his own bank is providing. This is so that the ISDA Schedule preamble and Part 4(f), the Credit Support Document provision, reflect the true position.

**The ISDA Master Agreement, Loan Agreement and Intercreditor Deed**

With a bilateral loan there will only be the ISDA Master Agreement and the Loan Agreement (ignoring any Security Documents).

In the ISDA Schedule there will usually be a provision stating that if there is any conflict of terms between the two documents, those in the Loan Agreement will prevail.

However, with club or syndicated loans there is likely to be a third document called an Intercreditor Deed which regulates the obligations and rights of the individual lending banks, the hedging banks, the Facility Agent and the Security Trustee. It is normal for the Intercreditor Deed to be stated as prevailing over all other documents where an inconsistency of terms arises among them.

**Hedge timing**

Often a Loan Agreement will be negotiated and signed before any hedging is undertaken. Where this is the case there is often a time limit of between 45 and 120 days for an ISDA Master Agreement to be executed after the signing of the Loan Agreement.

Where it is desired to put the hedging in place during this period and before an ISDA Master Agreement is executed, a swap is often transacted under a Long Form Confirmation which will typically incorporate the unamended terms of the main text of the ISDA Master Agreement and make some Schedule choices. However, the Confirmation will not cover all the choices necessary in the ISDA Schedule and so it is only a stopgap until the ISDA Master Agreement is executed.

The Long Form Confirmation may also state that the swap will be terminated if the ISDA Master Agreement is not executed within the agreed deadline.

Sometimes, but not often, the hedging is put in place at the same time as the Loan Agreement and the ISDA Master Agreement are signed.
Occasionally a borrower may wish to take out an interest-rate swap before the Loan Agreement is signed. This called a pre-hedge and the swap will have a forward start date.

Where this is done it might be necessary to revisit and amend the Confirmation after the Loan Agreement is signed especially if a fixed rate is stated in the Loan Agreement and this differs from the figure in the pre-hedge Confirmation.

Conclusion

ISDA negotiators are becoming increasingly involved in loan-linked negotiations even though some banks may defer the hedging in an environment of falling interest rates. Others, however, will insist that the hedging is put in place speedily and if that is the case, it is hoped that the above basic guidelines will be helpful to ISDA negotiators.

Paul Harding
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