CAPITAL MARKETS FUNDING - LEGAL DREAM OR NIGHTMARE?

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In this section I have been asked to cover what happens if a swap goes wrong. Specifically, what compensation is paid if a swap is prematurely terminated.

The swap agreement generally includes default clauses which are standard in Euroloan or Eurobond agreements. These would include a failure to pay, material breach of reps and warranties, cross-default to other debt or swap obligations, a merger where the company is not the survivor, actual or potential insolvency, and illegality. Unlike the standard Euroloan agreement however these clauses apply to both parties. Usually, however, the cross-default clauses and merger provisions only apply to the corporate party rather than to the financial institution party.

Although I will concentrate on swaps terminated as a result of these events of default, it is worth noting that some documents allow for termination on other grounds including what we call "no fault" clauses such as increased costs to one of the parties in maintaining the swap. Because most swap contracts involve one party being under water at any point in time (that is to say the swap does not look as attractive now as when originated) these no fault provisions have to be considered carefully to ensure that they are not used simply to terminate an unfavourable swap position.

Just as an aside, this increased cost provision will be particularly interesting in the future when and if regulatory agencies impose explicit capital adequacy requirements against financial institutions' swap liabilities.

Once one of the principal default events discussed above occurs, the non defaulting party normally has the right to advise the defaulting party that it is fixing a termination date, usually 7-30 days later, and as of that date the costs of termination will be assessed.

When this notice should be given and whether it is effective is a major issue. An important case in California involving a swap revolved around a notice of termination given by a non defaulting party when the counter party was declared insolvent but had not

actually missed a swap payment. Rather than describe this case in detail, the parties involved were Renault Acceptances B.V. and Beverley Hills Savings and Loan Association. Renault gave the termination notice to Beverley Hills who had been declared insolvent by the Federal Home Loan Bank Board in the US. However, immediately after declaring the bank insolvent the Federal Loan Bank Board had created a new entity, Beverley Hills Federal Savings and Loan Association to acquire the old Beverley Hills and take over all its obligations. Beverley Hills objected to the notice but Renault terminated and demanded $918,000 in compensation. The case is still continuing.

Assuming that you, as a non defaulting party, decide to terminate, two approaches have been taken in documentation to determine compensation. One is to have the loss covered by a blanket indemnity (or general damages) and the second approach is a formula (or liquidated damages). These damages can be either one way or two way. In one way damages the defaulting party pays the non defaulting party his damages. In two way damages, whoever suffered the loss will be compensated regardless of fault. Lawyers tend to disagree about whether the general damages or liquidated damages approach is better and it may vary by jurisdiction. They also disagree about whether a one way or two way damages approach is better. My own view is that because a swap agreement carries mutual benefits and obligations, one that can be seen as fair to both parties by the court would more likely be enforced. Therefore I would opt for two way damages as one way damages might be seen as a penalty.

I would also opt for a formula approach because with general damages the indemnified party has the burden of proving what are in all likelihood contingent losses. These losses would no doubt be litigated and the judge would have to be convinced that the losses were fair. A pre-agreed formula is, in my judgment, more likely to be seen as an attempt to quantify losses rather than as a penalty.

At least two approaches have been used to provide a formula for damages. The first method is to estimate the cost of replacing the stream of cash flows to be received by the non defaulting party in the case of one way damages and the defaulting party in the case of two way damages. On US dollar interest rate swaps if the fixed rate recipient is the non defaulting party the replacement cost is estimated by calculating the amount required to buy a portfolio of US government securities which would give a yield identical to the original fixed rate in the swap contract.

An alternative method, which has been adopted by the Australian Swap Committee, is to determine the replacement value of a terminated swap by notionally entering into a replacement swap. The replacement value is determined by averaging quotes received from five reference swap dealers that are members of the Committee, eliminating the highest and lowest quotes, to enter into a swap on substantially identical terms with the non defaulting party as the swap terminated with the defaulting

party. An amount which a reference dealer would charge (in the form of a fee) to enter the identical swap is the positive amount, i.e. compensation to be paid to the non defaulting party. If the quotes received indicate that the dealer would pay to enter the swap, no compensation is paid to the non defaulting party. However, because the Australian agreement provides for one way damages in that situation, this net benefit received by the non defaulting party is not paid to the defaulting party.

The benefit of this latter approach to calculating damages, e.g. the replacement swap concept, is that it takes two pages to describe versus four and a half pages when the replacement cost is calculated by reference to the US or Australian bond market. This is because the dealers quoting are essentially doing all the necessary calculations to market the defaulting party's swap obligations as reflected in the dollar figure they will either pay or receive in cash up front to enter into the notional replacement swap.

The disadvantage is that if no more than one quote is received by the non defaulting party the contract reverts to a more general approach in which the non defaulting party estimates his losses in arranging alternatives to secure the financial equivalent of the payments to be received from the defaulting party.

Having discussed what happens if something goes wrong in a swap, how can these risks be minimized? First of all it has to be recognised that entering into an interest rate or a currency swap is not riskless. At Chase AMP we have developed a methodology to analyse the potential loss we would have if each swap counter party were to default. This potential loss is less than the amount of the contract but it can be substantial. The exposure in currency swaps tends to be greater than in interest rate swaps because of the principal we exchange at the end of the contract. We then seek explicit credit approval for the maximum calculated exposure to the counter party. Our credit people approve it as if it were an unsecured credit exposure for the tenor of the swap to the counter party.

Like any other credit exposure, assessment of risk up front is ultimately the best protection. Second, via documentation, we recognise that if we are dealing with counter parties of like credit standing to ourselves we can accept documentation which may not cover every risk but is satisfactory in most respects. The Swap Committee that was formed in Australia, which signed a common swap document, implicitly recognised that the parties thereto were of like standing (whether they think so or not). Finally, with credits of lesser standing, credit enhancement techniques such as collateralisation for the maximum credit exposure on a mark to market basis have been used.

Because swaps is a relatively new area, there is not a great deal of experience in the courts as to what happens if the swap is terminated. In most cases where a swap has been terminated, the termination costs have been settled privately. I can only assume

that the swap documents drafted by some of the members of this audience were so clear in their intended result that there was no reason to go to court. Nevertheless as the colleague from New York that I mentioned earlier said with respect to swaps, remember the Tibetan saying "beware of honey offered on a sharp knife".