

Cross-Collateralizing Hedged Loans

Securing Loan Collateral in the Event of a Swap Default

When introducing swaps to borrowers, it is important to make sure the loan collateral is accessible to the Bank in the event of a default on the swap. When a swap is initially executed, it has no value (except for the value related to any fees that may be embedded into the swap rate). As interest rates change over time, the swap will begin to take on value, whether positive or negative. The value generally becomes negative to your borrower when rates fall and positive when rates rise. The Bank has credit exposure when rates fall and the value of the swap relative to the borrower is negative (e.g., it is an asset to the Bank).

If a borrower defaults on the swap when rates have fallen, the Bank will have a potential loss equal to the negative mark-to-market value of the swap. Because the Bank has entered into two offsetting swaps – one with the borrower and one with a dealer counterparty – the Bank will terminate its offsetting swap with its dealer counterparty at the time of default and will need to pay a breakage fee to the dealer counterparty. Ordinarily, the Bank would pay the breakage fee to the dealer counterparty using funds received from the borrower. If the borrower does not have sufficient funds to fully compensate the Bank for the full breakage cost, the Bank will want to recover the additional funds using the collateral that was used to secure the loan agreement.

To secure the potential exposure on the swap, the Bank should ensure that the loan collateral is accessible to the Bank to cover any potential loss that may result from a default on a swap. To enable the Bank to claim the loan collateral for losses on the swap, it should ensure that its security agreement is written broadly enough to cover any obligations related to a swap. It should also make certain changes to the standard swap agreement. The changes to both the loan and swap documentation are discussed below:

Loan Documentation

The security agreement on the loan should be written broadly enough to include obligations under a swap agreement. If the security agreement is written narrowly such that the collateral can only be used to satisfy obligations under the loan, it may limit the Bank's ability to claim the collateral to satisfy obligations under the swap. To accomplish this, the Bank should supplement its language in the security agreement related to "Obligations" by including language similar to the following:

"Obligations" shall mean... **any** indebtedness, liabilities, or obligations, now existing or hereafter arising, due or to become due, absolute or contingent, of the Borrower to the Lender and/or its affiliates under any Financial Contract permitted hereunder.

"Financial Contract" shall mean (1) an agreement (including terms and conditions incorporated by reference therein) which is a rate **swap agreement**, basis swap, forward rate agreement, commodity swap, commodity option, equity or equity index swap, bond option, interest rate option, foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency rate swap agreement, currency option, any other similar agreement (including any option to enter into any of the foregoing); (2) any combination of the foregoing; or (3) a master agreement for any of the foregoing together with all supplements.

The above language broadens the definition of Obligations to include any obligations, not just the obligations associated with the loan. It also uses the definition of Financial Contract to specify that potential obligations may include interest rate swaps.

Swap Documentation

The Bank should make the following addition to the swap documentation (ISDA Schedule to the Master Agreement). This addition specifically identifies the loan to which the swap relates and designates that the collateral related to that loan is accessible in the event of default on the swap.

- Name the loan document/credit agreement as a Credit Support Document, and add the following sentence:

"Party B agrees that the security interests in collateral granted to Party A under the foregoing Credit Support Documents shall secure the obligations of Party B to Party A under this Agreement."

OR

- **Collateral Security.** Party A agrees that all of its obligations under this Agreement (whether present, future, contingent or otherwise) shall be secured by any collateral security from time to time granted by Party A to Party B (whether before or after the date hereof) including, without limitation, all security provided in respect of Party A's obligations under the Credit Agreement **{if security is already in place – describe agreements i.e. Security Agreement dated _____ made by [Counterparty] in favor of [the Bank and other lenders]}**. Party A undertakes to and agrees with Party B to enter into, execute and deliver all such additional agreements, documents, instruments and other assurances and to do such acts and things as Party B may require in order to effect the foregoing.

"Credit Agreement" means the [credit/loan agreement/ term sheet] dated _____ made between Party A and [names of lenders – if syndicated loan and lenders not all named, add *and such other lenders as may become parties to the agreement from time to time*], as amended, supplemented, restated or replaced from time to time (but without giving effect to any amendments, supplements, restatements or replacements thereto, or any waivers or consents granted thereunder, not consented to by Party B).

OR

- **Credit Support Document:** Credit Support Document is not applicable in relation to Party A. Credit Support Document is applicable in relation to Party B and shall mean each agreement and instrument, now or hereafter existing, of any kind or nature which secures, guarantees or otherwise provides direct or indirect assurance of payment or performance of any existing or future obligation of Party B under this Agreement, made by or on behalf of any person or entity (including, without limiting the generality of the foregoing, any credit or loan agreement, note, reimbursement agreement, security agreement, mortgage, pledge agreement, assignment of rents or any other agreement or instrument granting any lien, security interest, assignment, charge or encumbrance to secure any such obligation, any guaranty, suretyship, letter of credit or subordination agreement relating to any such obligation

and any other financial support agreement relating to Party B or any Credit Support Provider) in favor of Party A or any of its Affiliates.

Security: Party B agrees that the security interests in collateral granted to Party A under the foregoing Credit Support Documents shall secure the obligations of Party B to Party A under this Agreement. To further secure the obligations of Party B under this Agreement, Party A may at any time without prior notice or demand set off against any credit balance or deposit account maintained with Party A by Party B or any of its Affiliates, all or any part of the Party B's obligations hereunder. Party B hereby grants to Party A a security interest in and lien on any such deposit accounts, credit balance or other money.

Either of the above alternatives should effectively accomplish the goal of cross-collateralization. The Bank's in house counsel may find one preferable to the other.

Sample Two-Way Swap Breakage Language for Loan Documentation:

In the case of any prepayment of the Loan or any Loan Portion, voluntary or involuntary, Borrower shall be required to pay, or entitled to receive, as the case may be, in connection with such prepayment, an amount equal to the present value, as of the date of prepayment, of the remaining scheduled payments with respect to Additional Interest in connection with the notional amount of the Interest Rate Protection Agreement corresponding to the principal amount prepaid (the "Swap Termination Amount plus (or less) any transaction costs).

Sample Prepayment Language for ISDA (Swap) Documentation:

(c) "**Additional Termination Event**" will apply to Party B. The following will constitute Additional Termination Events with respect to Party B, which shall be the sole Affected Party:

- (i) **Repayment or Prepayment in Full.** The repayment or prepayment in whole of the [NAME OF DEBT INSTRUMENT] or such other debt instrument as may be designated in any Confirmation executed pursuant to this Agreement (the "**Specified Debt**"). For purposes of this Section 1(g)(i), all Transactions under this Agreement shall be Affected Transactions.

- (ii) **Overhedging.** As a result of the repayment or prepayment in part of the Specified Debt, the aggregate Notional Amount of the Transaction(s) exceeds the amounts outstanding under the Specified Debt.

For purposes of (ii), above, the Additional Termination Event shall be deemed to occur in respect of only such portion of the Notional Amount of such Transaction(s) under this Agreement as may be determined by Party A to exceed the aggregate amount of the Specified Debt outstanding immediately following such repayment or prepayment and such Transaction(s) shall be deemed to be the sole Affected Transaction(s). For avoidance of doubt, if hedging transactions are being provided with respect to the Specified Debt by more than one bank, then any reduction of the Notional Amount of the Transaction(s) under this Agreement shall be effected in such a manner as to ensure that the ratio of the Notional Amounts of the transactions under all such hedging agreements shall remain constant. Further, following the occurrence of the Early Termination Date under this Agreement pursuant to paragraph (ii), above, the portion of the Transaction(s) which are not deemed to be Affected Transactions shall continue in accordance with the provisions of this Agreement.

Please Note: The loan must be defined as Specified Debt either in the Schedule or in the confirm for the related transaction. This language also covers situations where the bank syndicates all or part of the loan.