

# Master Agreements, Netting, Credit and Collateral in Bilateral Energy Markets

EEI Meeting with CFTC, SEC and Prudential Regulators
October 25, 2010

#### <u>ISDA Master Agreement – Day 0 Due Diligence</u>

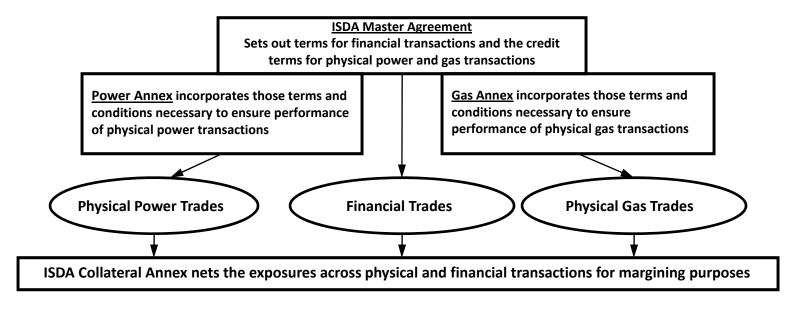
#### **Prudent Extension of Unsecured Credit:**

- Swap dealers and energy companies, using ISDA Master Agreements, have prudently extended unsecured credit and managed their exposures to each other
- Market participants perform extensive due diligence
- Credit review practices have evolved and matured over the past 15 years and include:
  - Review of credit ratings and supporting analyses
  - Assessment of financial strength by reviewing financial statements: debt levels, asset values, etc.
  - Credit scoring (quantitative and qualitative factors, including evaluations based on fixed income, equity and credit default swap indicators)
  - Regulatory support (e.g., mechanisms to pass through fuel and purchased power costs)
  - Identification of available liquidity: bank lines and cash reserves
  - Risk management practices
  - Consideration of other exposures (e.g., lending relationship with the counterparty)
- Negotiated credit thresholds are incorporated in master agreements
  - Scaled to reflect counterparties' risk tolerance, creditworthiness and financial condition
  - Ensure against excessive exposure of swap dealers to energy companies
  - Ensure against excessive exposure of energy companies to swap dealers
  - Include fixed thresholds and credit rating matrix structures
- Margining of excess exposures
  - Cash and non-cash collateral
  - Net exposure of all transactions (will likely include transactions that are not OTC swaps)
  - Exposure includes accounts receivable, accounts payable and change in value of forward positions

#### ISDA Master Agreement – Day 1 Negotiation and Execution

#### **Key Features of the ISDA Master Agreement:**

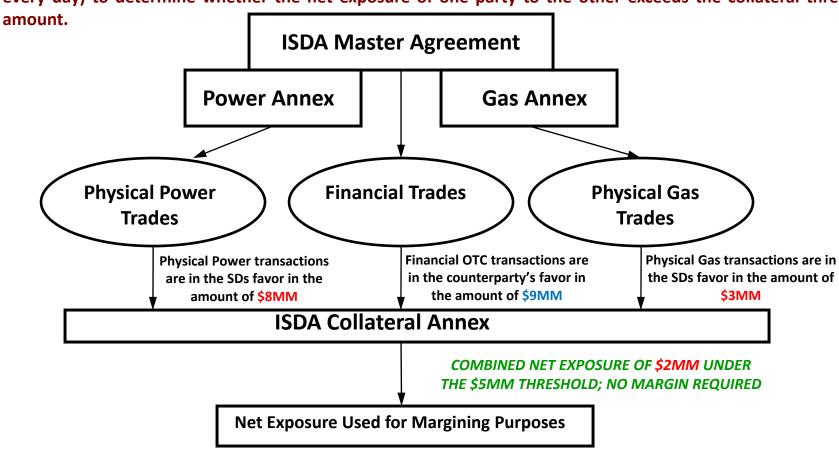
- Credit terms are bilaterally negotiated based on the parties' due diligence
- The ISDA Master Agreement allows for physical power and gas transactions to be covered by the same legal and credit terms and conditions that govern OTC swaps, and therefore enables netting of exposures under these different types of bilateral transactions



- Margin amounts usually determined objectively
  - Unsecured credit line (collateral threshold) typically a fixed dollar amount or a matrix of different dollar amounts associated with different credit ratings (as credit rating improves, threshold increases)
  - Some parties also include objective or subjective measures to address material adverse changes in a party's creditworthiness or financial condition
- In rare cases, an upfront amount of collateral called an independent amount can be required, but this is not the equivalent of initial margin required by exchanges
  - Typically used only when degree of insecurity is such that there is concern about the ability to recover amounts owed before the deadline by which valuation-based margin must be provided

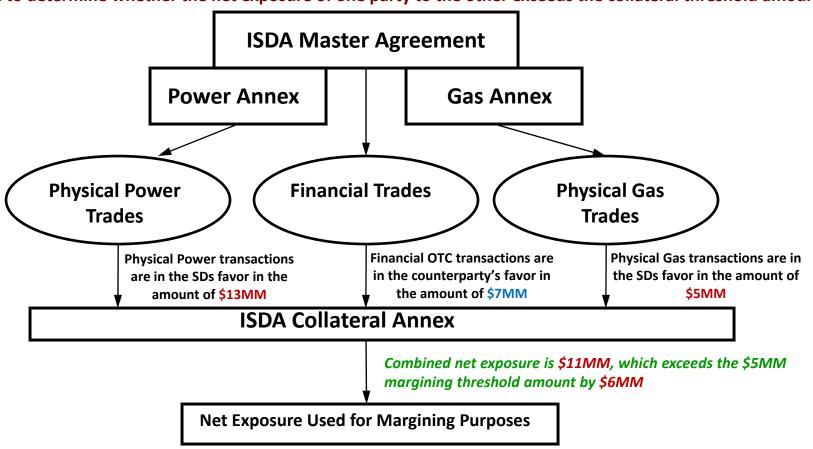
#### ISDA Master Agreement - Day 2 Margining and Netting

Example of netting benefits: This example assumes that the swap dealer has net exposure of \$11MM to a counterparty related to physical transactions; the counterparty has exposure to the swap dealer of \$9MM related to financial swap transactions; and the parties have agreed to a \$5MM collateral threshold for each party with respect to net exposure for all transactions. Because on a net basis the swap dealer has exposure to the counterparty of \$2MM, no collateral would need to be exchanged because the net exposure is under the collateral threshold amount. Each party will revalue outstanding positions on the next valuation date (typically every day) to determine whether the net exposure of one party to the other exceeds the collateral threshold



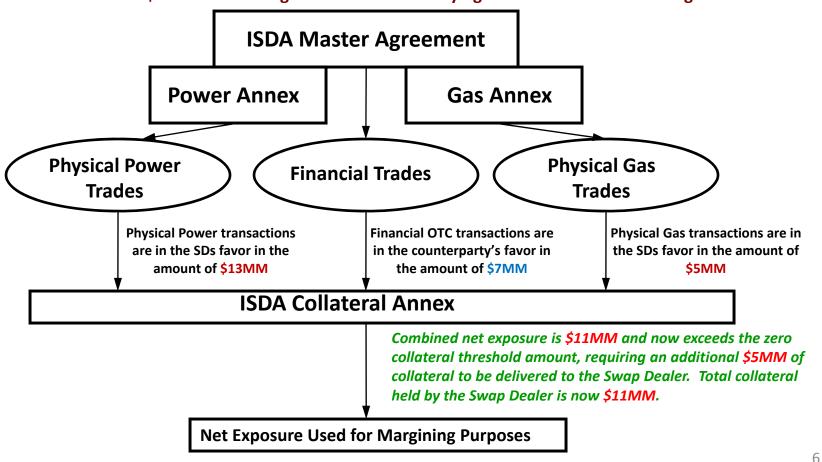
#### **ISDA Master Agreement – Day 3 Changes to Exposures**

Continuing example of netting benefits: On a future valuation date, the value of outstanding physical and financial transactions has changed, altering the relative exposures of each party to the other and the swap dealer is now exposed to the counterparty by \$11MM. In response, the swap dealer would issue a margin call to the counterparty and the counterparty would be required to provide collateral of \$6MM (the swap dealer's exposure in excess of the collateral threshold) to the swap dealer within the timeframe specified in the ISDA Collateral Annex (generally within one business day). Each party will revalue outstanding positions on the next valuation date to determine whether the net exposure of one party to the other exceeds the collateral threshold amount.



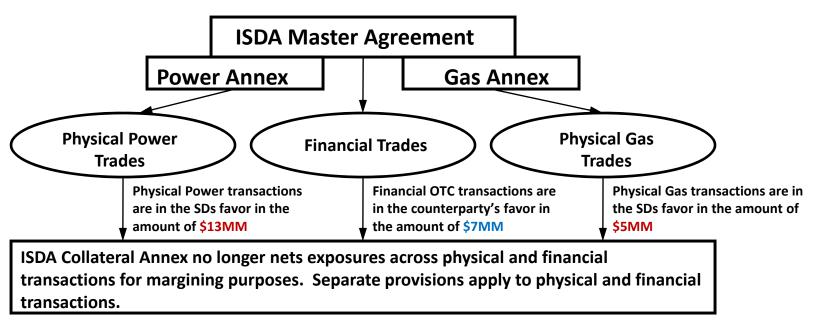
#### <u>ISDA Master Agreement – Day 4 Ongoing Credit Review</u>

**Example of Credit Event:** In addition to revaluing positions on subsequent valuation dates, each party continually reevaluates the creditworthiness and financial condition of the other party. In this continuing example, the swap dealer has determined that the counterparty has experienced a material adverse change in its creditworthiness or financial condition as defined in the ISDA Master Agreement and/or ISDA Collateral Annex, causing the collateral threshold for the counterparty to be reduced from \$5MM to zero. In response, the swap dealer would issue a margin call to the counterparty and the counterparty would be required to provide additional collateral of \$5MM even though the value of underlying transactions has not changed.



#### **ISDA Master Agreement – Day 5 Regulation**

Regulatory restructuring of energy markets: If rules governing margin requirements for non-cleared swaps mandate elimination of unsecured credit without taking into consideration legally enforceable netting and set-off rights that allow parties to calculate exposure and exchange collateral, as necessary, based on a single net amount for all transactions (including transactions that are not swaps), then such rules may increase the exposure of swap dealers to some counterparties.



Counterparty exposure under the financial transactions is now \$7MM, requiring \$7MM of collateral to be delivered to the counterparty by the Swap Dealer.

Swap Dealer exposure under the physical transactions is now \$18MM, requiring an additional \$7MM of collateral to be delivered to the Swap Dealer.

The new regulatory structure in this example would require each party to post collateral to the other, when on a net basis only one party would be exposed to the other. It would tie up a total of \$25MM in collateral as apposed to \$11MM or \$6MM in the prior examples.

## <u>Day 5 Continued – Unintended Consequences</u>

- Margining threshold amounts allocated by swap dealers to energy companies are relatively small and are the subject of a due diligence process that has been working:
  - Aggregate capital drain that would come from not allowing margining threshold amounts for any energy company would far outweigh the incremental benefit to the safety and soundness of the swap dealer.
  - Such capital drain would likely lead to less investment, fewer jobs and more volatile customer rates.
  - A better way to protect swap dealers would be to establish appropriate levels of capital to be held by swap dealers when dealing in OTC transactions with non-swap dealers and non-major swap participants that are not cleared or clearable.
- If swap parties are unable to continue to net financial transaction exposures with physical power and gas transaction exposures as a result of the new regulations, unintended consequences would result:
  - Separate margin requirements for OTC swaps would cause swap dealers and energy companies to revert to past practice of using separate agreements for different products.
  - Additional capital may be required to satisfy margin calls (prior slides).
  - Capital may come in the form of loans, credit facilities, letters of credit, etc. that could increase swap dealers' total credit exposure – which the statute is intended to decrease.
- Many end-user participants in energy markets, including EEI members and not-for-profits (i.e., munis and coops), are limited in their ability to pledge assets as collateral. As all forms of capital and margin involve costs, requirements should be appropriate for the risk.

Rules should not jeopardize netting benefit that causes markets to be more liquid, and that enables swap dealers and energy companies to materially reduce their exposures to each other

### **Other Pertinent Issues**

- Concepts of "Initial Margin" and "Variation Margin" are unique to cleared markets and do not have direct application to non-cleared swaps
  - Variation margin on exchanges represents daily settlement of losses
  - OTC market is structurally different
    - Collateral provided secures exposures: it is not used for daily settlement; settlement is monthly
    - Providing additional margin on top of the amount necessary to cover exposure adds no security to the system; in a closeout situation – even with a zero threshold – it would have to be returned to the providing party
- Energy markets are not like market for mortgage-backed securities (MBS) and its derivative Collateralized Debt Obligation (CDO) market
  - Prices and value are much more transparent any valuation differences can be resolved, so exposure aligns with true value at risk
  - Asset-based trading means risk is often "right-way" risk: when margin calls increase, so too does the value of the underlying assets, thereby reducing exposure to the financial system
- The ISDA Master Agreement is designed to work in tandem with bankruptcy law
  - Swaps and forwards are "Safe Harbored"
  - The parties can exercise a contractual right to terminate, liquidate, and closeout all transactions, and set off margin held in satisfaction of a liquidated amount, notwithstanding the automatic stay that would otherwise apply under the federal bankruptcy code
  - To the extent a defaulting party is closed out owing amounts greater than posted collateral, the non-defaulting party will be an unsecured creditor (thus counterparties are keenly aware that prudent credit management is vitally important to the health of their companies)

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