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Whitepaper: Collaboration and Standardisation Opportunities in Derivatives and SFT Markets

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Key Points:

- Whilst combining legal terms documenting stock loans, repos and OTC derivatives is an entirely logical idea, and certainly feasible as a documentation project, market-wide acceptance of the finished product would be by no means assured.
- Both the GMRA and GMSLA (but not the ISDA Master Agreement) include “mini close-out” procedures – whereby the affected transaction may be closed out without causing a wider event of default affecting all transactions.
- Under the GMRA and GMSLA, the close-out methodology is driven primarily by valuation of securities whereas for OTC derivatives it is the replacement cost of the affected derivative contract itself.
- Stock loans and repos cover only one asset class (securities) whereas OTC derivatives cover a broad range of asset classes.

INTRODUCTION/abstract:

The article will consider proposals for standardisation across product-specific master agreements set out in a Whitepaper issued by the International Swaps and Derivatives Association, Inc. (‘ISDA’) in October 2020 entitled “Collaboration and Standardization Opportunities in Derivatives and SFT Markets” and will review some key arguments in the Whitepaper.

The Whitepaper looks at common features across the current industry-wide master agreements governing, respectively, repurchase (or ‘repo’) transactions, securities lending (or ‘stock loan’) transactions and over the counter (OTC) derivatives transactions. It examines the opportunity to merge those three master agreements into a single unified agreement to facilitate “greater standardization and improved efficiency” across the derivatives and securities financing transaction (SFT) markets. We refer in this article to each of the three categories of transaction as a ‘product line’.

To summarise the broad themes of the Whitepaper, it states that “the SFT and derivatives markets use different terminology for the same concepts and different processes or methodologies to accomplish the same goals” which “limits the ability to achieve synergies and efficiencies between these markets and potentially risks creating unintended inconsistencies across them”. The Whitepaper goes on to say that “while …. differences …. are required due to the nature of the repo, securities lending and derivatives markets, ISDA believes there is an opportunity to put in place common standards with respect to the terminology and documentation used in these markets”, which “in turn, can mean that a common solution is found by automating and updating the documentation in each market”.

The authors of this article are practitioners in reviewing and negotiating these master agreements. We will argue that, whilst combining

legal terms documenting the three product lines is an entirely logical idea, and certainly feasible as a documentation project, market-wide acceptance of the finished product would be by no means assured.

Given that market participants engaging in these product lines have grown accustomed to the architecture and terminology of their respective industry-wide master agreements, an entirely new agreement would require considerable time and resources to be devoted to a transition process that market participants may not welcome, and which may not be of benefit to them all. Without clear regulatory or legal impetus for the change, transition would not be a priority for many.

Were such an ambitious and large-scale documentation project to proceed then, depending on drafting, the result may be an agreement which is more complicated than the sum of its parts and unwieldy in practice. A number of past industry initiatives have produced new documentation which has not been widely adopted by the market.

We begin with a summary of the three product lines.

OVERVIEW OF EACH PRODUCT LINE

Repurchase transactions (repos)

Repurchase transactions are known in colloquial and abbreviated form as “repos”. A repo starts with one party (the seller) selling (most typically fixed income) securities to the other party (the buyer) – so, the first step of the transaction is a sale for which consideration passes from the buyer to the seller. The repo includes an obligation on the seller to buy (or ‘repurchase’) identical securities in an identical amount at the end of the term of the repo. A repo may be either ‘fixed term’ or ‘on demand’.

The primary purpose of the repo market has been to facilitate secured lending – the lender (being the ‘buyer’) lends money to the borrower (being the ‘seller’) to enable the borrower to raise cash (being the consideration) in exchange for collateral (being the securities).

Under the economics of the repo, the lender/buyer’s return is the difference between the price at which it buys the securities and the price at which it sells the securities back to the borrower/seller. The ‘repurchase price’ reflects the interest rate for the financing (known as the ‘price differential’). In other words, the difference between the purchase price and the repurchase price is the financing cost.

(Changes in market value of the securities are not relevant to the economics of the trade – as one would expect, considering that the securities are the ‘collateral’.)

The industry standard master agreements for repos are (1) the Global Master Repurchase Agreement (GMRA) (English law) covering the ‘world excluding the United States’ and (2) the Master Repurchase Agreement (MRA) (New York law) covering the US market. The overwhelming majority of repo transactions are governed by such agreements. In common with the ISDA Master Agreement, each comprises a printed form of agreement containing standard provisions, which are amended and supplemented by an Annex I, as well as various other optional annexes.

Securities lending transactions (stock loans)

Securities lending transactions or “stock loans” are transactions where (most typically equity) securities are ‘borrowed’ by one party (the borrower) from the other party (the lender) in return for a fee. The ‘borrowing’ involves an outright transfer (hence, similar to the sale leg of the repo outlined above) of securities from the lender to the borrower, subject to an obligation on the borrower to return identical (known as

'equivalent') securities to the lender, usually on demand, but also possibly at the end of an agreed term.

Although repos of equities are possible, as are stock loans of fixed income securities, it is important to underline that repos are *in essence* transactions designed for fixed income securities (i.e., bonds) and stock loans are *in essence* transactions designed for equity securities (i.e., shares).

The economics of stock loans work such that the borrower pays a stock lending fee for the loan and provides collateral to cover its obligation to return equivalent securities. Collateral typically takes the form of cash, although it is also possible to deliver collateral in the form of securities or letters of credit instead.

The main driver behind a stock loan transaction is for the borrower to acquire the securities, for purposes including covering short sales, facilitating 'buy-ins' and avoiding settlement failures. The lender will earn a return on lending securities which it would otherwise 'hold' (for example, pension funds or tracker funds may enter into stock loans to provide an enhanced return on securities held by the fund).

The Whitepaper makes the observation that stock loans can look very similar to repos where cash is provided as collateral under the stock loan.

The industry standard master agreements for stock loans are (1) the Global Master Securities Lending Agreement (GMSLA) (English law) covering the 'world excluding the United States' and (2) the Master Securities Lending Agreement (MSLA) (New York law) covering the US market. Again, in common with the ISDA Master Agreement, each comprises a printed form of agreement containing standard provisions, which are amended and supplemented by schedules, annexes and addenda.

Although the GMSLA is a widely-accepted and dominant agreement for the market, stock loans are also transacted under securities lending provisions in prime brokerage agreements (typically entered into by hedge funds), and under programme lending agreements (typically entered into by pension funds and tracker funds). In other words, the stock loan market is not dominated by the GMSLA and MSLA to quite the same extent as the repo market is dominated by the GMRA and the MRA.

OTC derivatives

OTC derivatives are contracts between two parties which reference an underlying asset, whereby the parties agree to make payments between them based on the performance of the underlying asset. The contract is called a derivative because it 'derives' its value from an underlying asset. 'OTC' means that the derivative is a private derivative which is not standardised and is not traded on an exchange (to be precise: which is not traded on regulated markets, meaning the main futures exchanges), hence it is traded 'over the counter'.

The most common underlyers would be shares, bonds, commodities, currencies, interest rates and market indices.

The vast majority of OTC derivative transactions are documented under an ISDA Master Agreement, with the remaining minority likely to be documented under 'local' documentation (such as the Deutscher Rahmenvertrag für Finanztermingeschäfte) or agreements with core terms looking very much like an ISDA Master Agreement (including long form confirmations).

The ISDA Master Agreement comprises a standard printed form of agreement, plus a Schedule which amends and supplements the printed form. The standard printed form and Schedule may also be supplemented by an array of other documentation, including a Credit Support Annex (providing for collateral delivery obligations between the parties), master confirmation agreements and asset class-specific definitional booklets, in a 'modular architecture'.

The Whitepaper deals only with OTC derivative transactions – and not 'futures' or 'exchange-traded derivatives' which are different types of products traded on futures exchanges. The documentation for the latter is deemed sufficiently different to not fall within the remit of the Whitepaper. Whilst there are common features in documentation governing OTC derivatives and futures, to include a fourth category – along with repos and stock loans – would no doubt be too ambitious to even be contemplated.

Characterisation

The Whitepaper notes that, in respect of all three product lines (i.e., stock loans, repos and OTC derivatives), a change of documentation would not affect their characterisation and treatment for the purposes of relevant legislation including the various US capital regimes. Under relevant legislation, such transactions are generally defined by reference to the type of transaction rather than according to the type of documentation used.

DOCUMENTATION OVERLAP

The GMSLA, GMRA and ISDA Master Agreement have all been subject to numerous iterations over the years, but have remained separate agreements.

Potential alignments

The Whitepaper argues that, although certain terms in each product-specific master agreement are indeed specific to the product line, significant overlap exists between other terms in each master agreement which are not necessarily product-specific. As such, potential alignment could be achieved across default and close-out/termination provisions, representations and warranties, notice provisions, governing law and jurisdiction provisions and generic definitions (for example relating to business day, bankruptcy/insolvency, income, dividends and tax).

Inconsistencies

The Whitepaper observes that a number of common definitions are used in each product-specific master agreement, but in an inconsistent way. For example, differences in the definitions of "insolvency" or "bankruptcy" under the three agreements could result in an insolvency-type event falling within the definition under one agreement, but not another, leading to a disparate outcome whereby a counterparty is capable of being defaulted under one agreement, but not another, in respect of the same event.

Such inconsistencies would merit an analysis across documentation at times of market stress and/or default to determine a non-defaulting party's potential remedies across the different product lines. To address inconsistencies in respect of default rights, counterparty documentation frequently includes a cross default mechanism to automatically default all product-specific master agreements between counterparties, should an insolvency-type event occur which falls within the "insolvency" or "bankruptcy" definitions under any of the product-specific master agreements.

Necessary divergences

Acknowledging a number of differences between repo/stock loan and OTC derivatives documentation, the Whitepaper nevertheless paints an optimistic view of opportunities for alignment, whilst also acknowledging that necessary divergences should be retained. For example, default and close-out/termination provisions differ between repo/stock loan and derivatives documentation by reason of the fundamental differences between the product lines. Repo/stock loan transactions involve transferring securities between two parties on a collateralised

basis, whereas OTC derivative transactions involve purely contractual (or 'synthetic') obligations between two parties.

Settlement fails

The 'failure to pay or deliver' event of default under repo and stock loan transactions is rarely if ever subject to a grace period (it bites as soon as there is a failure to deliver all or some of the securities or to redeliver equivalent securities), whereas the equivalent 'failure to pay or deliver' event of default for OTC derivative transactions includes a grace period of at least one business day. The GMRA and GMSLA also reflect the reality that settlement fails commonly occur in the SFT market which may not be due to the 'fault' of the failing party. As such, both the GMRA and GMSLA include 'mini close-out' procedures whereby, upon a failure to deliver securities or redeliver equivalent securities, the affected transaction may be closed out without causing a wider event of default affecting all transactions. In other words, the fundamental structure of the two groups of transactions (repo and stock loan transactions on the one hand, and OTC derivative transactions on the other) is quite different. ISDA acknowledges the need to respect differences where they are "needed to maintain key economic features of the transactions".

Termination events, illegality and force majeure

The ISDA Master Agreement also caters for termination events, illegality and force majeure, which are not addressed in either the GMRA or the GMSLA. Whilst additional events of default are frequently included under the GMRA or GMSLA (typically mirroring counterparty-specific risk and credit-related events which are included as additional termination events under an ISDA Master Agreement), it would be very unusual to introduce illegality and force majeure events of default into a GMRA or GMSLA. It is not that these issues have not been considered, but more that the two groups of transactions, and their markets, are so different.

Close-out and valuation

The Whitepaper notes that the processes for closing out and valuing transactions under the ISDA Master Agreement are similar to those under the GMRA and GMSLA, the main difference being that the methodology for determining the early termination/close-out amount is driven primarily by valuation of the securities in the case of repos and stock loans, whereas for OTC derivatives it is the replacement cost of the affected derivative contract itself, including valuations ascribed to replacing or unwinding hedge positions.

Documentation architecture

At the heart of ISDA's approach to consolidating the three master agreements is the application of ISDA's modular style of documentation to repos and stock loans, as well as to OTC derivatives. The intention would be to supplement the existing ISDA Master Agreement with further repo/stock loan-specific provisions in the Schedule, and to publish a separate definitional booklet for repo/stock loans together with dedicated transaction confirmations. The success of ISDA's 'modular' approach to documentation could have benefits if applied to stock loans and repos as well.

It is important to note that currently a less extensive but essentially similar documentation architecture applies to stock loans and repos, but limited to the GMRA or GMSLA as the overall framework agreement, including a range of annexes, all supplemented by a transaction confirmation.

Product-specific supplements

The need for market-specific or product-specific supplements and definitions for stock loans and repos is much less, for the reason that

stock loans and repos each cover only one asset class (i.e., securities), whereas OTC derivatives cover a broad range of asset classes. In other words, it is possible in theory to write a derivative on any underlying asset class, with a requirement for specific definitions and additional documentation specific to the asset class, whilst the ISDA Master Agreement itself remains product-agnostic. However, the world of stock loans and repos is generally confined to lending and returning (or selling and repurchasing) securities, and catering for cash collateral.

'Essential features'

The Whitepaper cites greater flexibility under the ISDA architecture as being potentially beneficial for stock loans and repos. However, given the Whitepaper's proposal that the 'essential features' of stock loans and repos would be preserved by adopting product-specific additional provisions and a definitional booklet, one questions whether imposing a potentially more complicated documentation architecture on more limited and confined transactions would have the desired benefit. On the contrary, the result might be a more protracted and complicated agreement than is necessary. Identifying these 'essential features' would be the subject of further discussions. They could include margining, close-out and valuation methodology and mini close-outs.

Close-out of transactions

Importantly, a determination would be needed as to whether an event of default should result in the close-out of all transactions under a new unified agreement, or whether repo/stock loan and OTC derivative transactions could be closed-out independently (subject to maintaining the effectiveness of close-out netting).

Breadth of scenarios

Further complexities may arise from the breadth of scenarios that the documentation would need to cater for. For example, a party may be both the buyer and the seller under different repo transactions, the lender and the borrower under different stock loan transactions and the long party and the short party under different OTC derivative transactions. Whilst all of this can be dealt with in the drafting, careful consideration would be needed to ensure that the resulting unified agreement would not be overly cumbersome.

New vocabulary

In relation to drafting, and depending on the finished product, users may to some extent need to familiarise themselves with a new vocabulary in respect of concepts and operations inherent to each product line. Given that each product market and its participants have grown used to using specific terminology in specific contexts, in order to understand and communicate concepts and aspects of trades unique to a particular product line, it would be necessary to preserve such terminology as far as possible in a unified agreement.

A unified success story

The Whitepaper refers to the Master Regulatory Reporting Agreement (MRRA) as an example of a single template agreement spanning different product lines. The MRRA covers delegated transaction reporting of derivatives transactions (both OTC and exchange-traded) as well as securities financing transactions (as defined in the Securities Financing Transactions Regulation (SFTR) – which include repo and stock loan transactions). The MRRA aims to deal with all delegated reporting – under both the European Market Infrastructure Regulation (EMIR) and SFTR (and the UK-onshored versions post Brexit) – in one agreement.

Although not in widespread use (as many delegated reporting service providers prefer to use their own form) the MRRA succeeds in

spanning the different product lines. (But let us remember that delegated reporting is a far less ambitious undertaking than the three-into-one unified master agreement.)

MARGIN

Stock loans, repos and OTC derivatives are all collateralised transactions (note that we refer to 'margin' and 'collateral' interchangeably).

Exposure

For a repo documented under a GMRA, exposure (for which margin is required) is calculated by reference to the difference between the current market value of the purchased securities and the repurchase price at the relevant time during the terms of the repo, taking into account the applicable margin ratio or haircut.

For a stock loan documented under a GMSLA, exposure (for which margin is required) is calculated by reference to the market value of the loaned securities plus an amount of margin representing an agreed percentage of the value of the loaned securities.

For an OTC derivative documented under an ISDA Master Agreement and Credit Support Annex, exposure (for which margin is required) is calculated by reference to the termination (or 'mark-to-market') value of the transaction. An initial margin amount called 'Independent Amount' is also factored into the overall margin requirement.

(Under all three product-specific master agreements, a net margin amount is required, covering all transactions in effect at the relevant time.)

It should be noted that, as an alternative to margining, repo transactions may be repriced or adjusted. Such mechanisms would, therefore, need to be retained in the proposed SFT definitional booklet and SFT transaction confirmation.

Portfolio margining

Considering that stock loans, repos and OTC derivatives are all collateralised transactions (albeit in different ways), using the same pool of margin to collateralise all stock loans, repos and OTC derivatives under one unified agreement, on a 'portfolio' basis, would indeed result in greater margin efficiency, although it would need to be determined whether to adopt a single method for calculating exposure for all three product lines or retain the different methodologies.

Single margin transfer

Two benefits would arise – first, avoiding three separate margin transfers for stock loans, repos and OTC derivatives under three separate product-specific master agreements, and second, using one common margin pool to collateralise all three product lines. Only a single margin payment or delivery would be required. However, one must bear in mind the requirement under regulatory regimes to collect/exchange variation margin in respect of uncleared OTC derivative contracts, which may prevent the combination of pools of collateral (i.e., to avoid the under-collateralisation of any such uncleared OTC derivative contracts in breach of regulatory requirements). As such, two collateral pools – one for repos/stock loans and one for OTC derivatives – may be necessary.

Cross-margining agreements

However, cross-margining across stock loans, repos and OTC derivatives can already be achieved to the same extent by using a cross-

margining agreement which 'sits above' the GMRA, GMSLA and ISDA Master Agreement. A cross-margining agreement can provide all the benefits described above (albeit that the drafting may be complicated).

Nothing that cannot be done already

As with all of the concepts around unification of the three product lines into one master agreement, there is nothing from a documentation perspective that a single unified agreement can do which cannot be done already – to take the example of cross-margining above, interaction and efficiency between master agreements can be achieved by existing documentation techniques.

The debate is really *only* about how best to structure legal agreements and to what extent the unification of similar operations in one agreement would be beneficial and result in efficiencies.

More scope for unified documentation for stock loans and repos?

Whilst the Whitepaper's aims are laudable in examining scope for documentation standardisation as between stock loans, repos and OTC derivatives, the authors of this article see more common ground between stock loans and repos. We believe that the commonalities/synergies between stock loans and repos may justify a common master agreement governing both of those product lines. However, we believe that there is further distance in terms of commonalities/synergies with OTC derivatives. This distance, and the resulting additional complexity in the documentation 'integration' process, would not in our view justify a common master agreement governing OTC derivatives in addition to stock loans and repos.

DOCUMENTATION FATIGUE

Recent years have witnessed a slew of new documentation and re-papering exercises, particularly in the OTC derivatives market. These have resulted from regulatory requirements in relation to the mandatory clearing of certain categories of OTC derivatives and the collection of initial and variation margin in respect of uncleared OTC derivatives, MiFID II, the Central Securities Depositories Regulation (CSDR), EMIR REFIT (which updated EMIR), Brexit, as well as ongoing IBOR transition projects. On a practical level, is there an appetite for more new documentation? Are the purported benefits, as set out in the Whitepaper, enough to stir the market into this undertaking? Given that, at this time, no specific legal or regulatory initiatives mandate a new unified master agreement, and noting the intention that the GMRA, GMSLA and ISDA Master Agreement would continue notwithstanding publication of a new unified master agreement, a necessary imperative to overcome document inertia may be missing.

THREE DOESN'T GO INTO ONE

The authors of this article create and review documents of varying complexity. The 'art' in creating (i.e., conceptualising and drafting) documents should focus on making the agreement as readable and coherent as possible. A 'jigsaw puzzle' of moving parts (here, read annexes and supplements to a master agreement covering the three product lines) may not be desirable. Moving three into one should not be seen as better *per se*. Whilst it is indeed sensible to discuss possible synergies and common pathways across these three enormous markets, the authors' view is that it may be a long time before we see one common master agreement to rule them all.

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