Reducing Collateral Risks in the Financial Crisis – Some Practical Measures

The on-going progress of the European financial crisis has continued to precipitate measures by financial institutions, funds and market participants to reduce their risk in a wide variety of structured financial transactions. In this context, the risks associated with the return of collateral in the event of financial institution failure require close examination. In a prime brokerage, derivatives or financing context where cash and securities have been posted to a bank to secure the client's obligations, it is important to understand the legal position concerning the return of cash and securities and whether such cash and securities have the legal protections that market participants anticipate. This requires an understanding of complex contractual relationships and the application of statutory rules, insolvency law and trust law.

Although the possible scenarios regarding the next stage of the financial crisis remains wide and varied, the legal parameters of a de-risking exercise for buy-side market participants in conditions of market stress and uncertainty tend to gravitate towards the set of practical considerations featured in this note.

Review the security interests relating to financing and prime brokered transactions, including securities lending:

- Does the arrangement operate as a security interest arrangement or a title transfer arrangement?
- To whom is the security granted and what is the scope of the obligations secured? Does the security interest secure amounts owing to all the bank's affiliates? Long delays have been seen in the return of collateral due to the uncertainty associated with whether all secured liabilities have been discharged, which may be a precondition to the return of collateral.
- Is there a right of re-hypothecation? If exercised, this is likely to destroy a client's proprietary interest, with the bank becoming the absolute owner of the transferred securities. The client would lose any proprietary interest in the securities and would merely hold a contractual claim against the bank for the redelivery of equivalent securities. Where securities equivalent to the securities transferred are credited again by the bank to the client's account, the client's contractual rights of redelivery would drop away with a property interest taking its place.
- If a right of re-hypothecation is present, are there any limits on such right and how is the limit calculated? Some clients may wish to place quantitative restrictions on the extent to which the securities may be the subject of a bank's right to use (for example, by restricting the right of use to the value of 140% of the client's net liabilities from time to time). This will come at a cost as the right of use enables a bank to use client securities as if they were its own, using the securities as collateral in financing transactions or lending to other clients of third parties, thereby reducing the costs of bank funding.
- What does the disclosure annex to the prime brokerage agreement setting out a summary of the key provisions permitting the use of safe custody assets say about re-hypothecation rights (see FSA Rules at CASS 9.3)?

Consideration of cash collateral:

- Do the FSA's Client Money Rules apply? Or are they excluded under the terms of the arrangement?
- Does the bank have discretion to invest cash with a third party? If so, what are the terms of such discretion?

Issues relating to securities used as collateral:

- Are securities commingled? Banks are required to segregate their own securities (house securities) and client securities. However, it is customary for banks to pool client securities in an omnibus client account; securities held for all pooled clients are not identified within the omnibus account as belonging to any particular client. This mixing of assets of more than one person gives rise to a tenancy in common (a form of co-ownership under English law). In the case of securities held in an omnibus client account where there is a right of use, it is important to establish which particular client's securities should be treated as having been used.
- What are the custody arrangements? Is there a third party custodian? Can the custodian appoint sub-custodians? Who is liable for custodian/sub-custodian's acts and what is the extent of the exclusions from custodian/sub-custodian liability?

Reporting requirements:

- What reporting procedures are in place so that the client can check that cash/securities are being properly segregated?
- What reporting procedures are in place so that client can check the extent of re-hypothecation?
- Is the client receiving the daily reports mandated by FSA Rules and Guidance at part 9 of the CASS Sourcebook (value and location of safe custody assets, total and location of client money, mark-to-market close-out exposure for OTC transactions, total secured obligations, etc.) and are these reports indicating any trends?

Margin agreements:

- Can a margin agreement override an ISDA master agreement and the related credit support annex to enable a bank to call for additional margin in times of stress?

CADWALADER

Adam Blakemore
Partner, Cadwalader, Wickersham & Taft LLP
Tel: +44 207 170 8697
E: Adam.blakemore@cwt.com

Nick Shiren
Partner, Cadwalader, Wickersham & Taft LLP
Tel: +44 207 170 8778
E: Nick.shiren@cwt.com