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Making ISDAs easier

May 2016

Introduction

More and more trustee investments involve the use of derivatives such as swaps, either as part of a liability-driven investment (LDI) strategy or to hedge against changes in interest rates, currency exchange rates or inflation. Some larger schemes will use over-the-counter derivatives set up directly with the counterparty banks, and this will involve signing up to contracts known as ISDA documents (or other types of industry standard documents, depending on the instruments used). The potential risks associated with derivatives were highlighted in the 2008 financial crisis, and trustees must understand the legal risks they bear by entering into an over-the-counter derivative contract, and ensure that the documents contain the necessary contractual protections.

9 steps to understanding ISDAs

1. In most cases, some changes will be needed to the wording of the banks' standard ISDA documents to ensure that trustees are properly protected. Even where the changes needed are not that complicated, experience shows that it can take a long time to reach agreement with the counterparty banks.

2. The time involved in this process, and the discussions that tend to be needed with the counterparty banks and the investment manager, can mean that the costs of agreeing ISDA documents are relatively high.

3. So it is essential to factor this time and cost into the timetable and budget. Trustees should discuss this with their investment consultants before making the decision to invest with a particular manager.

4. It is fairly common for investment managers to provide umbrella ISDAs – meaning that the ISDAs are pre-negotiated between the investment manager and the counterparty bank. But, crucially, it is the trustees, and not the investment manager, who will be the party to the ISDA contract.

5. Therefore, it is still necessary to ensure that umbrella ISDAs contain the right legal protections. There are two possible ways of doing this:
   - In some cases, trustees can save costs by putting the onus on the manager to confirm that all its umbrella ISDAs contain adequate protections for trustees.
   - Some managers will not, or cannot, give this confirmation. So the next best option is to review the key points in all the ISDA documents, and ask the manager to arrange any necessary changes with the counterparty banks. With several ISDAs, this can take time, and can lead to the high costs mentioned above.

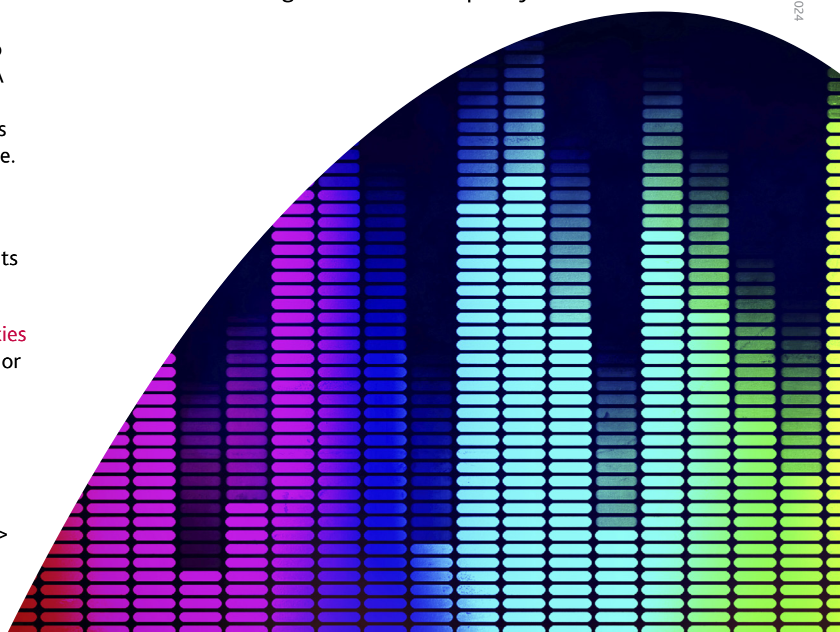
6. An alternative in some cases is to draw up bespoke ISDAs. In these cases, trustees will generally want their advisers to provide the first draft. Each counterparty bank will need to review the draft against its standard ISDA wording, and negotiation is likely to be needed.

7. Either way, it is important to clarify early on how many counterparties are needed. The investment manager might have, for example, four or five counterparties that it would normally use. But if the mandate can operate just as well with two, that will greatly cut down the time spent negotiating the ISDA documents.

8. When it comes to reviewing the ISDA documents, the main legal points include:
   - clarifying the circumstances in which the trustees or the bank could terminate;
   - consequences for the ISDA contract if the scheme's sponsoring company entered insolvency, or the scheme entered an assessment period for the Pension Protection Fund; and
   - importantly, whether it is clear that the trustees are only liable in their capacity as trustees of the scheme.

   ISDA documents will also include detailed warranties and representations to be given by the trustees, which will need to be reviewed very carefully.

9. Finally, and importantly: if the ISDA documents need to be negotiated with the counterparty banks, a decision must be made about who drives the process – the manager, who will probably have an existing relationship with the banks, or the trustees' consultant or legal advisers. Either way, strong pressure needs to be kept up, since the counterparty banks' internal review and approval processes are multi-layered and often time-consuming, and this can act as a barrier to finalising the documents quickly.



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Further reading

We can provide a due diligence questionnaire that you can ask investment managers to complete. The questionnaire sets out important questions about the manager's ISDA documents so that you know what will be involved before you decide to appoint the manager. For details of this questionnaire, please email stephen.scholefield@pinsentmasons.com or your usual Pinsent Masons adviser.

You may also be interested in our guide to making investment arrangements easier.

Pensions law can be tricky… but it doesn't have to be. These 'making it easier' guides explain key issues in simple terms, giving practical help to trustees and employers.

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Current topics include: Using advisers; Scheme changes and Becoming a trustee

Comments and ideas for further topics are welcome…

Email: Stephen Scholefield

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