NORTON ROSE FULBRIGHT

Coronavirus/COVID-19

Issues for the OTC derivatives markets

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Introduction

While there has been much focus on the potential human and social cost of COVID-19, attention is starting to be paid to its potential impacts on the financial markets and financial products. Some of these impacts are more direct, such as the inability to perform obligations due to quarantine measures. These are discussed further below. Others, which may become apparent more quickly, are more indirect, such as the continued volatility in the financial markets leading to margin calls which cause a cash squeeze on counterparties. For example, since the outbreak, and as concern has mounted, there have been some extreme movements in the equity markets due to market concerns about the knock-on effects of coronavirus on businesses in a range of sectors. There have also been sharp movements in the commodities and foreign exchange markets. The indirect effect of these market dislocations are often seen first in the derivatives markets.

Collateral demands under over-the-counter derivatives

For a broad range of commercial reasons, corporates could be trading over-the-counter derivatives varying from foreign exchange, interest rates, commodities and equities through to freight forwards. The first casualties of any large market movements are often non-bank counterparties who are holding the wrong side of a trade (or a series of trades) in a particular market and are suddenly faced with collateral demands they cannot meet.

Over-the-counter derivatives often require that the party that is out of the money must provide collateral (usually cash or other liquid assets) to cover potential losses. A sudden and unexpected market movement, whether it be in equities, interest rates, foreign exchange or commodities prices, can impose a significant collateral liability on a counterparty on a daily basis based on the market value of their trading positions. Further collateral liabilities may accumulate for days or weeks if the relevant market continues to move against the counterparty.

This can lead to cash flow problems for the affected counterparty and eventually the counterparty can reach a point where it can no longer meet collateral calls. If the market movement is very large, this can happen with alarming speed.

A failure to meet a collateral demand can lead to the close-out (i.e. termination) of all outstanding derivatives transactions. Typically, following a formal demand, the counterparty has only a few days to post the collateral. If this is not done, the non-defaulting party will have the right to terminate all outstanding transactions, value the terminated transactions and require the defaulting party to pay the net amount calculated to be due. Whether a party will choose to terminate or not, and whether it will seek to rely on any other protections such as so-called "flawed assets," will depend upon a number of factors, including whether it is in or out of the money (i.e. would be receiving or making a payment on termination).

Unscheduled holidays, payments and deliveries and notices

Payments and deliveries under derivatives and their associated collateral documents will only be due on business days in the relevant jurisdiction(s). If a public holiday is declared in an area that is affected by COVID-19, this may impact whether the payment or delivery is actually due. This, in turn, may affect calculation periods.

The ability to serve notices may also be affected, either because of an unscheduled holiday (such that the notice cannot become effective until the next business day), or because in practice, it is impossible to deliver notices in a manner that is permitted by the documents. For example, parties will often either need to – or prefer to – serve default notices and early termination notices by hand or by courier. In an area that is affected by quarantine, this may not be possible.

The consequences of Force Majeure under the 2002 ISDA Master Agreement

The 2002 ISDA Master Agreement does contain a type of Force Majeure clause (Section 5(b)(ii)). Force Majeure applies in the absence of any more specific disruption or fallback provisions. These should be checked first, and will differ depending on the product type, the relevant ISDA definitions booklet, and the elections made by the parties in their trading documentation. Force Majeure is a termination event rather than event of default under the 2002 ISDA Master Agreement and, while it can lead to the termination of all transactions, it has different consequences than termination following an event of default.

Where Force Majeure is triggered, it creates a waiting period of eight local business days for normal payments or deliveries. By contrast, for payments or deliveries of collateral, there is no waiting period. Ifthe situation is not remedied within the waiting period, if any, there is a right to close out (i.e. terminate) some or all of the outstanding transactions. Unlike a close-out following an event of default, the terminated transactions are valued at a mid-market price. This could be advantageous to parties who are out of the money as it may reduce the amounts they otherwise would pay if the transactions were terminated following an event of default, particularly in an illiquid market where there is a wide bid-offer spread.

Force Majeure applies to "force majeure or acts of state" which prevent the office through which the affected party makes and receivespayments or deliveries from doing so or from posting collateral. Unlike banks, some corporates may only have one office through which they make payments of deliveries. The clause covers not only situations where performance is impossible but also where it would be "impracticable" for the office to perform, for example to make or receive a payment or delivery. It only applies where the force majeure or act of state is beyond the control of the office and all reasonable efforts have been taken to overcome the impracticability. It applies not just on the payment or delivery date itself, but also applies on an anticipatory basis, looking at whether the payment or delivery would be impossible or impracticable if it were due on that day. The scope of this clause is untested but it arguably would apply where, for instance, government quarantine measures prevent employees of a counterparty from being able to attend its office to send authenticated instructions and there are no other practical alternatives. This will be highly fact-specific and may, for example, depend on whether the government quarantine measures have the force of law (although it is expected that, even if performance may not be "impossible" because the quarantine measures do not have force of law, it may well be "impracticable"). It may also depend on whether the relevant entity has business recovery plans in an area that is not affected by the measures.

Loan and bond cross default provisions – the domino effect

A default in respect of derivative trades always carries the risk of triggering a domino effect on a derivatives counterparty's other financial exposures. Loans, and sometimes bonds, contain cross-default clauses which permit the lender or bondholders to require immediate repayment of all amounts due under the loan or bond if there is a default under "Financial Indebtedness." This term is given an extended meaning in LMA loans: *"Financial Indebtedness means any indebtedness for or in respect of…any derivative transaction entered into in connection with protection against or benefit from fluctuation in any rate or price (and, when calculating the value of any derivative transaction, only the marked to market value shall be taken into account)."* This wording is potentially wide enough to capture failures to pay under derivatives transactions.

If exercised, these clauses can cause businesses that are otherwise perfectly viable to fail because they cause all borrowings to become immediately repayable. For this reason, lenders are careful to weigh up the merits of relying upon cross-default clauses as it may lead to the cash flow insolvency of the borrower and result in a reduced recovery for them. This is especially so where lenders are unsecured or they judge that their security may be inadequate to cover the amounts owed. At a practical level, unless they are parties to both arrangements, it may also be difficult for a lender to be aware of the failure under the derivative itself, which is a private contractual arrangement.

In extreme cases, where lenders do become aware, cross-default clauses have the potential to be a mechanism by which market dislocation in reaction to COVID-19 causing defaults under derivatives transactions could eventually lead to some businesses becoming insolvent.

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