

## **Rating Trigger Termination Clauses in ISDA and similar Master Agreements**

1. Certain Governmental Agencies and Supranationals require so-called rating trigger clauses as Termination Events under ISDA and other master FX and OTC derivative agreements. This practice is still rather limited but has started to spread. Apparently, the clause is required regardless of if collateral arrangements are in place in the form of a Credit Support Annex to an ISDA Agreement or otherwise, although there is only (with daily margining) an overnight risk.

2. It should be noted that rating triggers are not used as Termination Events in bond and loan documentation, e.g. in the related Eurobond and syndicated London loan market. Institutional investors often have rating limits in their investor criteria, but these criteria only apply in relation to the time of the investment. If possible, the asset is sold when the investor wishes to terminate the exposure.

3. The contractual consequences of the occurrence of a Termination Event in relation to a party are similar to those of an Event of Default in that the "Affected Party" (in ISDA terminology) will be subject to a close-out of all transactions under the relevant Master Agreement, mainly at the discretion of the "Non-Affected Party" (although parties can negotiate alternative ways). Following a notice of termination, the aggregate market value of all outstanding transactions (the "Close-Out Amount") shall be determined. In a turbulent market situation and with less liquid transactions there is plenty of room for evaluation here and, consequently, for "arbitrage" losses for the Affected Party.

4. Bank ratings in particular are largely dependent on the health of the domicile country. Thus, a downgrading of a bank may take place because of external events outside its control. More important, if termination rights are exercised, the acceleration of all transactions under a terminated master agreement may initiate a chain reaction thereby creating "systemic risk". Although a notice of termination of an ISDA Agreement or a similar agreement is not public, it may quickly become known in the market. If not for other reasons, because of the abovementioned method for determining the Close-Out Amount. In the ISDA Agreement the terms require directly or indirectly that quotes are obtained from market participants on all transactions which are subject to the close-out.

5. To conclude, it can be argued that there is an important element of systemic risk in the introduction of rating trigger termination clauses as best practise in the financial services sector. Further, this practise would expose the parties to a material additional risk, should the close-out procedure encompass the winding up of less liquid instruments or transactions at, in essence, off market prices.