

Collateral Support for Derivative Transactions in Kuwait

Sadie Hussain - Associate - Banking & Finance / Commercial
- Kuwait City

Abdullah Masud - Associate - Banking & Finance
- Kuwait City

With the rapid growth of the derivatives market through the late '90s and early 2000s and reaching a unprecedented approximate of \$542 trillion in 2017, it may be deemed simply prudish to allow the definition of a derivative as a "financial weapon of mass destruction" without having explicating on what heaves derivatives into this category. Former Chairman of the United States Securities and Exchange Commission, Arthur Leavitt in the 1995 IDB/ISDA Conference held in Washington D.C described derivatives as "something like electricity; dangerous if mishandled, but bearing the potential to do good" and it is with this common sentiment that it has been a prime focal point for international regulator, The International Swaps and Derivatives Association ("ISDA") to ensure precautionary mechanics are placed in a bid to minimise the prevalent risks associated with such financial instruments.

ISDA provides the standard documentary formalities for swaps and derivatives. The use of the ISDA documentation in order to effectuate such derivative transactions is customary in Kuwait. ISDA documentation generally consists of the ISDA Master Agreement (the "Master Agreement"), the ISDA Schedule and the ISDA Confirmation.

Given the high-risk of over the counter derivatives, many parties employ, what is called, the Credit Support Annex (the "CSA") in order to provide themselves with more credit protection. More specifically the CSA allows a means of transfer of collateral by a counterparty. The CSA is supplemental to the Master Agreement and does not create a security interest in the collateral, but rather places an obligation on the collateral provider (known as a "Transferor" under the CSA) to transfer the relevant collateral to the counterparty to the transaction (known as a "Transferee").

The collateral (identified as the "Eligible Credit Support") may take the form of cash or securities and must be in an amount and form sufficient to satisfy the requirements listed under the respective CSA. The type of Eligible Credit Support that a party is willing to accept will be detailed in Paragraph 11 of the CSA itself and it is worth noting that the CSA also details the precise mechanics pertaining to the manner in which the Eligible Credit Support will be posted.

Since the CSA is deemed a bilateral agreement, any amendments to and elections under it are made primarily pursuant to Paragraph 11 of the CSA. While the CSA affords the swap counterparties considerable freedom to amend the exact mechanics in Paragraph 11, the basic principle is that collateral calls and returns are calculated on a mark-to-market basis and determined on specific valuation dates (usually daily or weekly).

We believe the laws of Kuwait would characterize each transfer of Eligible Credit Support as effecting an unconditional transfer of ownership in the assets transferred. Notwithstanding the same, we would draw some caution to the fact that Kuwaiti laws do not specifically address the issue of how the transactions delineated in the CSA would be characterized. There is certain speculation, specifically in that there is some risk that such transfer may be re-characterized as 'creating a security interest.' It is our opinion that pursuant to the laws of Kuwait each transfer of Eligible Credit Support would be characterised as 'effecting an unconditional transfer of ownership in the assets transferred.' Pursuant to the terms of the CSA, and as a matter of English law, transfers of Eligible Credit Support involve an outright transfer of title, free and clear of any liens, claims, charges or encumbrances or any other interest of the transferring party or of any

third person. Therefore, if an event of default exists under an Master Agreement, an amount equal to the value of the relevant credit support balance is deemed to be an unpaid amount under the Master Agreement and therefore is taken into account for purposes of determining the amount due upon close-out of the respective transactions.

Based on the foregoing, in our opinion the risk of re-characterization is remote. Given the language of the CSA (particularly referencing paragraph 5(b) of the CSA), whereby it is made clear that the Transferee receives the Eligible Credit Support free and clear from all restriction and that the intention of the parties is, in essence, a “true sale,” and that no security interest is created by virtue of the transfer. Furthermore, such transactions do not correspond with the form of security interests as the same are outlined in Kuwaiti law. We do not believe there exists means to further reduce such risk, specifically in terms of making any amendments to the CSA, since the CSA includes an express provision indicating the transactions contemplated thereby would not constitute a mortgage, encumbrance or other security interest and in doing so it essentially provides for this.

Our analysis stands on the assumption that the Eligible Credit Support would be restricted to cash, which is located outside of Kuwait, in addition to foreign issued securities. It is worth noting that there may be limitations under Kuwaiti laws, in substituting the respective Eligible Credit Support if the same includes Kuwaiti collateral. In our experience, Eligible Credit Support in the Kuwait market primarily consists of cash and not securities. Generally, local securities are not used as Eligible Credit Support due to the formalities associated with the transfer of such securities. In a bid to avoid such obstacles, local banks are now leaning more toward the use of an ISDA Credit Support Deed, which calls for the perfection of collateral rather than an outright transfer of title.

Notwithstanding the above, in the instance that a Kuwaiti court does re-characterize the Eligible Credit Support as creating a security interest, Kuwaiti bankruptcy and insolvency law will apply (i.e. the collateral will be subject to the relevant Kuwaiti bankruptcy court’s discretion and may be set aside by the court).

Another consequence of a re-characterization would be the potential application of Kuwaiti law relating to the creation and validity of the security interest. In other words, in the event of bankruptcy of a Counterparty, the collateral will be evaluated by a Kuwaiti bankruptcy court to confirm whether or not the collateral underwent the formal steps required to create a security interest in Kuwait. If the Kuwaiti bankruptcy court finds that such collateral did not undergo the formal steps required to create a valid security interest, it will also find the collateral to be subject to set aside.

Given the importance of the derivatives market in international financial sphere, coupled with the GCC’s proliferated use of derivatives products, we expect that Kuwait, in a bid to strengthen and further develop its financial sector, shall continue to grow in accommodating the sophisticated mechanics that such products entail. It is inevitable that in the emergent use of derivatives products, it shall become more incumbent on GCC parties to further avail themselves of the security that is provided by the Credit Support Annex, in order to mitigate the prevalent risks associated with such financial instruments.

For further information, please contact Sadie Hussain (s.hussain@tamimi.com) or Abdullah Masud (a.masud@tamimi.com).