

An examination of the development of ISDA agreements' implementation at Bank Julius Bär within the scope of the financial crisis

Bachelor Thesis in Banking and Finance
Department of Banking & Finance
University of Zurich

Prof. Dr. Kjell G. Nyborg

Assistant: Jiri Woschitz

Marco Schmid

October 20, 2012



**University of
Zurich^{UZH}**

Executive Summary

Question

The ISDA Master Agreements are legal documents used to set up industry standards for many OTC global derivatives markets. They are the most used contracts in transactions for OTC derivatives. Although the framework of the ISDA Master Agreements didn't change a lot since the establishment, the implementation by banks changed extremely since the default of Lehman Brothers in September 2008. This thesis investigates the implementation of the framework at Bank Julius Bär within the scope of the financial crisis. In particular, we examine the collateral balance for OTC products at Bank Julius Bär over a period of three months. We analyze if the movements for different currencies and counterparties relate to economic developments and shocks in the market.

Procedure

This thesis is split into four parts. The first part gives an overview about the ISDA Master Agreements and its components. We show the main differences between the 1992 and 2002 ISDA Master Agreements and describe the "Schweizer Rahmenvertrag". This part is based on the literature *Mastering the ISDA Master Agreement* published by Harding (2002). The second part is about collateral and based on the ISDA Margin Survey 2012. It provides information about the use of collateral in the OTC derivatives business such as the total collateral outstanding or the gross credit exposure. Then we examine the implementation of ISDA Master Agreements at Bank Julius Bär. We analyze the development of the number of Credit Support Annexes. In the last part we investigate the collateral balance for OTC products at Bank Julius Bär. This daily report was collected over a period of three months, started on 14.06.2012. The report gives an overview about the collateral held and delivered by Bank Julius Bär, split in the three currencies CHF, EUR and USD and the top ten counterparties, with whom collateral had been settled. Based on this report we analyze the course of the currencies and counterparties and relate the movements to economic developments and shocks in the market.

Results

In the first part we conclude that the framework of the ISDA Master Agreements hardly changed over time. Apart from the update of the 1992 to the 2002 Agreements no significant change took place. On the contrary, the implementation of the framework by Bank Julius Bär changed extremely since the default of Lehman Brothers. The number of Credit Support Annexes rose from three to more than 120 nowadays. This tremendous increase underlines the willingness of the bank to reduce credit risk by increasing collateralization of their OTC transactions.

The evaluation of the collateral balance for OTC products at Bank Julius Bär provided many interesting facts. During the first two months more collateral was delivered than held. We

observed an enormous shift of the collateral balance of over US\$ 800 million within three months. The Swiss Franc was the most used currency as collateral and constituted far more than a half of the total collateral. Surprisingly, the USD was the less used currency as collateral which can be explained by the higher refinancing costs for the USD. Government securities were rarely used which is consistent with the data of the ISDA Margin Survey 2012. Only with one counterparty out of the top ten ranking government securities were used as collateral.

45 counterparties were registered in the daily top ten ranking within the examination. Three of them have been listed every day in the top ten ranking, namely Credit Suisse International, Royal Bank of Scotland Plc. and Societe Generale. On the other hand, four counterparties are listed only once. Most of the frequently listed counterparties are global players as well as Swiss institutes. UBS was the counterparty with the highest volatility and held rank 1 for the highest outstanding collateral 42 times. It is the only counterparty which held rank 1 for delivered as well as for held collateral. The highest settlement of collateral took place on 03.07.2012 when UBS delivered over CHF 112 million to Bank Julius Bär. On this day the highest turnover of collateral at Bank Julius Bär was registered with more than USD 230 million. UBS constituted together with Credit Suisse International, Royal Bank of Scotland Plc. and Societe Generale 62.33% of the CHF delivered on average. Bank Julius Bär had extremely high outstanding collateral with these four counterparties. It peaked on 26.07.2012 when the outstanding collateral reached an amount of CHF 268 million. This value is much bigger than any position observed in EUR and USD during the observation.

General Evaluation

The description of the ISDA Master Agreements in the first part of the thesis should give a good overview over the framework. As the ISDA Master Agreements are a set of complex documents we focus on the, in our view, most relevant parts. We avoid looking at the legal aspects too detailed. The analysis of the collateral balance for OTC products at Bank Julius Bär took place during a period of lower volatility compared to the years 2007-2009. We estimate that during these years the outstanding collateral and the movements had been much higher than in this observation.