Over-the-counter (OTC) derivatives have been greatly maligned in the wake of the global financial crisis. Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), entitled “Wall Street Transparency and Accountability,” promises to make significant changes to the OTC derivatives industry. Most notably, it calls upon the Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (“SEC”) to issue rules that provide for mandatory clearing of certain swaps and security-based swaps and the execution of such trades on a designated contract market or a swap execution facility.

However, the rulemaking to implement the Dodd-Frank Act is proceeding more slowly than envisaged by lawmakers, and therefore OTC trades continue to be transacted as they have been for the past two and half decades - bilaterally, through ISDA Master Agreements. This article will provide an elementary discussion of the ISDA Master Agreement and will be divided into two parts. Part I describes the origins of the ISDA Master Agreement, sets out its architecture, and discusses the areas on which compliance and risk professionals should focus. Part II, which will be published in a forthcoming issue, will delve into the terms of the ISDA Master Agreement and discuss its most commonly negotiated provisions.

Why an ISDA Master Agreement?

In the early days of privately-negotiated OTC derivatives transactions, a central barrier to the development and expansion of the market was non-standardization, the lack of a common language through which market participants could discuss and document the products they were developing. The first serious efforts at standardization began in the 1980s. Local trade associations in different geographical regions sought to resolve the problem independently. The British Bankers Association’s Interest Rate Swap Working Party and Forward Rate Agreement Working Party developed a standard prescriptive set of terms for interest rate swaps and forward transactions. In Australia, a working group took a similar approach. However, in the United
States, a group of swap dealers who formed the International Swap Dealers Association devised a master agreement and menu approach. Under this approach, the master agreement provides terms that apply generally to all trades and the parties may choose additional provisions that best apply to their deal from a menu of standard terms. This master agreement and menu approach has become the dominant method by which market participants document their OTC derivatives transactions today.

The formation of the International Swap Dealers Association (subsequently renamed the International Swaps and Derivatives Association, and known in both cases as “ISDA”) in 1985 marked the beginning of an ongoing effort to standardize the documentation relating to OTC derivatives transactions. While total standardization of OTC transactions is not possible, ISDA has produced a set of form agreements and defined terms that have gradually reduced the provisions that need to be negotiated by the parties to an OTC transaction.

The ISDA Master Agreement sets forth general legal and administrative terms that will apply to all transactions entered into under it. These terms include:

- payment and delivery obligations;
- netting of payments;
- representations and warranties;
- events of default and termination events; and
- liquidation upon an event of default or termination event.

Despite the fact that the ISDA Master Agreement is a standardized industry-accepted agreement, its terms are often heavily negotiated. Changes or additions to the pre-printed form ISDA Master Agreement as well as the menu-type elections required by the pre-printed form (for example, governing law) are set out in a Schedule to the ISDA Master. The pre-printed form together with the Schedule make up the ISDA Master Agreement. Part II of this article will discuss the most common changes made to the ISDA Master.

**Credit Support Annex**

The Schedule to the ISDA Master may also include a standard form collateral agreement - the Credit Support Annex. The New York law Credit Support Annex (“CSA”), published by ISDA in 1994, enables parties to an ISDA Master to receive and provide collateral, so as to reduce counterparty credit risk. The CSA is a bilateral form agreement that provides for bilateral margining. The mark-to-market of the parties’ exposure across all OTC derivatives transactions subject to the ISDA Master Agreement is calculated daily allowing the “in-the-money” party to make calls for collateral from the “out-of-the-money” party.

**Confirmations**

The ISDA Master Agreement, including the Schedule and CSA, is an agreement of the parties that all OTC transactions between them will be governed by a common set of legal terms. The economic terms of each transaction subject to an ISDA Master Agreement are usually agreed over the telephone, and once so agreed, the trade is live. However, the parties must also confirm their agreement to these terms with a paper or electronic form “confirmation”.

ISDA publishes forms of confirmations in, or in conjunction with, the definitional booklets for various products. These confirmations focus...
substantially on the economic terms of the trades, such as price, notional amount, underlying asset, and payment dates. There remain many non-economic terms that must or may be applied to the confirmation that cause trade confirmations to be long and cumbersome to negotiate. Historically, parties to an OTC transaction would frequently have trades outstanding for months while they tried to agree to appropriate elections. For example, in equity derivatives, negotiations can often revolve around the consequences of certain market events, like a tender offer, or whether a party should be entitled to optional early termination of the trade. Delays in confirming trades can cause major backlogs leading to operational risk and documentation risk as the trades become subject to an incomplete set of terms.

To simplify and standardize the negotiation of trade confirmations, ISDA has been developing, through working groups comprised of buy-side and sell-side industry participants, a number of form Master Confirmation Agreements (“MCAs”) for various products (e.g., equity swaps and options, CDS, variance swaps) in several jurisdictions (e.g., U.S., Europe, Asia excluding Japan, Japan). Parties can now select an ISDA form MCA, which was approved by an ISDA working group and represents the compromise agreed by the industry for a particular product. The parties can then simply negotiate the elections in a supplement to the MCA (a “Supplemental Confirmation”). In practice unfortunately, some MCAs still take considerable time to negotiate because of the sensitivity of the elections or because the market deviates from the approach selected by the working group.

Despite potential protracted negotiations of an MCA, it does speed up the process of confirming trades. Once an MCA for a particular product has been agreed to between the parties, every time they want to put on that type of trade all that remains to be confirmed by the parties are the economic terms, over which there would usually be little controversy. The development of MCAs has gathered pace in the last decade with the increase in regulatory pressure to reduce confirmation backlogs and hasten trade processing. More recent developments include electronic confirmation of Supplemental Confirmations that only contain economic terms, further speeding up the confirmation process and reducing the burden on the back and middle offices.

**Definitional Booklets**

To address the need to document trades in different products, ISDA developed a series of definitional booklets which continue to be revised to account for market developments. Most ISDA definitional booklets have gone through various editions to reflect developments in, and the greater sophistication of, the underlying products. There are now definitional booklets covering interest rate, currency, commodity, credit, bond and equity products and their various offshoots (See Table 1).

### Table 1: Currently available ISDA definitions.

<table>
<thead>
<tr>
<th>Category</th>
<th>Definitions</th>
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<tr>
<td><strong>Bullion Definitions</strong></td>
<td>1997 ISDA Bullion Definitions&lt;br&gt;1997 ISDA Short Form Bullion Definitions</td>
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<tr>
<td><strong>Commodity Derivatives Definitions</strong></td>
<td>2005 ISDA Commodity Definitions&lt;br&gt;2000 Supplement to the 1993 ISDA Commodity Derivatives Definitions&lt;br&gt;1993 ISDA Commodity Derivatives Definitions</td>
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<tr>
<td><strong>Credit Derivatives Definitions</strong></td>
<td>2003 ISDA Credit Derivatives Definitions&lt;br&gt;1999 ISDA Credit Derivatives Definitions</td>
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<tr>
<td><strong>Equity Derivatives Definitions</strong></td>
<td>2011 ISDA Equity Derivatives Definitions&lt;br&gt;2006 ISDA Fund Derivatives Definitions&lt;br&gt;2002 ISDA Equity Derivatives Definitions&lt;br&gt;1996 ISDA Equity Derivatives Definitions&lt;br&gt;1994 ISDA Equity Option Definitions</td>
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<tr>
<td><strong>FX and Currency Options Definitions</strong></td>
<td>1998 FX and Currency Option Definitions&lt;br&gt;1992 FX and Currency Option Definitions</td>
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<tr>
<td><strong>Government Bond Option Definitions</strong></td>
<td>1997 ISDA Government Bond Option Definitions</td>
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<tr>
<td><strong>Definitions for Interest Rate &amp; Currency Derivative Transactions</strong></td>
<td>2006 ISDA Definitions&lt;br&gt;2000 ISDA Definitions&lt;br&gt;Annex to the 2000 ISDA Definitions&lt;br&gt;1991 ISDA Definitions</td>
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<tr>
<td><strong>2007 Property Index Derivatives Definitions</strong></td>
<td>2007 ISDA Property Index Derivatives Definitions</td>
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Annexes

In the last decade, ISDA in conjunction with commodity industry associations published annexes to be added to the ISDA Master by parties wishing to enter into agreements for the purchase and sale of physical commodities, including power, gas, oil and coal. These annexes were drafted through a combined effort with the relevant commodity industry association and reflect prevailing market terms for these industries. As a result of the addition of physical annexes, as further explained below, parties can net payments across physical and financial transactions.

The Single Agreement

By its terms, each ISDA Master Agreement (including its Schedule, CSA, and annexes, if any) together with any confirmation or Supplemental Confirmation subject to an MCA (including the relevant definitional booklet applied to the trade), entered into between two parties, form a single agreement. The benefits of the single agreement are threefold:

1. Parties can elect to net payments across transactions if they are due on the same day and in the same currency.
2. Parties will collateralize their trades based on their portfolio of trades rather than on individual trades.
3. Upon an event of default or other termination event with respect to one party (the “defaulting party”), the other party will be entitled to terminate all the outstanding transactions, value them and net out amounts owed by the defaulting party from any amounts that may be owed to the defaulting party.

Accordingly, the single agreement concept reduces counterparty credit risk by ensuring that settlement and margin payments only flow from the party who owes the greater amount.

The chart below illustrates the ISDA Master Agreement structure:
Risk and Compliance Issues

There are numerous aspects surrounding an ISDA relationship that require attention and monitoring from compliance and risk professionals. This article will focus on four areas of concern:

1. Ensuring that an organization is permitted to enter into derivatives transactions;
2. Complying with the Dodd-Frank Act recordkeeping requirements;
3. Monitoring and managing counterparty credit risk; and
4. Monitoring and managing one’s, and one’s counterparty’s, potential default.

Ensuring that your organization is permitted to enter into OTC derivatives transactions

This consideration may seem somewhat basic but not all entities are permitted under their organizational documents to enter into OTC derivatives transactions. A review of these documents to ensure that there are no prohibitions to the use of OTC derivatives is a necessary first step to entering into an ISDA relationship. The second step is to determine whether your organization is an Eligible Contract Participant (“ECP”) under the Commodities and Exchange Act, as only ECPs can legally trade in OTC derivatives. The definition of ECP is a lengthy one that bears periodic review.

Admittedly, these two inquiries may be in the legal department’s realm, but for many smaller organizations where roles are sometimes blended, understanding the restrictions to entering into OTC transactions is crucial.

Complying with the Dodd-Frank Act Recordkeeping Requirements

The Proposed Rule on Swap Data Recordkeeping and Reporting Requirements: Pre-Enactment and Transition Swaps, 17 CFR 46, published on April 25, 2011 pertains to pre-enactment swaps and transition swaps. “Pre-enactment swaps” are defined as swaps entered into before July 21, 2010 and whose terms have not expired as of that date. “Transition Swaps” are swaps entered into on or after July 21, 2010 but prior to a date that will be specified in the CFTC’s final swap data reporting rules.

The Pre-Enactment and Transition Swaps rule provides that parties to a trade must keep records of the following:

(A) the “minimum primary economic terms” of a trade, including:

(i) any information necessary to identify and value the transaction (e.g., underlying asset and maturity);

(ii) the date and time of execution of the transaction;

(iii) volume (e.g., notional or principal amount);

(iv) information relevant to the price and payment of the transaction until the swap is terminated, reaches maturity, or is novated;

(v) whether the transaction was accepted for clearing by any clearing agency or derivatives clearing organization, and if so, the identity of such agency or organization;

(vi) any modification(s) to the terms of the transaction; and

(B) the final confirmation of the transaction.

(C) any master agreement governing the swap, and any modification or amendment thereof; and

(D) any credit support agreement or equivalent documentation relating to the swap, and any modification or amendment thereof.

For swaps that have expired prior to April 25, 2011, parties need to keep the records (information and documents) they already have.

Monitoring and Managing Counterparty-Credit Risk

Parties actively trading under an ISDA Master Agreement should diligently monitor credit exposure and manage collateral.
Calculating Exposure and Mitigating Risk

To mitigate counterparty credit risk, a party must monitor its credit exposure on a daily basis. In practice, this means that each party will need to have operational systems in place that will allow it to calculate its “exposure” at the end of each business day. “Exposure” (as defined in the 1992 ISDA Master) is essentially the sum of the positive and negative mid-market valuations of the outstanding transactions under the ISDA. If a party’s (the “Secured Party”) exposure exceeds the value of collateral that has been posted by the other party (the “Pledgor”) to the Secured Party (taking into account interest and distributions, as applicable) with respect to all transactions, then the Secured Party is over-exposed and should request additional collateral from the Pledgor to cover the additional credit risk. Conversely, if the Secured Party’s exposure is less than the value of collateral it is holding with respect to all transactions, then the reduced credit risk would entitle the Pledgor to call for a return of collateral.

Threshold Amount and Minimum Transfer Amount

After a party’s exposure is determined, it may be qualified by certain credit terms in the CSA. For instance, parties may agree to a “threshold amount”, which is the unsecured credit exposure that the Secured Party is willing to allocate to the Pledgor (i.e., the Pledgor is not required to post collateral unless and until the Secured Party’s exposure equals or exceeds the threshold amount). A Secured Party would likely only agree to a threshold amount when facing a financially stable and credit-worthy counterparty. While at one point in time threshold amounts were commonly negotiated in favor of broker-dealers, threshold amounts have become rarer in the post-Lehman market.

Another tool, which is largely driven by operational considerations but also may have some risk implications, is the “minimum transfer amount” or “MTA”. Collateral calls for amounts smaller than the MTA are not permitted under the CSA. As a result, having an MTA prevents the call of nuisance amounts and allows the parties to avoid unnecessary costs involved in small transfers. The practical implications of the MTA is that the Secured Party is unsecured for any exposure that is less than the MTA.

Collateral Management Dispute

Parties should also consider having a system for identifying discrepancies in their respective valuations of collateral or calculation of exposure, and for resolving any disputes that may arise.

Monitoring and managing your and your counterparty’s potential default

A key consideration when trading under an ISDA Master Agreement is the risk of default; one’s own default and that of one’s counterparty. There are various mechanisms that can assist a party in assessing whether its counterparty is moving toward a default. Advance notice of a default will allow a party to reduce its exposure...
Financial Information

Assessing the risk of a party’s default requires careful review of the financial information received from a counterparty. A proxy for determining the financial health of a corporation or a limited liability company is its shareholders’ equity or members’ capital, whereas that of an investment firm is its net asset value. Should these measures of financial health present an unacceptable rate of decline over a specified time frame (typically monitored in one-month, three-month or twelve-month increments), such decline should prompt risk mitigation tactics. To monitor these risks, parties will require certain deliverables. In addition, to be entitled to take action when a counterparty’s situation has reached a critical point, parties will request Additional Termination Events (“ATEs”) triggered by net asset value declines or credit rating declines.

Deliverables

Under the ISDA Schedule, corporations, partnerships and other conventional entities typically deliver annual and quarterly financial statements, whereas hedge funds and other investment vehicles typically deliver annual and monthly financial statements. These periodic financial statements provide parties with a snapshot of the financial health of their counterparties.

Publicly traded entities should ensure that the timing of the delivery of their financials under the ISDA is similar to (or more lenient than) the timing mandated by their regulator. Private entities delivering financial statements should ensure that they can meet the agreed delivery timing and should have a system in place that guarantees timely delivery. Hedge funds for instance typically obtain their monthly statements from their administrators and should check with the administrator to determine how much time is needed after the end of each month to prepare and deliver the statements.

Additional Termination Events

Parties use ATEs as an indicator of an impending default, such as a failure to pay a settlement amount or deliver margin. Should an ATE be triggered, the counterparty will have the right to terminate all transactions under the ISDA. A hedge fund’s monthly financial statements typically contain the fund’s net asset value and may have information about redemptions and subscriptions with respect to the previous months. Counterparties to a hedge fund may request net asset value triggers: if the fund’s net asset value declines by a certain percentage on a monthly, quarterly or yearly basis, the counterparty would be entitled to declare an ATE. Similarly, what is commonly referred to as the “credit rating downgrade ATE” is used by counterparties as an indication of an impending default by a publicly traded counterparty (which is a rated entity or is a subsidiary of a rated entity), and would also trigger the right of termination. Private entities may be subject to ownership ATEs.

From a risk perspective it is critical for ISDA parties to familiarize themselves with the financial history of their counterparties. This will enable parties to quickly spot problems in the financial health of their counterparties. It is equally critical for parties to keep track of any ATE triggers in the agreement.

In the spirit of self-preservation, parties should also monitor the ATE triggers that apply to them and, to the extent possible, take pre-emptive measures to avoid triggering a termination event under the ISDA Master.

Conclusion

The ISDA Master Agreement is an industry-standard form that allows market participants to trade any number of OTC derivatives products under a single agreement. The ISDA Master reduces the cost and time associated with negotiating OTC trades, reduces counterparty credit risk by providing the mechanism for collateralizing exposure and by allowing for netting of payments and close-out netting upon default, and allows for the seamless addition of various trades to an existing portfolio. The apparent simplicity of the ISDA Master should not however, detract from the fact that there are inherent risks in entering into trades under an ISDA. Therefore, parties should ensure that they are:

- entitled to enter into the trades;
- complying with the Dodd-Frank Act record-keeping requirements;
monitoring and managing their counterparties’ credit risk; and
• monitoring their, and their counterparties’, risk of default.

Part II of this article will discuss the provisions of the ISDA Master Agreement that are most heavily negotiated.

ENDNOTES

1 Other credit support annexes have been published by ISDA but they are not within the scope of this article.
2 Many of the terms of the ISDA Master and CSA, specifically the netting and collateral provisions, have been reviewed at ISDA’s request by local counsel to confirm their enforceability in the local jurisdiction, thereby, relieving each party to the agreement of the need to engage in this research on its own and at its own expense.