

ISDA Agreements; Considerations in Setting up the Relationship

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You want to hedge currency or interest rate risk or even use derivatives to address credit risk or leverage your balance sheet? Your bank wants you to enter into International Swaps and Derivatives Association, Inc. ('ISDA') agreements? You think that the ISDA agreement is a standard form document with limited negotiable points?

While the ISDA agreement is highly standardised and is used in a wide variety of derivatives transactions, it is not a standard form document. In this article, we will examine certain key issues that should be considered in order to set up a derivatives trading relationship.

Document Architecture

First, back to basics. The parties will need an ISDA agreement to enter into any over-the-counter ('OTC') derivatives trades between them. The constituent parts are:

- the ISDA master agreement - this is the pre-printed master agreement that forms the basis of the OTC derivatives relationship between two parties. It is, by itself, not negotiated or amended; multiple transactions across different asset classes and products are documented under the same ISDA master agreement;
- schedule to the ISDA master agreement - this document amends the term of the ISDA master agreement based on the requirements of the parties;
- credit support documents - in addition to standard credit support documents such as guarantees, ISDA has published various forms of credit support annexes and credit support deeds to assist in providing security or exchanging collateral in respect of the transactions under the ISDA master agreement; and
- confirmations - this is the short document that sets out the economic terms of a transaction and usually incorporates a set of ISDA's published definitions which is most relevant to the asset class. While this may seem to be the simplest part of the puzzle, this often can be the most complex one. The ISDA documents are set up so that the terms of the Confirmation prevail over the ISDA Master Agreement but this can lead to unintentional changes to the ISDA Master Agreement.

It is in the interest of both parties to establish this framework before they commence trading derivatives. The documents will need to be amended to reflect the type of and creditworthiness of the parties as well as the type of transactions being contemplated between the parties.

Counterparties



While the creditworthiness is an important factor in determining whether to trade with them, the counterparty's jurisdiction of incorporation is also a key point that should be considered. Two main factors dominate the counterparty's jurisdiction discussion: the insolvency risk. and the regulatory issues.

Insolvency risk

Derivatives master agreements include the concept of close-out netting which is the process used to determine the net obligations of a defaulting counterparty to the derivatives transactions entered into under the master agreement. In summary, the defaulting counterparty's remaining contractual obligations are terminated, and the final positive and negative replacement values of its positions are combined into a single net payable or receivable amount. However, this is possible when the relevant bankruptcy laws of a jurisdiction include carve-outs for close-out netting. While certain countries in the middle east have adopted relevant netting legislations to exclude close-out netting from the purview of bankruptcy laws, a few countries that have not adopted separate netting laws remain and thus, local counsel should be consulted in order to analyse whether existing bankruptcy laws allow for close-out netting.

Regulatory issues

Derivatives have been in focus since the 2008 financial crisis which led to a series of reforms by the United States of America, the European Union and certain other countries. The Dodd-Frank Wall Street Reform and Consumer Protection Act in the USA and the European market infrastructure regulation in the European Union introduced obligations including trade reporting, central clearing, margin requirements and special resolution regimes to improve the OTC derivatives market. Most of these regulatory regimes focus on the same points though there are nuances between them. To assist market participants to comply with these regulatory changes by various authorities, ISDA created a series of protocols. However, when entering into a new ISDA agreement, the parties should consider relevant applicable regulations and related obligations and reflect those while drafting the ISDA agreement.

As consequence of the above factors, it is important to investigate the resultant choice of an entity to

enter into derivatives transactions from a credit and regulatory perspective. As an example, it is worth considering whether you may be asked to exchange variation or initial margin for transactions when dealing with banks from certain jurisdictions or whether close-out is more prolonged for your bank's default due to the special resolution regimes applicable in those jurisdictions. Similarly, as many banks have complex corporate structures, it may be helpful to deliberate on tax considerations or additional changes or termination events required to address any concerns arising from such structures.

Hedging Facility Linked Swaps

You are contemplating entering into a large financing facility and your bank wants you to enter into a new finance linked ISDA Agreement to document the related swap. A finance linked ISDA agreement is considerably different from the standard ISDA agreement. The key issue is interlinking the finance facility and swap and the respective documents. In this process, you should consider, among others:

- the inter-relation between the ISDA agreement, facility agreement and any inter-creditor deed and addressing the related issues holistically;
- the treatment of ISDA Agreement events of default, facility agreement defaults and pre-payments;
- the applicability of the events of default to your hedge counterparty; and
- crucially, there is no mis-match between the swap terms and the finance facility.

Conclusion

In summary, the ISDA agreement is not a standard form document that can be signed without negotiations. In this article, we have touched on just a few of the issues which need to be considered when documenting derivatives; there are many more negotiating points and potential pitfalls. Accordingly, although often viewed as a standard, it is essential to seek guidance from experts while negotiating the ISDA agreement.

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