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**Legal Framework for Derivatives**

Hedging transactions such as Foreign Exchange (FX), Fixed Income (FI), Interest Rate Swaps (IRS), Commodities Derivatives are usually covered by the combination of a standard master agreement and deal specific confirmations.

**ISDA Master Agreement 2002:** The International Swaps and Derivatives Association is a trade organization of participants in the market for over-the-counter derivatives. It is headquartered in New York and has developed a standardized contract (the «ISDA Master Agreement») to govern derivatives transactions. The ISDA Master Agreement is a bilateral framework agreement which contains general terms and conditions, such as provisions relating to payment netting, representations, basic covenants, events of default and termination, and provisions for close-out netting. However, it does not, by itself, include details of any specific derivative transaction the parties may enter into confirmations.

The ISDA Master Agreement is a standardized format that will not be amended. The Agreement also includes a Schedule in which the parties elect certain options and may modify sections of the Master Agreement if desired.

The two primary issues dealt with in the ISDA Master Agreement are:

**Credit Events of Defaults:** The ISDA Master Agreement includes eight Events of Default, the most important of which are generally considered to be Failure to Pay or Deliver, Bankruptcy and Cross Default. Cross Default refers to a default of Specified Indebtedness, which is defined as any obligation in respect of borrowed money. It is called «Cross» because it relates to transactions entered into with third parties.

**Termination Events:** The ISDA also includes Termination Events, which are distinguished from Events of Default since they are considered events that are not the fault of the counterparty. In addition to the enumerated Termination Events, the ISDA Master Agreement allows parties to specify «Additional» Termination Events in the Schedule or in a Confirmation, which can be specially tailored. These are often linked to credit concerns, with parties utilizing the provision, for instance, to incorporate downgrades in credit ratings (either unilaterally or bilaterally), or to include a trigger upon material changes in the management structure of a party.

Another key credit aspect of the ISDA Master Agreement is the ability to link entities related to the parties to the ISDA Master Agreement to the agreement by naming them as Specified Entities in relation to certain Events of Default and Termination Events. If an entity is designated as a Specified Entity («SE») for Party X in relation to an event and such an event occurs with respect to the SE, then the event will be triggered against Party X under the ISDA Master Agreement and the counterparty will have the right to terminate the ISDA Master Agreement even if the event has not occurred in relation to Party X itself. Parties may wish to provide for this if other entities of a group are also trading counterparties or if they are simply important from a credit risk perspective.

**Netting Payment & Settlement Netting:** This form of netting deals with the offsetting of payment or delivery obligations owed under one or more transactions due on the same business day and expressed in the same currency or having the same International Security Identification Number («ISIN»). It is used to mitigate settlement risk, also known as Herstatt Risk, after a failed German bank that highlighted the dangers of settlement risk.

**Close Out Netting:** This form of netting deals with offsetting of market values or replacement costs calculated in respect of two or more transactions existing on an early termination date. It is used to mitigate credit risk. Netting of exposures across a variety of transactions (cross-product) enables a potential reduction of credit risk and recognition thereof for risk capital purposes. When the two or more transactions are terminated, close-out netting will be performed, the transactions will terminate and be

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replaced by a market value or replacement cost position. Then, a single amount in the termination currency will be determined payable by one party to the other.

**Credit Support Annex (CSA):** ISDA also offers a credit support annex: the ISDA Credit Support Annex («CSA»), an add-on document that can be easily appended to an existing ISDA Master Agreement, which further permits parties to mitigate their credit risk by requiring a party to which a derivative Transaction.

The main clauses negotiated in the CSA are:

- β **Threshold:** defines the level of mark-to-market exposure below which no collateral is required to be posted Eligible
- β **Collateral:** defines the type of instruments which can be posted as collateral
- β **Valuation Date:** defines the regularity of the counterparties estimating their respective mark-to-market exposure for the purpose of determining any required collateral
- β **Minimum Transfer Amount:** assuming there is no independent amount defined, this is the amount by which a party’s exposure must exceed the sum of the posted collateral, before more collateral may be called Distributions and Interest Amount: posted cash would earn interest, while the counterparty who had posted it, is unable to use it this clause defines what rate of interest it would earn (e.g. EONIA, 3m LIBOR). If securities are posted, the counterparty posting continues to receive bond coupons Rating Triggers: should a counterparty be downgraded by one or more rating agencies to a pre-defined level, for example from A to BBB, certain provisions might become more stringent or become applicable at that point. The most commonly agreed consequences are the Threshold going to zero or the frequency being increased to daily etc.

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