Offsetting of Derivatives

General Features of the ISDA Master Agreement

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General Features of the ISDA Master Agreement

- Covers multiple transactions
- At any time, some transactions in the money for a party and some out of the money
- Future payment obligations conditional upon, among other things, no Event of Default having occurred
- Provides for close-out netting and payment netting
  - does not provide for netting by novation

Rights to Net under the ISDA Master Agreement

- **Comprises two distinct rights, Close-out Netting and Payment Netting**
- **Close-out netting (Sections 5 and 6)**
  - most important feature of ISDA Master Agreement
  - legal, credit and regulatory focus on these provisions of agreement (mitigates credit risk)
  - operates following default
  - provides for replacement of obligations under individual transactions with a single net sum
- **Payment netting (Section 2(c))**
  - operates in the normal course of business day to day
  - set-off of obligations due on a particular day
  - usually only important operationally (mitigates settlement risk)
  - Single Agreement Concept (Section 1(c)) is not a right to net but underpins the netting provisions

Termination and Close-out netting provisions – Sections 5 and 6

- Close out netting involves the replacement of individual obligations with a single net sum - it is conceptually different to set off

- If Event of Default or (in certain circumstances) Termination Event occurs and is continuing, Non-defaulting Party entitled to:

  - give notice to designate Early Termination Date
  - terminate all transactions => no further amounts due under individual transactions
  - determine a net sum (payable by either party depending on which is net out of the money)

Net sum replaces the payments and deliveries under the individual transactions

- Method of valuing terminated transactions prescribed in the ISDA Master Agreement (different methodology in 1992 ISDA Master Agreement v 2002)

- Enforceability of close-out netting provisions in bankruptcy supported by legal opinions in 54 jurisdictions

Calculation of Net Sum
(Early Termination Amount)

- Valuation of the unperformed payment and delivery obligations under each transaction
- Valuation of both (a) future obligations and (b) obligations due but not performed as at the date of termination
- Non-defaulting Party determines MTM value of all terminated transactions (both positive and negative)
- any amounts previously due from either party but not paid prior to the termination (Unpaid Amounts) are added and subtracted, as applicable
- aggregate of MTM values and Unpaid Amounts becomes the net sum payable:
  - if positive, Defaulting Party pays to Non-defaulting Party
  - if negative, Non-defaulting Party pays absolute value to Defaulting Party

Single Agreement Provision - Section 1(c)

- Commercially, transactions treated individually for booking, payment and other practical purposes
- Legally, Master Agreement and all transactions entered into under it form one single, indivisible contract
- Principal function is to protect against “Cherry-picking” by liquidator or other insolvency official
- Cornerstone of the ISDA Master Agreement
- Does not constitute netting by novation

Cherry-picking

- Insolvency official's right to disclaim unprofitable (out of the money) contracts and assume only profitable (in the money) contracts
  - counterparty required to claim in the bankruptcy for in-the-money transactions, but will probably receive only a fraction of its claim
  - but required to continue to perform the out of the money contracts in full
  - greatly increases credit risk and market risk

Automatic payment netting provision – Section 2(c)

- Payment netting: replacement, on a payment date, of two or more payment obligations due on that date; the party owing the larger amount pays the difference to the other party
- Occurs automatically in relation to payments that are due
  - on the same day,
  - in the same currency
  - either:
    - if no election is made otherwise, in respect of the same transaction (the standard position); or
    - if elected by the parties to apply to groups of transactions, in respect of such group of transactions

- Reduces settlement risk by reducing the cash flows required between the parties
- Essentially a form of set-off
- Should not be confused with close-out netting and is not related to credit events or Events of Default
- Conceptually different from netting by novation, since the original payment obligations remain

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