

INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION (ISDA)

ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 800 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business. Among its most notable accomplishments are: developing the ISDA Master Agreement; publishing a wide range of related documentation materials and instruments covering a variety of transaction types; producing legal opinions on the enforceability of netting and collateral arrangements (available only to ISDA members); securing recognition of the risk-reducing effects of netting in determining capital requirements; promoting sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives

Mission

The Association's primary purpose is to encourage the prudent and efficient development of the privately negotiated derivatives business by:

- Promoting practices conducive to the efficient conduct of the business, including the development and maintenance of derivatives documentation.
- Promoting the development of sound risk management practices.
- Fostering high standards of commercial conduct.
- Advancing international public understanding of the business.
- Educating members and others on legislative regulatory, legal, documentation, accounting, tax, operational, technological and other issues affecting them.
- Creating a forum for the analysis and discussion of, and representing the common interest of its members on, these issues and developments.

Documentation

http://www.isda.org/educat/pdf/documentation_of_derivatives.pdf

<http://www.isda.org/educat/pdf/ten-themes.pdf>

Master agreements

The ISDA Master Agreement, the authoritative contract widely used by industry participants, represents a milestone achievement because it has established international contractual standards governing privately negotiated derivatives transactions that reduce legal uncertainty and allow for reduction of credit risk through netting of contractual obligations. As the business has developed and grown, ISDA expanded and updated the Master Agreement and its supporting documents, a process that continues today.

Ensuring the enforceability of the netting provisions of the ISDA Master Agreement has been, and remains, a key initiative, because of its importance in reducing the credit risk arising from the business. The Association's work in this area has resulted in a series of laws being passed in various countries that ensure legal certainty in those nations. Since its original request for opinions from the G-10 countries in 1987 that only addressed the enforceability of certain provisions of the 1987 Master Agreement, ISDA continues to expand the number of countries covered by netting opinions to over 40. The scope of the opinions now includes the enforceability of the termination, bilateral close-out netting and multibranch netting provisions of the 1987, 1992 and 2002 Master Agreements. Counsel has also been asked to review whether the inclusion of additional derivatives transactions, such as credit derivatives, bullion transactions and weather derivatives, affects the legal opinions being rendered.

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These opinions are now updated annually to comply with requests from various central banks. ISDA continues to expand its efforts related to the enforceability of netting provisions in emerging markets jurisdictions, working with the relevant legislative and regulatory representatives. In addition, ISDA also solicits legal opinions on the enforceability of the ISDA Credit Support Documents in various jurisdictions. Those opinions are also updated on an annual basis and are available to members on this website.

Frequently Asked Questions

1. What is a derivative?

A derivative is a risk-shifting agreement, the value of which is derived from the value of an *underlying asset*. The underlying asset could be a physical commodity, an interest rate, a company's stock, a stock index, a currency, or virtually any other tradable instrument upon which two parties can agree.

2. Major derivative categories

Derivatives fall into two categories. One consists of customized, privately negotiated derivatives, which are known generically as *over-the-counter (OTC)* derivatives or, even more generically, as *swaps*. The other category consists of standardized, exchange-traded derivatives, known generically as *futures*. In addition, there are various types of product within each of the two categories as described below.

3. How do privately negotiated (OTC) derivatives differ from futures?

First, the terms of a futures contract—including delivery places and dates, volume, technical specifications, and trading and credit procedures—are standardized for each type of contract. For swaps, the same characteristics are subject to negotiation by the parties to the contracts. Second, futures contracts are always traded on an exchange, while swaps are traded on a bilateral basis. Third, those who engage in futures transactions assume exposure to default by the exchange's clearinghouse; for OTC derivatives, the exposure is to default by the counterparty. Fourth, credit risk mitigation measures, such as regular mark-to-market and margining, are automatically required for futures but optional for swaps. Finally, futures are generally subject to a single regulatory regime in one jurisdiction, while swaps—although usually transacted by regulated firms—are transacted across jurisdictional boundaries and are primarily governed by the contractual relations between the parties. Various products, including futures contracts and exchange-traded options, fall within the generic category of futures, but all have the common characteristics described above. The definitions that follow refer exclusively to privately negotiated (OTC) derivatives.

4. Product description: Forward contracts

A forward is a customized, privately negotiated agreement between two parties to exchange an asset or cash flows at a specified future date at a price agreed on the trade date. Entering a forward contract typically does not require the payment of a fee.

5. Definition: Trade date

The trade date is the date on which the parties agree to the terms of a contract. The *effective date* is the date on which the parties begin calculating accrued obligations, such as fixed and floating interest payment obligations on an interest rate swap.

6. Definition: Notional principal

Notional principal, or notional amount, of a derivative contract is a hypothetical underlying quantity upon which interest rate or other payment obligations are computed.

7. Product description: Forward rate agreements (FRA)

A forward rate agreement is a forward contract on a short-term interest rate, usually Libor, in which cash flow obligations at maturity are calculated on a notional amount and based on the difference between a predetermined *forward rate* and the market rate prevailing on that date. The settlement date of an FRA is the date on which cash flow obligations are determined.

8. Short-term interest rates: Libor

Libor, which stands for London Interbank Offered Rate, is the interest rate paid on interbank deposits in the international money markets (also called the *Eurocurrency markets*). Because Eurocurrency deposits priced at Libor are almost continually traded in highly liquid markets, Libor is commonly used as a benchmark for short-term interest rates in setting loan and deposit rates and as the floating rate on an interest rate swap.

9. What is a swap?

A swap is a privately negotiated agreement between two parties to exchange cash flows at specified intervals (payment dates) during the agreed-upon life of the contract (maturity or tenor). Entering a swap typically does not require the payment of a fee.

10. Product description: Interest rate swaps

An interest rate swap is an agreement to exchange interest rate cash flows, calculated on a notional principal amount, at specified intervals (*payment dates*) during the life of the agreement. Each party's payment obligation is computed using a different interest rate. In an interest rate swap, the notional principal is never exchanged. Although there are no standardized

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swaps, a plain vanilla swap typically refers to a generic interest rate swap in which one party pays a fixed rate and one party pays a floating rate (usually *Libor*).

11. Risks associated with interest rate swaps

Typically, a party entering a swap gives up (or takes on) exposure to a given interest rate. At the same time, each party takes on the risk—known as counterparty credit risk—that the other party will default at some time during the life of the contract.

12. Suppose a client enters into an interest rate swap with a derivatives dealer to protect against rates rising by locking in a fixed rate. Doesn't that mean the dealer expects rates to fall? Otherwise, why would the dealer take on the risk of losing money?

The dealer's view on interest rates does not matter. When the dealer assumes a client's risk, the dealer typically lays off—that is, hedges—that risk with an offsetting transaction. Suppose, for example, a dealer enters into a swap in which the client pays a fixed rate to the dealer and the dealer pays a floating rate to the client. The dealer could hedge the risk by entering into an offsetting swap with another client or dealer. Or, it could take a Treasury security position with interest rate exposure that offsets the swap. Or, it could take an offsetting futures position. Over the entire portfolio some risks might be uncovered at various times—which is essential to the existence of a liquid market—but such risks are carefully monitored and controlled by dealers.

13. The value of an interest rate swap

The value of an interest rate swap to a counterparty is the net difference between the *present value* of the payments the counterparty expects to receive and the present value of the payments the counterparty expects to make. At the inception of the swap, the value is generally zero to both parties, and becomes positive to one and negative to the other depending on the movement of interest rates. *Present value* is the value of a quantity to be received in the future, adjusted for the time value of money (interest foregone while waiting for the quantity).

14. Credit risks associated with swaps

Loss on a swap occurs if two things happen: First, the counterparty must default; and second, the swap must have a positive value to the party that does not default. The amount of the loss depends on the credit exposure of the swap.

15. What is the actual amount at risk in a swap?

The *credit exposure* of a swap is the amount that would be lost if default were to occur immediately. Credit exposure is generally equal to the current market value if positive, and zero if current market value is negative. Swap participants also calculate future exposures of swaps, which are potential positive values during the life of the swap; future exposures are used to establish credit charges (expected exposure) and credit limit usage (peak exposure).

16. Product description: Options

An option is an agreement that gives the buyer, who pays a fee (*premium*), the right—but not the obligation—to buy or sell a specified amount of an underlying asset at an agreed upon price (*strike or exercise price*) on or until the expiration of the contract (*expiry*). A call option is an option to buy, and a put option is an option to sell.

17. How do options differ from swaps and forwards?

In a forward or swap, the parties lock in a price (e.g., a forward price or a fixed swap rate) and are subject to symmetric and offsetting payment obligations. In an option, the buyer purchases protection from changes in a price or rate in one direction while retaining the ability to benefit from movement of the price or rate in the other direction. In other words, the option involves asymmetric cash flow obligations.

18. Credit exposures associated with options

For a buyer of an option, the amount at risk is generally the value (premium) of the option at default. For the seller of an option, there is no credit exposure.

19. Is an option a form of insurance?

Options differ from insurance in that options do not require one party to suffer an actual loss for payment to occur. In addition, the owner of an option need not have an insurable interest—such as ownership in the underlying asset—in the option.

20. Product description: Interest rate options

In an interest rate option, the underlying asset is related to the change in an interest rate. In an interest rate cap, for example, the seller agrees to compensate the buyer for the amount by which an underlying short-term rate exceeds a specified rate on a series of dates during the life of the contract. In an interest rate *floor*, the seller agrees to compensate the buyer for a rate falling below the specified rate during the contract period. A *collar* is a combination of a long (short) cap and short (long) floor, struck at different rates. Finally, a *swap option (swaption)* gives the holder the right—but not the obligation—to enter an interest rate swap at an agreed upon fixed rate until or at some future date.

21. Currency derivatives

A *currency forward* is a contract in which the parties agree to exchange cash flows in two different currencies at an agreed upon date in the future. A *cross-currency swap* is essentially an interest rate swap in which each side is denominated in a different currency. And a *currency option* is a contract that gives the buyer the right, but not the obligation, to exchange one currency for another at a predetermined exchange rate on or until the maturity date.

22. Product description: Cross-currency swaps

A cross-currency swap is an interest rate swap in which the cash flows are in different currencies. Upon initiation of a cross-currency swap, the counterparties make an initial exchange of notional principals in the two currencies. During the life of the swap, each party pays interest (in the currency of the principal received) to the other. And at the maturity of the swap, the parties make a final exchange of the initial principal amounts, reversing the initial exchange at the same spot rate. A cross-currency swap is sometimes confused with a traditional *FX swap*, which is simply a spot currency transaction that will be reversed at a predetermined date with an offsetting forward transaction; the two are arranged as a single transaction.

23. What is a credit derivative?

A credit derivative is a privately negotiated agreement that explicitly shifts credit risk from one party to the other.

24. Product description: Credit Default Swaps

A credit default swap is a credit derivative contract in which one party (*protection buyer*) pays an periodic fee to another party (*protection seller*) in return for compensation for default (or similar *credit event*) by a *reference entity*. The reference entity is not a party to the credit default swap. It is not necessary for the protection buyer to suffer an actual loss to be eligible for compensation if a credit event occurs.

25. What risks does do the parties to a credit default swap give up and what risks do they take on?

The protection buyer gives up the risk of default by the reference entity, and takes on the risk of simultaneous default by both the protection seller and the reference credit. The protection seller takes on the default risk of the reference entity, similar to the risk of a direct loan to the reference entity.

26. Product description: Total Return Swaps

A total return swap is an agreement in which one party (total return payer) transfers the total economic performance of a reference obligation to the other party (total return receiver). Total economic performance includes income from interest and fees, gains or losses from market movements, and credit losses.

27. What risks does do the parties to a total return swap give up and what risks do they take on?

The total return receiver assumes the entire economic exposure—that is, both market and credit exposure—to the reference asset. The total return payer—often the owner of the reference obligation—gives up economic exposure to the performance of the reference asset and in return takes on counterparty credit exposure to the total return receiver in the event of a default or fall in value of the reference asset.

28. Why is derivatives documentation (such as the ISDA Master Agreement) important?

Swaps and related OTC derivatives combine characteristics of loans with characteristics of traded capital market instruments. On the one hand, each swap transaction creates a credit relationship between the counterparties, the terms of which need to be negotiated and documented just as would the terms of a traditional loan. But unlike a loan, the credit exposure is two-way and unknown at the inception of the swap (see above, items 13 – 15). On the other hand, swaps are traded in the market and might involve repeated interaction between two counterparties; renegotiation of credit terms for each transaction would be costly and would act as a drag on trading activity. Consequently, market participants developed the ISDA Master Agreement (click [here](#) for a history), which would contain the ‘non-economic’ terms—such as representations and warranties, events of default, and termination events—leaving counterparties free to negotiate only the ‘economic’ terms—that is, rate or price, notional amount, maturity, collateral, and so on. Additional benefits of the ISDA Master Agreement include provisions that facilitate payment netting and close-out netting.

29. Definition: Payment netting

Payment netting reduces payments due on the same date and in the same currency to a single net payment.

30. Definition: Close-out netting

If a counterparty to an ISDA Master Agreement defaults, the close-out netting provisions of the ISDA Master Agreement provide that offsetting credit exposures between the two parties will be combined into a single net payment from one party to the other.

31. What is the status of an individual transaction under the ISDA Master Agreement?

In jurisdictions where close-out netting is enforceable, all transactions under the ISDA Master Agreement constitute a ‘single agreement’ between the two counterparties instead of being separate contracts. The confirmation of a transaction serves as evidence of that transaction, and each transaction is incorporated into the ISDA Master Agreement.