



Overview

The ISDA Master Agreements

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The ISDA Master Agreement was created by the International Swaps and Derivatives Association Inc. (ISDA), a trade association dedicated to ensuring the efficiency of the OTC derivatives industry.

The aptly named Master Agreements are truly “master agreements” that allow parties to enter into any number of derivative transactions at any time after the agreement has been executed. The Master Agreements are not product-specific and therefore a corporation wanting to hedge foreign exchange risk and a hedge fund wanting exposure to a specific stock can both perform their trades under a Master Agreement.

While the Master Agreements are industry standard form documents, they should not be mistaken for form documents not subject to negotiation. Parties should vigorously negotiate the terms of their agreements to ensure that their economic and legal rights are preserved.

Versions

There are currently two ISDA Master Agreements commonly used by market participants, the 1992 ISDA Master Agreement (the “1992 ISDA”) and the 2002 ISDA Master Agreement (the “2002 ISDA”).

There are two versions of the 1992 ISDA - the Local Currency - Single Jurisdiction version and the Multicurrency - Cross Border. The Local Currency - Single Jurisdiction version which is seldom, if ever, used, is, as its name suggests, limited in that it can only be used by parties organized in the same jurisdiction and does not provide for the parties to transact in different currencies. The Multicurrency - Cross Border version is more versatile, and can be used by parties that are in the same jurisdiction or in different jurisdictions and for transactions involving one or more currencies. By contrast, there is only one version of the 2002 ISDA. It is a multicurrency, cross border agreement which updates the 1992 ISDA to reflect changes in the industry in the intervening years. Despite including these specific updates, the 2002 ISDA has not supplanted the 1992 ISDA and both Master Agreements remain commonly used in the industry with the buy-side preferring to use the 1992 ISDA as it provides for more lenient event of default grace periods.

Structure of the ISDA Master Agreement

The Master Agreement is a pre-printed form which can be purchased on the ISDA website. Parties do not amend the pre-printed form. Elections, additions and amendments to the pre-printed Master Agreement are made on the Schedule to the Master Agreement. If the parties choose to, or are required to, collateralize their obligations, they typically enter into a Credit Support Annex, which is an annex to the Schedule to the Master Agreement.

Key Terms

The Master Agreement is the legal agreement between the parties. It includes the necessary provisions to govern a long term relationship, such as:

- The obligations of the parties to make payments or deliveries in accordance with the terms of their transactions;
- Representations and warranties;
- Covenants;
- Events of Default, which are enumerated in the Master Agreement and are: (i) a failure to pay or deliver, (ii) a breach of covenant or repudiation of the Master Agreement; (iii) default under a Credit Support Document or by a Credit Support Provider, (iv) misrepresentation under the Master Agreement or Credit Support Document, (v) Default under Specified Transaction, (vi) Cross Default, (vii) bankruptcy, and (viii) and Merger without Assumption (which is when a party or its Credit Support Provider merges or amalgamates or transfers substantially all of its assets to another entity and the surviving entity does not assume the obligations under the Master Agreement). If any of these events occur, the non-defaulting party is entitled to terminate all transactions under the Master Agreement;

- Termination events, which are events that, while not necessarily caused by the credit deterioration or bad behavior of a party, could lead to the termination of affected transactions. Termination Events, defined in Section 5(b) of the Master Agreement, are: (i) illegality, (ii) tax event; (iii) tax event upon merger, (iv) credit event upon merger, (v) Force Majeure (only in the 2002 Master Agreement), and (vi) Additional Termination Events, which are negotiated in the Schedule; and
- Remedies if an event of default or termination event has occurred (the “close-out provision”).

Individual Trades and Confirmations

Once the Master Agreement has been executed, the parties can trade. The terms of a transaction under a Master Agreement can be negotiated in a variety of ways, including over the telephone, by email or electronic messaging, and once agreed, the trade is live. However, the parties are required to confirm their agreement with a paper or electronic document called a “confirmation”. The confirmations typically incorporate one or more ISDA definitional booklets relevant for the product being traded. The definitional booklets include terms that are specific to the product being traded and provide a common language for the market participants. While definitions can be amended by the parties in a confirmation, parties circumvent the need to provide their definition of what would constitute, for example, a “price source disruption” by incorporating the definitional booklet.

Benefits of a Master Agreement

By its terms, each Master Agreement (including its Schedule, CSA, and annexes, if any) together with all confirmations (including the relevant definitional booklet applied to the individual trades), entered into between two parties, form a single legal agreement. The benefits of the single legal agreement are manyfold including:

1. Payments across transactions due on the same day and in the same currency can be netted, if so elected by the parties.
2. If parties have chosen to collateralize their trades, their trades can be collateralized on a portfolio basis rather than on an individual basis.
3. Upon an event of default or termination event with respect to one party (the “defaulting party”), the other party will be entitled to terminate all the outstanding transactions or the affected transactions pursuant to a termination event, value them and net out amounts owed by the defaulting party from any amounts that may be owed to the defaulting party. Only the party with the greater debt will be liable to pay the netted amount.

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