Keeping up with the market

Executive summary

- The growth of the over-the-counter derivative market – now totalling $285 trillion – has prompted a number of developments.
- A new set of ISDA Definitions reflects market developments and consolidates the various Supplements into one document, consolidating the structure and adding currencies.
- Definitions introduce or update provisions to help parties easily document transactions such as swaption straddles, mark-to-market currency swaps, and arrears-setting transactions and incorporate ISDA-published matrices to reduce the administrative burden.

The growth of the over-the-counter (OTC) derivatives market shows few signs of slowing. This continued growth spans the full spectrum of transaction types, including the segment of the market that still dwarfs the others: interest rate and currency derivatives. According to the most recent biannual market survey conducted by the International Swaps and Derivatives Association (ISDA), the aggregate outstanding notional amount of OTC interest rate and currency derivatives rose 34% from the end of 2005 to the end of 2006, to a staggering total of $285.7 trillion.

This growth carries with it a number of new market developments. To respond to these developments and to help promote further growth, ISDA recently updated its core definitions for interest rate and currency derivatives by publishing the 2006 ISDA Definitions. This article provides an overview of the most noteworthy changes.

UPDATING THE STANDARD The 1991 ISDA Definitions, and, subsequently, the 2000 ISDA Definitions, have long been the standard for documenting OTC interest rate and currency derivatives. The 2000 Definitions have aged well, their flexible structure enabling ISDA subsequently to publish 20 different Supplements to ensure that new currencies, floating rate definitions and other provisions could be added to keep pace with the market.

However, it was apparent by 2005 that a new set of Definitions would be valuable both to reflect market developments and to consolidate the various Supplements together into one document. With substantial input from a broad range of market participants, ISDA worked for over a year to develop the 2006 Definitions, which are expected quickly to replace the 2000 Definitions as the market standard set of terms for documenting interest rate and currency derivative transactions.

SINGLE DOCUMENT With flexibility in mind, ISDA had previously published some terms and provisions, such as those relating to currencies and floating rates, in the Annex to the 2000 Definitions, which it updated from time to time via amendments and supplements. However, contrary to initial expectations, there was only ever one version of the Annex. With that in mind and in order to allow for increased convenience of reference, there is no Annex to the 2006 Definitions. Terms that were previously contained in the Annex to the 2000 Definitions are now consolidated with other terms in the 2006 Definitions. At the same time, the 2006 Definitions retain the flexibility that was so useful in keeping the 2000 Definitions up to date, since ISDA plans to publish amendments and supplements to the 2006 Definitions on its website – and, indeed, market discussions relating to the first potential supplements are already well under way.

Parties should note that when they incorporate the 2006 Definitions into a document, they are presumed to incorporate the 2006 Definitions as amended and supplemented up to the date on which they enter into the relevant transaction or agreement. Thus, if the parties are happy to incorporate all amendments and supplements to the 2006 Definitions published by ISDA up to that date, they need not refer to amendments or supplements in their documentation. However, if they wish to exclude one or more amendments or supplements, they can specifically do so, of course.

CHANGES TO KEY DEFINITIONS Two areas of the 2006 Definitions that have seen substantial changes are the floating rate definitions (rate options) contained in Section 7.1 and the day count fraction definitions contained in Section 4.16.

Many of the rate options have been amended, and a number of additional definitions have been included. One reason for many of these

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changes was to take account of Reuters' acquisition of the Telerate service. Another reason was to provide market participants with alternative definitions for a particular floating rate, each of which references a different information vendor. However, each rate option continues to refer to only one information vendor or other source in order to ensure certainty in the case of dispute. It is also worth remembering that parties to a transaction remain free to define their own floating rate option in a confirmation and, where they specify one of the rate options included in the 2006 Definitions, to amend the terms of that rate option in the confirmation.

The 2006 Definitions include some changes to the day count fraction definitions that were contained in the 2000 Definitions. Some of the changes simply clarify via a formula how day count fractions are intended to operate in practice, but two new day count fraction definitions have also been introduced. The first new day count fraction is Actual/Actual (ICMA), which is based on Rule 251 of the statutes, by-laws, rules and recommendations of the International Capital Market Association. The second is 30E/360 (ISDA), which is designed to yield the same results in practice as the 30E/360 day count fraction included in the 2000 Definitions (a definition for 30E/360 is also included in the 2006 Definitions but has been amended in order to reflect usage by other organisations and software vendors).

NEW COVERAGE The 2006 Definitions introduce (or, in some cases, incorporate and update from Supplements to the 2000 Definitions) a number of new provisions that enable parties easily to document transactions such as swaption straddles, mark-to-market currency swaps, and arrears-setting transactions. Additionally, the 2006 Definitions contain provisions incorporating ISDA-published matrices which lessen the administrative burden of trading for parties by providing a number of deemed-to-apply terms for frequently occurring types of transactions.

Swaption straddles are transactions consisting of two swaptions, each relating to a different underlying swap transaction. Under one underlying swap transaction, the buyer is the fixed rate payer, and under the other, the buyer is the floating rate payer. Where (as is most common) the swaption straddle is European style, the buyer may, on the expiration date, exercise only one of the swaptions. Thus, the buyer effectively has the right to enter into a swap on specified terms as either the fixed rate payer or the floating rate payer. Where the swaption straddle is US or Bermudan style, the buyer may in certain circumstances exercise both swaptions (albeit not at the same time), effectively allowing the buyer to back out of the earlier exercised swaption if the terms of the two swaptions (other than the identity of the fixed rate payer and floating rate payer) are identical. In addition to providing terms and provisions relating to swaption straddles, the 2006 Definitions include an updated form of confirmation that parties can use to document a swaption or a swaption straddle.

The 2006 Definitions also contain new provisions and a form of confirmation relating to mark-to-market currency swap transactions. Parties can use these types of currency swaps periodically to eliminate exposure arising from movement in the relevant currency exchange rate. Under a mark-to-market currency swap, one party's currency amount is, for each calculation period, subject to adjustment by reference to the then prevailing currency exchange rate for the relevant currencies and the other party's currency amount remains constant. Further, on each payment date an amount is payable by one party to the other calculated by reference to the amount of any such change in the adjusting currency amount. This procedure eliminates, on an ongoing basis, exchange-rate exposure arising from the beginning of one calculation period to the beginning of the next.

The two matrices that the 2006 Definitions make reference to are the newly refreshed ISDA Settlement Matrix for Early Termination and Swaptions (the Settlement Matrix) and the new 2006 ISDA Definitions MTM Matrix for Mark-to-market Currency Swaps (the MTM Matrix). Each matrix will specify, for certain types of transactions, a range of standard elections for terms and provisions that would otherwise be negotiated and included in the related confirmations. These standard elections apply to any relevant type of transaction unless the parties specify otherwise. The Settlement Matrix is deemed to apply to (i) transactions that feature optional or mandatory early termination provisions and (ii) swaptions, in each case where they involve a currency that is included in the Settlement Matrix. Similarly, the MTM Matrix is deemed to apply to mark-to-market currency swaps that involve a currency pair that is included in the MTM Matrix.

ISDA intends to update and expand each matrix from time to time and to publish each new version on its website. The most recently published version of the matrix as of the date of a transaction will be deemed to apply to that transaction. Parties who wish to apply the terms of an earlier version of the matrix can so specify in their confirmation.

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