Master agreements

The ISDA master agreements are legal documents used to set up industry standards for many over-the-counter global derivatives markets. Published by the International Swaps and Derivatives Association, the ISDA master documents are a set of complex documents that specify the economic terms of transaction in various over the counter derivatives. They emphasize the terms and obligations of derivatives contracts. They also contain many definitions as well as basic legal, credit and mechanical terms. Their original scope was mainly interest rate derivatives, but they now include FX, commodity equity and credit derivatives markets.

Central to the ISDA Master agreements, are the 1992 Master agreements and its 2001 supplements, based on the ISDA following documentation:

- ISDA Definitions: 1991 Definitions (as amended by the 1998 Supplement), 1992 ISDA Municipal Counterparty Definitions, 1993 Commodity Derivatives Definitions, 1996 Equity Derivatives Definitions, 1997 Government Bond Option Definitions, 1997 Bullion Definitions, 1998 FX and Currency Option Definitions, 1998 Euro Definitions, 1999 Credit Derivatives Definition
- Credit support annex: 1994, 1995, 1996 and 1997 credit documents
- The EMU protocol of 1998
- Confirmation and margin provision documents of 1992 and its margin provision document of 2001

- Users' Guides to OTC derivatives (2001)

Figure 1 summarizes the various documents and their connections

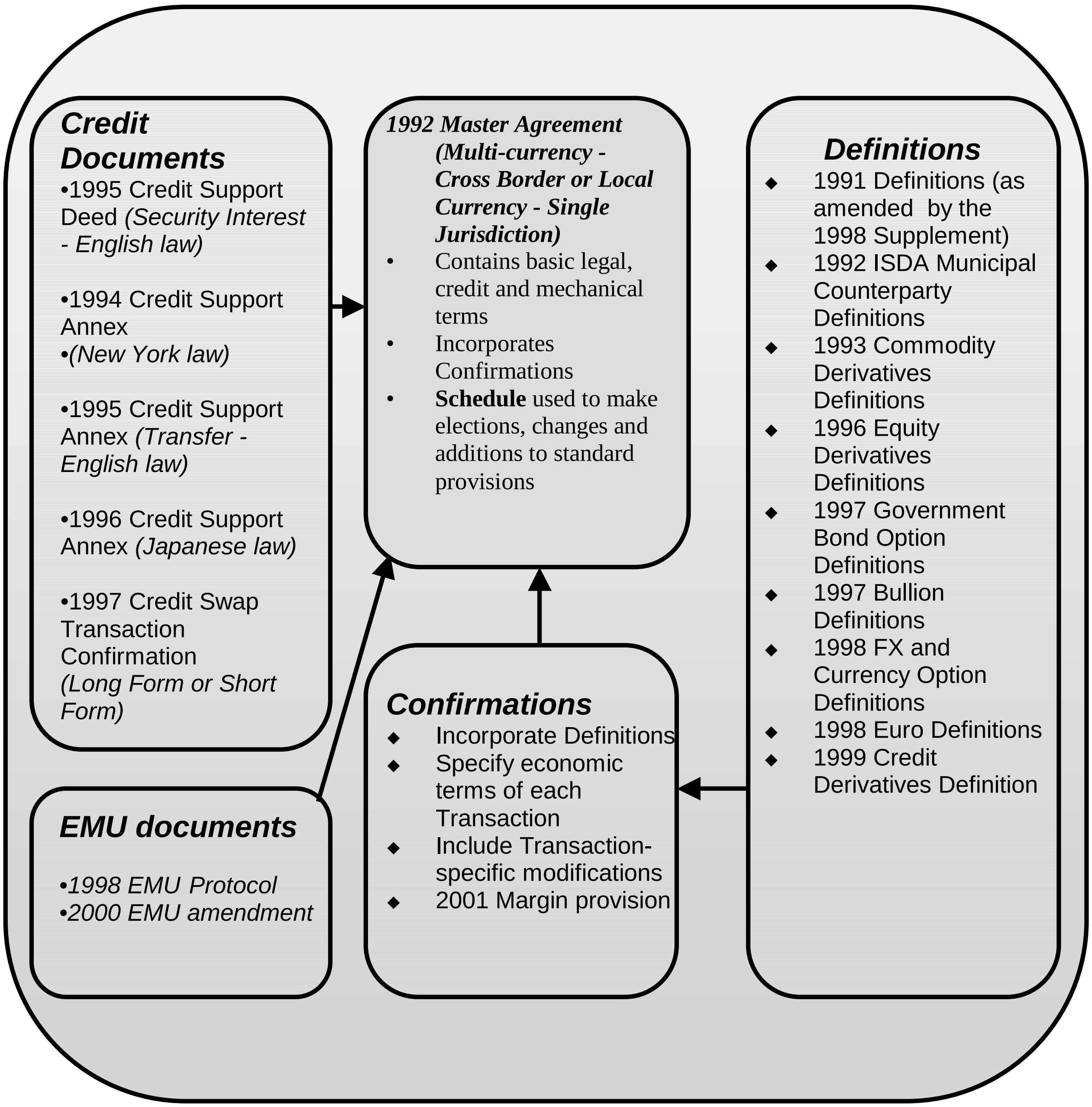

Figure 1: Architecture of the ISDA documentation

The ISDA definitions cover general definitions about the transaction parties, the concept of fixed and floating amounts, the terms and dates of the contract (in particular the day count fraction convention) and the payment. In particular, they define in details rates used for interest rates derivatives contracts, the price calculation for floating rate options, emphasizing the rounding, interpolation, and discounting methods. They also provide sample forms of confirmations. The scope of the 1991 ISDA Definition is mainly interest rates derivatives. It covers interest rate and currency swaps, FRAs, interest rate caps, collars and floors, cash settled and regular swaptions. These definitions have been completed to include FX, commodity, equity and credit derivatives regularly in the 1993, 1996, 1997, 1998, 1999 extensions to the definitions.

The 1998 supplements to the 1991 ISDA definitions have expanded the range of currencies, revised the terms of rate option and swaptions. They have examined cash settlement provision and provided additional forms of confirmations. The 1998 EURO Definitions supplement have given more business day and Euro rate options definition. They have outlined the provisions for equity derivatives and bond options products. Table 1 summarises the ISDA essential terminology

The master agreements play an important role in the risk management of financial derivatives as they act as key references for OTC contracts. In particular, for the netting and capital adequacy questions, they serve as basic legal documents.

Dates	*Amounts*	*Other*
Trade Date	Notional Amount	Business Day Conventions
Effective Date	Fixed Amount	Business Days
Termination Date	Floating Amount	
Reset Date	Currency Amount	
Period End Date		
Payment Date		
Initial/Final Exchange Date		

Table 1: Essential ISDA terminology

The ISDA master agreements eliminate any ability to interpret contracts as they define strictly the transaction terms. For instance, the school case of the fixed floating swap is explicitly examined. The two sides of the swap are calculated as follows:

- The fixed amount is equal to the notional amount times the fixed rate times the fixed rate day count fraction
- The floating amount is equal to the notional Amount times the floating rate plus eventually a spread times the floating rate day count fraction
- The floating rate is determined for a reset date by reference to a floating rate option (usually LIBOR)
- Day count fractions are used to calculate the number of days in a calculation period (see accrued interest and day count fraction)

The confirmation defines all the terms of the exchange and acts as the reference legal document in case of issues between the two parties. The ISDA master agreements leave no ambiguity in terms of the dates. Usually:

- the payment dates adjust for business days (meaning that they have to be on a business day, either using the convention of modified following, modified preceding, following or preceding)
- the period end dates adjust either to follow payment dates or for business days
- the reset dates adjust for business days (unless this would cause the reset date to fall on the payment date)
- the termination date does not adjust

The ISDA Master agreements serve also as key reference for counterparty issues for capacity and authority issues. They have recently play an important role in setting standards for the growing business of credit derivatives, defining the different types of credit derivatives transactions and their mechanisms (for instance for credit default swap transaction, total return swap or credit-linked note). They have also outlined the concept of credit protection and its market, categorizing the designation of a reference entity and reference obligation. They also have given definitions for credit events (see credit events) as well as proper order of notices in case of a credit event and its following payout.

Last but not least, ISDA master agreements have aim at setting up criterion for the structured finance business (repackaging and securitisation (CLOs, CBOs and CDOs)). They have stressed the influence of ratings (by rating agency) in credit derivatives transactions.

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[1] The views and opinions expressed herein are the ones of the author's and do not necessarily reflect those of Goldman Sachs

Entry category: operation risk

Scope: ISDA master agreements

Related articles: credit events.