

2002 ISDA Agreement Series

Key Concepts and Terms of Close-Out Netting  
Provisions and Credit Support Documents

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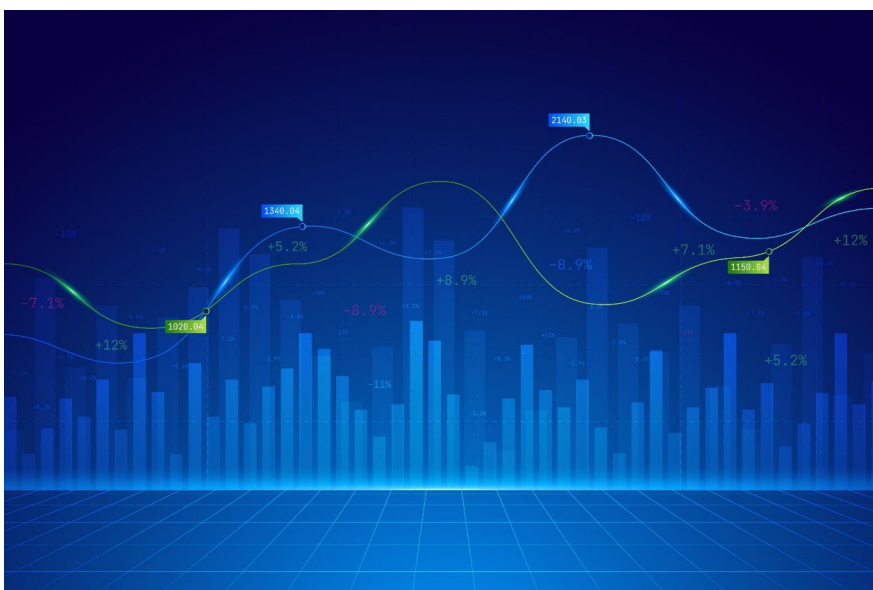
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## Introduction

In this 2002 ISDA Agreement Series, it is intended to briefly illustrate key concepts and terms under the Close-Out Netting Provisions of the 2002 ISDA Agreement and the Credit Support Documents, exchange of variation margin (“VM”) and initial margin (“IM”) with respect to the non-centrally cleared over-the-counter derivatives transaction (“OTC derivatives transaction”) under the 2002 ISDA Agreement as well as other significant issues thereunder. As one of the explanatory notes of the 2002 ISDA Agreement Series, this explanatory note will focus discussion on key concepts and terms of the Close-Out Netting Provisions and Credit Support Documents which are essential for understanding the exchange of VM and IM under the new regulatory regime.

### **Historical Landscape of VM and IM Requirements**

The new regulatory regime for exchange of VM and IM was rooted in the 2008 financial crisis. In response to the 2008 financial crisis, the Basel Committee on Banking Supervision (“BCBS”) and the International Organization of Securities Commissions (“IOSCO”) jointly published margin requirements for OTC derivatives transaction (the “BCBS-IOSCO Principle”). The core of the BCBS-IOSCO Principle is systemic credit risk management to maintain financial stability. In particular, acute emphasis is given to the more stringent margin requirements, that is to say, exchange of VM and IM, as an effective measure to incentivize parties to avoid excessive risk taking when entering into OTC derivatives transaction and limit contagion by ensuring that losses can be offset by collateral in the event of a counterparty’s default.

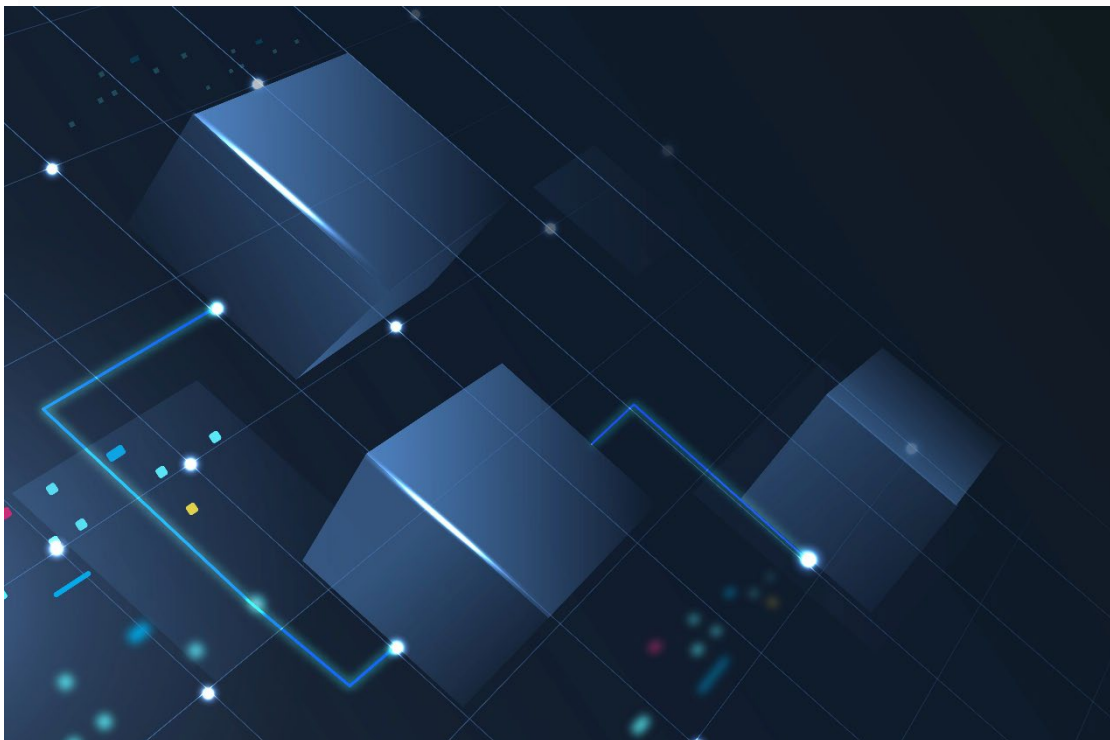


## Architecture of ISDA Agreement

The architecture of ISDA documents is depicted below prior to moving on to key concepts and terms of the Close-Out Netting Provisions and the Credit Support Documents, the exchange of IM and VM and other relevant issues.

The 2002 ISDA Agreement is the preeminent market standard contract published by the International Swaps and Derivatives Association (“ISDA”) used to document OTC derivatives transaction worldwide. The set of ISDA documents underlying the OTC derivatives transaction generally includes:-

- (i) the 2002 ISDA Master Agreement;
- (ii) the Schedule to the 2002 ISDA Master Agreement (the “Schedule”);
- (iii) the Confirmations;
- (iv) the Credit Support Documents, if any <sup>1</sup>; and
- (v) any amendment, supplements or restatements in respect of any of the above.



<sup>1</sup> “Credit Support Documents” is defined in Section 14 (Definitions) of the 2002 ISDA Master Agreement and include “Credit Support Annex” and “Credit Support Deed”.

The following discusses the ISDA documents and provides a snapshot of some key concepts and terms thereunder.

*The 2002 ISDA Master Agreement:* The 2002 ISDA Master Agreement is a leap from the 1992 ISDA Master Agreement and came out following the Asian currency crisis, the Russian debt default and issues surrounding Long-Term Capital Management. Alongside the modifications and clarifications in response to such financial events, one of the major amendments made to the 1992 ISDA Master Agreement rests on the operation of Sections 5 and 6 thereof, which underlines (i) the events of default and termination events; and (ii) early termination of the OTC derivatives transaction (whether in whole or in part) contemplated thereunder.

*The Schedule:* The Schedule forms an integral part of the 2002 Master Agreement. In the Schedule, the parties may choose whether and how certain optional provisions in the 2002 ISDA Master Agreement are reinstated or displaced. As an illustrative example, the parties may specify whether the following provisions apply to either or both parties to the 2002 ISDA Master Agreement:-

- (i) the “Netting of Payments” provisions under section 2(c) of the 2002 ISDA Master Agreement; or
- (ii) the “Close-Out Netting” provisions under section 6(e) of the 2002 ISDA Master Agreement (the “**Close-Out Netting Provisions**”).

Put simply, the parties shall amend the provisions of the 2002 ISDA Master Agreement through specification of addition to, or deletion of, the relevant provisions in the Schedule.

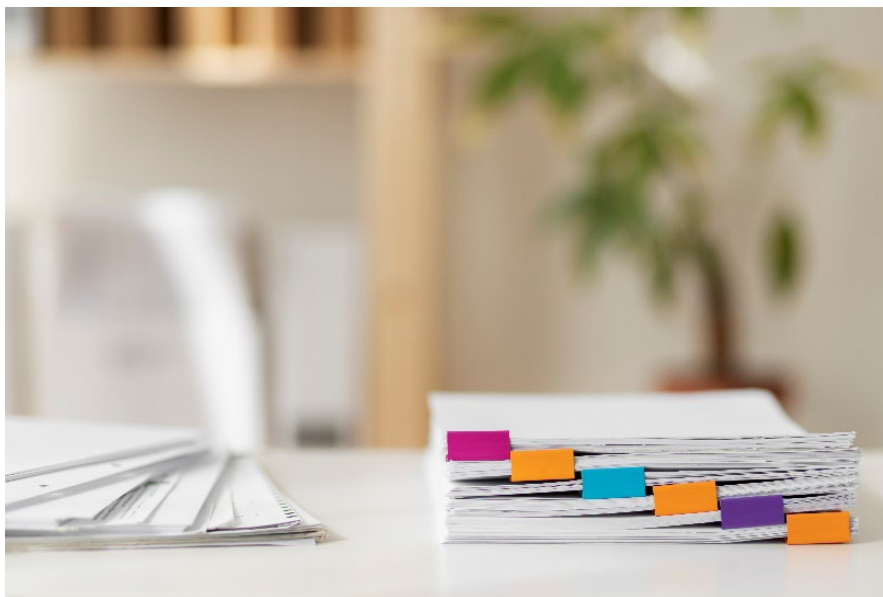
*The Confirmations:* The Confirmations constitute an integral part of the 2002 ISDA Master Agreement and are exchanged between the parties to evidence and confirm the respective OTC derivatives transaction executed under the 2002 ISDA Master Agreement. In the event of any inconsistency amongst the 2002 ISDA Master Agreement, the Schedule and the Confirmations, the provisions of the Confirmations shall prevail<sup>2</sup>.

<sup>2</sup> Section 1(b) (Inconsistency) of the 2002 ISDA Master Agreement.

**Security Deed:** ISDA had published credit support documents either in form of a stand-alone security agreement or an annex to the 2002 ISDA Master Agreement. Where the relevant credit support document is entitled a “**Deed**”, it is a separate security document and parallel to the 2002 ISDA Master Agreement, relying on its effectiveness principally upon the creation of a security interest in collateral transferred thereunder.

**Annex:** On the contrary, where the credit support document is entitled “**Annex**”, it is an integral part of, and subject to, the 2002 ISDA Master Agreement to which it is annexed. The effectiveness of such annex relies principally upon the Close-Out Netting Provisions. Such an annex shall not create any security interest in the collateral posted and collected. Rather, the full legal and beneficial ownership of the collateral are passed to the Transferee (also known as collateral taker)<sup>3</sup>. In a nutshell, the Transferor (also known as collateral giver)<sup>4</sup> retains no proprietary interest in the collateral itself.

**Latest Version of Credit Support Documents:** In so far as English law is concerned, the latest version of the Credit Support Documents relating to VM and IM as collateral are (i) the ISDA 2016 Credit Support Annex for Variation Margin (VM) (Bilateral Form – Transfer) (ISDA Agreements Subject to English Law) (the “**2016 VM CSA**”); and (ii) the ISDA 2018 IM Credit Support Deed for Initial Margin (IM) (Security Interest – English Law). In this explanatory note, discussion is focused on the 2016 VM CSA.



<sup>3</sup> “Transferee” means, in relation to Valuation Date, the party in respect of which Exposure is a positive number and, in relation to a Credit Support Balance, the party which owes Credit Support Balance or, as the case may be, the Value of Credit Support Balance to the other party. For the definitions of “Valuation Date”, “Exposure”, “Credit Support Balance” and “Value”, please see Paragraph 10 (Definitions) of the 2016 VM CSA and/or explanation hereinafter.

<sup>4</sup> “Transferor” means, in relation to a Transferee, the other party (see Paragraph 10 (Definitions) of the 2016 VM CSA).

## Key Concepts and Terms under Close-Out Netting Provisions and the 2016 VM CSA

For illustration of mechanism of the exchange of VM and IM, key concepts and terms under the Close-Out Netting Provisions and the 2016 VM CSA are listed out and explained in this section.

“Early Termination Amount”: Under Section 6(e) of the 2002 ISDA Master Agreement, the Early Termination Amount can be regarded as consisting of three components, namely, (i) payable or deliverable payment obligations prior to the Early Termination Date<sup>5</sup> which remain unpaid; (ii) payable or deliverable payment obligations which would have been payable or deliverable prior to the Early Termination Date if all conditions to payment or delivery had been satisfied, or if the Early Termination Date had not been designated; and (iii) payments for the future value of the Terminated Transactions<sup>6</sup>. Under Section 6(a) of the 2002 ISDA Master Agreement, the Non-defaulting Party has the right to designate an Early Termination Date for all outstanding transactions upon occurrence and continuance of an Event of Default unless Automatic Early Termination<sup>7</sup> applies. Where Automatic Early Termination applies and certain insolvency event occurs, then an Early Termination Date will occur automatically for all outstanding transactions. By definition, the Early Termination Amount is equivalent to the sum of (1) the Close-out Amount determined by the Non-defaulting Party (i.e. the Determining Party<sup>8</sup>) as of the Early Termination Date; and (2) (a) the Unpaid Amount (as defined in Section 14 (Definitions) of the 2002 ISDA Master Agreement) owing to the Non-defaulting Party, less (b) the Unpaid Amounts owing to the Defaulting Party. As a result, the Early Termination Amount represents the total sum of the Close-out Amount and the net Unpaid Amount. Further, the Early Termination Amount may be reduced by set-off (“**Set-Off**”) pursuant to Section 6(f) (Set-Off) of the 2002 ISDA Master Agreement. Thus, the Close-out Amount and Set-Off are key factors in determining the Early Termination Amount.

<sup>5</sup> “Early Termination Date” means the date designated by the Non-defaulting Party as an effective early termination date of all outstanding transactions (see Sections 6(a) (Right to Terminate Following Event of Default) and 6(b)(iv) (Right to Terminate) of the 2002 ISDA Master Agreement).

<sup>6</sup> “Terminated Transaction” is defined in Section 14 (Definitions) of the 2002 ISDA Master Agreement.

<sup>7</sup> “Automatic Early Termination” has the meaning specified in Section 6(a) of the 2002 ISDA Master Agreement. <sup>8</sup> “Determining Party” means the party determining a Close-out Amount in accordance with Section 14 (Definition) of the 2002 ISDA Master Agreement.

“Close-out Amount”: The Close-out Amount is the amount which reflects the economic loss, costs, or gain to each party resulting from the termination of the executed transactions and often be regarded as the “replacement value” of the Terminated Transactions. Further, the Determining Party should act in good faith and use commercially reasonable procedures when determining a Close-out Amount in order to produce a commercially reasonable result, taking into account the relevant information (e.g. quotations, information consisting of relevant market data and other information)<sup>9</sup>.

“Exposure”: Under Paragraph 10 (Definitions) of the 2016 VM CSA, Exposure means the netted, mid-party, market-to-market value of each transaction between the parties and represents an approximation of the overall amount of loss that would be suffered by the counterparties if any of them defaults. The calculation thereof is made as if the Covered Transaction<sup>10</sup> were being closed out as at the Valuation Time<sup>11</sup> using the methodologies in Section 6(e) (Payments on Early Termination) of the 2002 ISDA Master Agreement.

“Credit Support Balance”: The Credit Support Balance is defined under Paragraph 10 (Definitions) of the 2016 VM CSA as, inter alia, the collateral the Transferor has posted and the Transferee has already collected and shall be deemed to be the Unpaid Amount for the purpose of the Close-Out Netting Provisions if an Early Termination Date is designated or deemed to occur<sup>12</sup>. In essence, it is the actual amount of collateral held at any one time by the Transferee under the 2016 VM CSA.

“Unpaid Amount”: It is defined under Section 14 (Definitions) of the 2002 Master Agreement as, inter alia, the aggregate of amounts that become payable to another party with respect to the Early Termination Date.

“Delivery Amount”: Delivery Amount means the amount of collateral (i.e. posting VM) the Transferor (i.e. collateral giver) must deliver if it agrees with a collateral call from the Transferee (i.e. collateral taker), provided that the Delivery Amount exceeds the Transferor’s Minimum Transfer Amount (see explanation hereinafter). In essence, the Delivery Amount shall equate the amount by which the Transferee’s Exposure exceeds the Transferor’s Credit Support Balance.

“Return Amount”: It is the collateral amount which will be returned by the Transferee to the Transferor because it is surplus to the Transferee’s risk exposure on the Transferor and is also above the Transferee’s Minimum Transfer Amount.

“Minimum Transfer Amount”: In order to avoid the need to transfer a “nuisance” amount as a Delivery Amount or Return Amount, the parties may specify a “Minimum Transfer Amount” in relation to each party. As a result, a Delivery Amount or Return Amount determined in relation to a Valuation Date will only be transferred if it exceeds the relevant Minimum Transfer Amount.

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