
# 2021 ISDA INTEREST RATE DERIVATIVES DEFINITIONS: MAJOR UPGRADE FOR THE DIGITAL AGE

The 2021 ISDA Interest Rate Derivatives Definitions (the "2021 Definitions") were published on 11 June 2021 and, following a period to allow for market implementation, will be adopted as the market standard definitional book for interest rate derivatives on 4 October 2021. The 2021 Definitions represent a major upgrade to the 2006 ISDA Definitions, reflecting a series of significant developments in market practice, regulation and technology which have occurred in the intervening 15 years. Substantive changes have been made to cash settlement provisions; reference bank polls; and the Calculation Agent provisions as well as to the presentation and layout of the floating rate options. The 2021 Definitions will also be available only in electronic format as a single "main book" on the new MyLibrary digital platform.

## PUBLICATION AND AMENDMENT – DIGITISATION AND CONSOLIDATION

We are now at the point where over 75 supplements have been published to the 2006 ISDA Definitions, a process which is widely viewed as having made them increasingly unwieldy to use. Supplements have been published in order, for example, to amend or include new floating rate options and add in fallbacks or new determination methods for floating amounts.

The 2021 definitions are available as a new, continuously updated single document, the "main book". This is published in a purely electronic format using a new web-based digital documentation platform created by ISDA, MyLibrary.

Instead therefore of continuously publishing separate supplements to keep the 2021 Definitions current, each time an update is required, the 2021 Definitions will be amended and restated in their entirety and a new version published ("re-versioning"). The version and date of publication of the 2021 Definitions will be clearly stated on its cover, enabling users to determine which version they are using and to navigate straight to the version, including relevant terms and definitions, that was in place at the date on which they entered into a previous transaction. In addition, users will be able to compare different

### Key issues

- 2021 Definitions to be adopted as the market standard definitional book for interest rate derivatives on 4 October 2021. They:
- are available in electronic format only and as a single "main book"
- make changes to cash settlement provisions to determine a cash settlement amount following mandatory or optional early termination or the exercise of a swaption
- make reference bank polls more standardised and robust with quotation templates and use of a prescribed methodology
- include a new Calculation Agent standard: determinations made in good faith using commercially reasonable procedures to produce a commercially reasonable result
- provide generic fallbacks where no bespoke fallback. The 2021 Definitions provide a framework to allow parties to identify a fallback rate as well as any adjustment
- set out floating rate options in a matrix format rather than narrative descriptions
- add a new concept of "unscheduled holidays", reflecting lessons learnt from recent market disruptions
- Nevertheless much of the 2006 ISDA Definitions is being substantively retained

versions of the 2021 Definitions and will also benefit from an enhanced navigation and search facility. To further improve standardization, certain definitions and elections have been set out in separate matrices, including the new floating rate matrix (see below). These matrices will be re-versioned as necessary.

The provision of the 2021 Definitions in digital form reflects ISDA's strategy of facilitating greater automation in derivatives markets. This is intended not only to improve efficiency, but also to allow information contained in the 2021 Definitions automatically to flow through to trading, operational and risk management systems in a reliable and consistent manner.

## CASH SETTLEMENT PROVISIONS

Amongst the key changes made in the 2021 ISDA Interest Rate Derivatives Definitions in comparison to the 2006 ISDA Definitions are modifications to the cash settlement provisions. The cash settlement provisions relate to the determination of the Cash Settlement Amount payable following the occurrence of an optional early termination or mandatory early termination of a transaction or following exercise of a cash settled swaption.

The existing cash settlement methodologies do not reflect that derivatives have become largely collateralised due to the mandatory margin rules we have seen and continue to see phased in across many jurisdictions and also the shift to overnight index swap discounting. In addition, the default cash settlement method for optional and mandatory early termination under the 2006 ISDA Definitions leaves a number of parameters unspecified which increases the likelihood of inconsistent outcomes for transactions concluded on the same or similar terms.

The new cash settlement methodologies included in the 2021 Definitions fall into two principal categories: mid-market valuation and replacement value. Mid-market valuation is intended to provide a valuation which does not favour either party in contrast to replacement value which is intended to protect one of the parties from the financial consequences of the termination of the trade.

There are three mid-market valuation methods, two replacement valuation methods as well as two cash settlement methods that are substantively unchanged from the 2006 ISDA Definitions (see text box).

The cash settlement provisions in the 2021 Definitions are also structured to help make reference bank polls more standardised and robust. Where reference bank polls are required, parties will use standard quotation templates and will have to conform to a prescribed methodology to determine the applicable Cash Settlement Amount. In addition, the minimum number of quotations required for a reference bank poll is reduced to two.

The expectation is that these changes will make it more likely that reference banks will provide a quote and also that quotes will be more consistent. Moreover by increasing the likelihood that reference bank polls will be successful, it will reduce the likelihood of the parties having to rely on the Calculation Agent’s determination of the Cash Settlement Amount.

### Cash settlement methodologies

**Three mid-market valuation methods:**

- 'Mid-Market Valuation (Indicative Quotations)
- 'Mid-Market Valuation (Indicative Quotations - Alternate Method)'
- 'Mid-Market Valuation (Calculation Agent Determination)'.

**Two replacement valuation methods:**

- 'Replacement Value (Firm Quotations)'
- 'Replacement Value (Calculation Agent Determination)'.

**Two methods substantively unchanged from 2006 Definitions:**

- 'Collateralized Cash Price'
- 'Par Yield Curve - Unadjusted'

## ENHANCED CALCULATION AGENT PROVISIONS

The 2021 Definitions include a number of provisions relating to the role of the Calculation Agent including a new standard by which it is required to act. This is the same standard as used for the close-out provisions of the 2002 ISDA Master Agreement and specifies that whenever the Calculation Agent is required to act or make a determination, it shall do so in good faith and using commercially reasonable procedures to produce a commercially reasonable result.

A more prescriptive framework for the Calculation Agent provides that, in relation to any required determination, the Calculation Agent is, on request, required to produce a 'Calculation Statement' which shows, in reasonable detail, the calculations made in connection with its determination and which includes the market data relied upon by the Calculation Agent in making that determination. In addition, the Calculation Agent is required, where practicable, to consult with the other party in relation to the selection of reference banks and to request quotations from reference banks using a template quotation request form.

Further, where the parties cannot agree on the selection of reference banks, the party which is not the Calculation Agent may, by the delivery of a 'Selection Notice', specify a proportion (up to a maximum of half) of the required reference banks.

There are also dispute resolution procedures should a party dispute the Calculation Agent's determination of a Cash Settlement Amount or its determination of an adjustment amount under the generic fallback provisions.

## FLOATING RATE OPTIONS – MATRIX FORMAT

Rather than listing the various floating rate options in a 'narrative' format as is the case in the 2006 ISDA Definitions, the 2021 Definitions set out the floating rate options in a tabular matrix format.

In this more standardized matrix format, different types of floating rate option are divided into categories and described using a common, rule-based naming convention. Publication sources are removed as a defining characteristic of floating rate options and instead, each floating rate option will reference the primary source of the relevant benchmark level, such as the administrator or central bank.

## BESPOKE AND GENERIC FLOATING RATE OPTION FALLBACKS

The 2021 Definitions incorporate the changes recently made to the 2006 ISDA Definitions in relation to fallbacks by way of the ISDA 2020 IBOR Fallbacks Supplement by also introducing permanent index cessation fallback provisions.

However, beyond such bespoke fallbacks many floating rate options do not have specific fallback provisions. As a result, the 2021 Definitions set out a generic fallback framework for rate options without a bespoke fallback which enables parties to identify a fallback rate and also any required adjustment for a particular transaction. This generic fallback framework is based on the Alternative Continuation Fallback provisions from the 2018 ISDA Benchmark Supplement and the fallback triggers include a new trigger not included in the

2006 ISDA Definitions where a party is no longer permitted under applicable law or regulation to use the relevant benchmark.

## UNSCHEDULED HOLIDAYS

Based in part on lessons learned from recent market disruptions, the 2021 Definitions introduce the concept of an 'unscheduled holiday'. This enables relevant dates (such as payment dates) to be moved forward to the next business day rather than backwards to the immediately preceding business day in circumstances where insufficient notice of a market closure is given and thereby avoids a payment obligation arising in respect of a day which has in fact already passed.

## THE 2006 ISDA DEFINITIONS

The 2006 ISDA Definitions will continue to be available for use. However ISDA has made clear that it will stop maintaining and updating them after the adoption date of 4 October 2021 and this should serve as an encouragement for parties to adopt the 2021 Definitions as the 2006 ISDA Definitions will increasingly cease to reflect market developments. In addition certain clearing and trading venues may require new transactions to incorporate the 2021 Definitions. In the run up to 4 October 2021, ISDA is seeking to assess the readiness of market participants to transition to the 2021 Definitions and the likely timing for such transition.

## CONCLUSION

The publication of the 2021 ISDA Interest Rate Derivatives Definitions represented the culmination of an extended and intensive process of development by ISDA, in which both buy and sell-side entities were closely involved.

The changes made to the standard for Calculation Agent determinations and to the process for reference bank polls reflect a dissatisfaction with existing processes which could lead to inconsistent valuations and which allow a significant degree of flexibility to calculation agents, usually the executing dealers, in their determinations.

Better structured, more user-friendly and in tune with an increasingly digitised market as well as reflecting key market and regulatory changes such as the increased use of collateral in derivatives and IBOR reform[1], the 2021 Definitions represent a major upgrade to the 2006 ISDA Definitions.

A significant first test of the 2021 Definitions will be in the extent and speed of their adoption by the market. Beyond that the market will also be observing the extent to which the enhanced Calculation Agent provisions function as intended and help reduce the likelihood for disputes as well as how much more robust the 2021 Definitions prove to be in the face of future market disruptions.

[1] See our briefings: "UK FCA announcement on cessation and loss of representativeness of LIBOR benchmarks: What next for Derivatives?"; "ISDA IBOR Benchmark Fallbacks Supplement and Protocol: key considerations"

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