MACFARLANES

Summary of key changes in the 2021 Definitions

Below is a summary of the key changes introduced by the 2021 Definitions.

Calculation Agent

Duties: Under the 2021 Definitions, the Calculation Agent is responsible for **all** determinations not otherwise required to be made by a party to the relevant transaction or other specified person thereunder. The 2006 Definitions instead took the approach of listing each of the Calculation Agent's various duties. (section 1.2.1)

Standard: Under the 2021 Definitions, the Calculation Agent is still required to act in good faith, but must also now use "commercially reasonable procedures to produce a commercially reasonable result" rather than simply act "in a commercially reasonable manner" as required by the 2006 Definitions. This reflects the standard required in the standard-form 2002 ISDA Master Agreement in relation to the calculation of a close-out amount and provides for a more objective (and generally buyside-friendly) standard than previously.[1] Note however that this does not mean that the Calculation Agent is now acting in a fiduciary duty – this is expressly stated in the 2021 Definitions (the 2006 Definitions having been silent on this particular issue). (section 1.2.2)

Determinations: The Calculation Agent must now notify the parties of any determination it has made as soon as reasonably practicable after doing so. Parties now have a right to request a statement setting out the Calculation Agent's determinations in reasonable detail including any Relevant Market Data used in making its calculations in a specific Calculation Statement as well as additional rights to challenge these determinations by submitting their own supporting Relevant Market Data. (section 1.2.3)

Notices: If the Calculation Agent is not a party to a relevant transaction, the parties themselves must now provide a copy of any notices they send to one another to the Calculation Agent. (section 1.3)

Dates

The 2021 Definitions include certain additions and improvements to how days, dates and periods are defined and determined, including Payment Dates, Period End Dates, Calculation Periods and Business Day calendars and conventions.

Banking Day: The term "Banking Day" has been removed from the 2021 Definitions – instead the existing term "Business Day" is used throughout. In practice, there is no difference in the calendars of both terms. (section 2.1.1)

Currency Business Day: The 2021 Definitions add the term "Currency Business Day" to reference the default financial centre of a particular currency. The definitions for currencies and relevant financial centres are now set out in the Currency/Business Day Matrix. (section 2.1.2)

Business Days: The 2021 Definitions include or incorporate changes to certain Business Day terms such as "NYSE Business Day", "Abu Dhabi Days" and "Hong Kong Business Days". By way of example, the changes to Hong Kong Business Days follow the return to work arrangements after a super typhoon hit Hong Kong and clarify the effect on a Hong Kong Business Day given a black rainstorm warning, a typhoon signal and/or an extreme conditions announcement (section 2.2).

No Adjustment Business Day Convention: The widely used but previously undefined term "No Adjustment Business Day Convention" for Period End Dates is a new addition to the 2021 Definitions. (section 2.3.5)

Unscheduled Holidays: The term "Unscheduled Holidays" has been added as a concept to the 2021 Definitions and is intended to eliminate certain unintended consequences of the Modified Following or Preceding Business Day Conventions in circumstances where a public holiday is announced on very short notice. This could previously result in a payment obligation technically occurring in the past (e.g. when the 2020 Chinese Lunar New Year extension was announced after the start of the holiday period). Under the 2021 Definitions, if a public holiday is called with less than two Business Days' notice (an Unscheduled Holiday) any relevant date (e.g. Date for Payment or Period End Date) will now be delayed until the next following Business Day. (sections 2.3.6 and 2.3.7)

Independent adjustment for Payment Dates/Period End Dates: Under the 2021 Definitions, parties are now able to specify an independent Business Day Convention for Period End Dates, even where they are relying on the default position that Period End Dates are the same as Payment Dates specified in the relevant Confirmation. (sections 3.1.11 and 3.1.12)

End of Month Convention: Under the 2021 Definitions, the term "EOM [*End-of-Month*] Convention" can now be used to easily denote the last calendar day of each month. (section 3.1.15)

1 In *Lehman Brothers Special Financing Inc v National Power Corp* [2018] EWHC 487 (Comm), the High Court considered the process for determining a "close-out amount" payable upon the early termination of a forward currency swap transaction made under the 2002 ISDA Master Agreement. The change in wording from "reasonably determines in good faith" in the 1992 ISDA Master Agreement to "act in good faith and use commercially reasonable procedures in order to produce a commercially reasonable result" in the 2002 Agreement was considered material and specifically designed to include greater objectivity.

Calculating Fixed and Floating Amounts

The 2021 Definitions include certain additions and improvements to how Floating Amounts and Fixed Amounts are determined, in particular setting them out as formulae where possible rather than the narrative approach taken by the 2006 Definitions.

Correction provisions: Under the 2021 Definitions, the correction time period for interest rates after they have been published has been extended from one hour to **the longer of** one hour and the period specified for correction by the relevant administrator under its methodology. Note that there is no obligation for parties to pay interest on the amount of any adjustment payment resulting from any such correction. (section 4.11)

Negative interest rates: In addition to the fixed negative interest rate provisions of the 2006 Definitions being imported to the 2021 Definitions, a new floating rate negative interest rate method has been added – Zero Interest Rate Method Excluding Spread. Under this mechanism, the actual floating rate is floored at zero prior to the addition or subtraction of any Spread applicable to the calculation of the Floating Amount. (section 6.8)

Floating Rate Options

Floating Rate Matrix: Under the 2006 Definitions, Floating Rate Options (FROs) used to determine the benchmark for floating rates were set out in blocks of text and their nomenclature did not follow any particular rules. Under the 2021 Definitions, the FROs have been reorganised into a Floating Rate Matrix and have been given a common rules-based naming convention to help identify them more clearly. Moreover, each rate will now have a single FRO, which will refer to the relevant administrator or central bank, rather than multiple different FROs stemming from different sources, as was the case previously. The Floating Rate Matrix will contain the key attributes of a particular FRO (e.g. Fixing Day, Fixing Time, Administrator etc.) in columns with rows representing different interest rate benchmarks. Under the Floating Rate Matrix, each FRO is organised into a Category (Screen Rate or Calculated Rate) and a Style that establishes which columns in the Floating Rate Matrix are applicable and the relevant operative provisions. A Floating Rate Matrix will be re-versioned in its entirety and published whenever a new FRO is added, removed or amended.

Screen Rate FROs: Screen Rate FROs are observed from a chosen source and typically require no input from the Calculation Agent. There are currently seven "Styles" of Screen Rate: Term Rate, Overnight Rate, Swap Rate, Published Average Rate, Compounded Index, Index and other.

Calculated Rate FROs: Calculated Rate FROs require the Calculation Agent to make a calculation to determine the relevant rate using a formula or methodology set out or referenced in the Floating Rate Matrix. There are currently three "Styles" of Calculated Rate: Compounded Floating Rate Option, Average Floating Rate Option and Specified Formula.

Naming convention: The 2021 Definitions have introduced a common rules-based naming convention for FROs which combines the currency, administrator-assigned name and function in a consistent pattern: CCY-Rate Name-[Function][2].

Fallbacks

The 2021 Definitions contain the triggers and fallbacks introduced by the IBOR Fallbacks Supplement (Supplement 70 to the 2006 Definitions) as well as triggers and fallbacks set out in other recent supplements relating to replacement risk free rate alternatives (including SOFR, SONIA, TONA and €STR) to certain interbank offer rates (IBORs) including both temporary non-publication fallback provisions and permanent cessation fallback provisions. The 2021 Definitions also contain some FROs that were not included in the 2006 Definitions which have required new fallbacks to be created. The relevant provisions in the Floating Rate Matrix and main book should be reviewed for each FRO to obtain a definitive view of relevant triggers and fallbacks.

Index Cessation Event: On 5 March 2021, the FCA announced the timing for the cessation or loss of representativeness of all 35 LIBOR settings at once[3] - this FCA statement represented an Index Cessation Event under the IBOR Fallbacks Supplement and protocol, triggering a fixing of the fallback spread adjustment at the point of announcement. As with the IBOR Fallbacks Supplement, the definition of Index Cessation Event in the 2021 Definitions includes a non-representative limb (i.e. the relevant rate will no longer be representative of the underlying market and economic reality it is intended to measure and that representativeness will not be restored), which may be applied either in the Floating Rate Matrix or in the Confirmation. In Version 1 of the Floating Rate Matrix this election is applicable for the LIBOR FROs. (section 8.2.3)

2 Note that a document detailing the FRO naming convention rules has been published separately on the ISDA website: https://www.isda.org/a/MCGTE/FpML-FRO-Naming-Convention-20210429.pdf

3 The FCA confirmed that all seven tenors for both Euro and Swiss Franc LIBOR, overnight, one-week, two-month and 12-month sterling LIBOR, spot next, one-week, two-month and 12-month yen LIBOR and one-week and two-month US dollar LIBOR will permanently cease immediately after 31 December 2021. Publication of the overnight and 12-month US dollar LIBOR setting will cease for good immediately after 30 June 2023.

Administrator/Benchmark Event: The 2021 Definitions include a new trigger (Administrator/Benchmark Event) to ensure robust fallbacks where a party to a transaction delivers notice to the other party confirming that either or both of the parties (or the Calculation Agent itself) is not or will not be permitted under any applicable law or regulation to use the relevant benchmark to perform its/their obligations. The trigger is broader than the Administrator/Benchmark Event first introduced by the 2018 ISDA Benchmarks Supplement as the 2021 Definitions refer to "an event or circumstance" rather than a prescribed list of specific events or circumstances. In Version 1 of the Floating Rate Matrix the trigger is specified to be applicable for each FRO included in the Floating Rate Matrix, noting that the application is subject to any alternative election made in the Confirmation. If an event or circumstance that would qualify as, or give rise to, an Administrator/Benchmark Event trigger, also qualifies as an Index Cessation event, then the Index Cessation Event provisions would prevail. (section 8.3.2)

Generic fallbacks: Where a FRO does not have a bespoke fallback, a new generic framework assists users to identify an appropriate replacement benchmark together with any necessary spread adjustment. The parties must use commercially reasonable efforts, acting in good faith, to try to identify a fallback to allow the relevant transaction to continue in accordance with its terms. (section 8.6)

Alternative Continuation Fallbacks: Upon the occurrence of a Permanent Cessation Triger or Administrator/Benchmark Event, but where no market-standard fallbacks have otherwise been identified and included in the 2021 Definitions, the generic fallback framework requires the parties to apply four Alternative Continuation Fallbacks in parallel (but if more than one applies, then the fallback listed higher will apply) as follows:

- Agreement between the parties.
- Alternative Pre-Nominated Index (as specified by the parties in the relevant Confirmation).
- Alternative Post-Nominated Index (as nominated by the central bank or other administrator of the benchmark).
- Calculation Agent Nominated Replacement Index (as determined by the Calculation Agent to be a commercially reasonable alternative, such determination being subject to any dispute resolution process).
- No-Fault Termination Rights. (sections 8.6.3 and 8.6.4)

Temporary cessation: Note that the framework differs in cases of any temporary cessation of publication.

Exercise of Swaptions/Optional Early Terminations

The framework relating to the exercise of Swaptions and Optional Terminations in the 2006 Definitions is substantively unchanged in the 2021 Definitions. One change to note is that the definitions of In-the-Money and Out-of-the-Money (used to determine if the exercise of the relevant rights is triggered under the Automatic Exercise and Fallback provisions and if a Cash Settlement Amount is payable by a party) have been modified under the 2021 Definitions to accommodate transactions other than vanilla interest rate swaps. For more complex transactions, the Mid-Market Valuation (Calculation Agent Determination) Cash Settlement Method (described below) will be used to calculate a hypothetical cash settlement amount used to determine whether a party is In-the-Money or Out-of-the-Money.

Cash Settlement Methods

Under the 2021 Definitions, a Cash Settlement Amount is due upon: (i) the exercise of a Swaption to which Cash Settlement applies; (ii) the exercise of an Optional Early Termination (OET) right under a transaction; or (iii) the Mandatory Early Termination (MET) of a transaction. Following each of these, the parties to the transaction will first attempt to mutually agree the Cash Settlement Amount. If they are unable to come to an agreement the relevant Fallback Cash Settlement Amount will be determined in accordance with the applicable Cash Settlement Method. Unless specified in the Confirmation, the Cash Settlement Method will be as set out in the ISDA Settlement Matrix for the relevant currency and type.

ISDA have substantially updated the provisions governing Cash Settlement Methods in the 2021 Definitions which have been designed to reduce the broad scope of discretion afforded to the Calculation Agent. These new methods can be divided into two categories: mid-market and replacement value.

Mid-market valuation

Mid-market valuation approach: The mid-market approach aims to determine a theoretical mid-market price for the transaction (in the case of an OET or MET) or the underlying transaction (in the case of the exercise of a swaption). The constraints of this methodology should reduce the discretion afforded to Calculation Agents and Cash Settlement Reference Banks in producing valuations and should result in a more consistently objective result. The 2021 Definitions introduce three valuation methods that follow this approach: (i) Indicative Quotations; (ii) Calculation Agent Determination; and (iii) Indicative Quotations – Alternative Method.

- **Mid-Market Valuation (Indicative Quotations)**: The first is for the Calculation Agent to select Cash Settlement Reference Banks. If at least two quotations are provided, the Cash Settlement Amount will be the arithmetic mean of the quotations provided. If less than two quotations, the Cash Settlement Amount shall be determined in accordance with Mid-Market Valuation (Calculation Agent Determination) below. This is the default method under the Settlement Matrix where an interest rate swap is terminating early. (section 18.2.1)
- **Mid-Market Valuation (Indicative Quotations – Alternate Method)**: The second mid-market method is identical to the first method except that each party selects three Cash Settlement Reference Banks and obtains the indicative quotations – giving the buy-side parties more influence on the process. If at least two quotations are received, the Cash Settlement Amount will be the arithmetic mean of the quotations provided. If less than two quotations, then each party shall make a determination as if it is the Calculation Agent under the Mid-market Valuation (Calculation Agent Determination) method below and the Cash Settlement Amount shall be the arithmetic mean. (section 18.2.2)
- **Mid-Market Valuation (Calculation Agent Determination)**: The final mid-market method is similar to the first two, except that the Calculation Agent produces the valuation without recourse to any indicative quotations provided by dealers (but still following the same Prescribed Methodology as the Cash Settlement Reference Banks under Mid-Market Valuation (Indicative Quotations). (section 18.2.3)

Defaults: Under the ISDA Settlement Matrix, the default Cash Settlement Method for MET is Mid-market Valuation (Indicative Quotations) and the default Cash Settlement Method for OET is Mid-market Valuation with Existing CSA[4] applicable. The default Cash Settlement Method for a cash-settled swaption varies depending on the currency and the Floating Rate for the floating leg of the underlying swap transaction.

Replacement Valuation

Replacement Value: The objective of the replacement value approach is to determine an amount that protects one of the parties (the Protected Party) from financial impact of an early termination of the transaction. The expectation is that this approach will not be used for cash-settled swaptions.

Like the Mid-market Valuation approach, there are two sub-categories: (i) Replacement Value (Firm Quotations); and (ii) Replacement Value (Calculation Agent Determination), which both attempt to determine a value for the transaction on a replacement-cost basis. Note that neither Replacement Value (Firm Quotations) nor Replacement Value (Calculation Agent Determination) is used as a default Cash Settlement Method for any currency currently set out under the ISDA Settlement Matrix. (section 18.2.5)

Replacement Value (Firm Quotations): The first method involves requesting the Cash Settlement Reference Banks to provide a firm quotation for the amount it would pay or charge the Protected Party to enter into a replacement transaction from Cash Settlement Reference Banks using a standard form of prescribed documentation. If at least two quotations are received, the Cash Settlement Amount (where there is only one Protected Party) will be the best quotation received. If there are two Protected Parties, each Cash Settlement Reference Bank will provide a firm quotation with respect to each of the parties, a mid-point will be calculated between these two quotations and the Cash Settlement Amount will be the arithmetic mean of each mid-point. If fewer than two firm quotations are received then the Calculation Agent will determine the Cash Settlement Amount as if the Cash Settlement Method was Replacement Value (Calculation Agent Determination). (section 18.2.4)

Replacement Value (Calculation Agent Determination): This is the same as using the Replacement Value (Firm Quotations) method but instead of using Cash Settlement Reference Banks, the Calculation Agent will make the determination using the Close-out Amount methodology in the standard-form 2002 ISDA Master Agreement.

Currency Provisions

Under the 2021 Definitions, the definitions of currencies, related financial centres and other provisions specific to a currency have been set out in the Currency/Business Day Matrix which should hopefully make them easier to update. Additional currencies have also been included in the Currency/Business Day Matrix to align with the 1998 FX and Currency Options Definitions.

4 If Existing CSA is specified as applicable then the assumption is that the specified main terms of the credit support annex between the parties apply on the basis that the transaction is the only transaction.

Macfarlanes LLP
20 Cursitor Street London EC4A 1LT
T +44 (0)20 7831 9222 | F +44 (0)20 7831 9607 | DX 138 Chancery Lane | macfarlanes.com