

ISDA® Operations Committee

Process Working Group

- Drive Process Efficiency
- Standardise Operational Practice
- Evolve 'Best Practice' Standards
- Influence Market Development / Technological Change

Best Practice Statement: Processing Novations

Purpose

The purpose of this Best Practice Statement is to outline guidelines for processing the transfer of privately negotiated or over-the-counter (“OTC”) derivative transactions confirmed under the terms of an ISDA Master Agreement.

ISDA publishes the following documents for use in effecting novations:

- long-form standard Novation Agreement, published in 2002; and
- 2004 ISDA Novation Definitions containing definitions, standard Novation Agreements and a short-form Novation Confirmation.

This Best Practice Statement addresses processing novations under the 2004 ISDA Novation Definitions and, in more general respects, applies to processing the novation of any Transaction documented under an ISDA Master Agreement.

Current State

- Differing standards and expectations exist across the market to process novations. This proliferation of practices causes uncertainty and consequent delays, increasing risks to the counterparties involved and creating operational inefficiency and backlogs in processing documentation.
- The ISDA Operations Process working group has consulted widely with ISDA members to identify the operational issues which cause problems in processing novations and has sought to address these directly in market discussions. The resulting consensus on a consistent approach going forward is set out in the Commentary which follows.
- Although parties are not obliged to adopt these guidelines, ISDA encourages participants to follow this Best Practice Statement in order to support a standardisation of the novations process.
- The precise documentation of each Transaction remains the responsibility of the parties concerned. ISDA assumes no responsibility for any use to which this Best Practice Statement may be put. Each party following the recommendations contained in this Best Practice Statement should satisfy itself that these recommendations are appropriate to reflect the commercial intentions of the parties.

Capitalised terms have the meaning given to them in the relevant ISDA definitional booklet.

Commentary

- **Notifications**

Transferor seeking approval	<ul style="list-style-type: none">○ The Transferor (outgoing party) should notify the Transferee (incoming party) and the Remaining Party of a novation on or before the Novation Date○ The Novation Date needs to be agreed by all parties in advance of the transfer taking place so that the trade may be rebooked and reported accurately
Remaining Party communications	<ul style="list-style-type: none">○ All communications should be at Front Office level and relevant approvals obtained○ Front Office personnel should ensure that any deals booked as cancellations or new trades which form part of novations are clearly identified as such to Operations support staff

- **Effectiveness of Transfer**

Novation Date and Rebooking of trades	<ul style="list-style-type: none">○ The Novation Date is the date that the deal transfers, ie the rights and obligations of the Transferor are novated to the Transferee○ The Transferor, Transferee and Remaining Party should rebook a novated trade to take effect from and including the Novation Date
Novation Trade Date	<ul style="list-style-type: none">○ Parties may, as part of the consent process on the Novation Trade Date, agree that the transfer will be effective from a forward starting Novation Date. This can occur for portfolio transfers where a longer lead-in period is required. A one Business Day delay in a Novation becoming effective is common practice for Credit Default Swaps
Due Date of Fees	<ul style="list-style-type: none">○ Payment of fees for the novation is a separate arrangement between the Transferor and the Transferee. Any 'effective date' agreed for calculation and settlement of fees is quite separate from the operation of Novation Date in relation to the Novation Transaction

Treatment of Cash Flow accruals	<ul style="list-style-type: none"> ○ When a novation occurs part way through a Calculation Period, accepted market practice under the New Transaction is for cash flows to accrue: <ul style="list-style-type: none"> ▪ from the last applicable Period End Date (usually same as Payment Date) for each party under the Old Transaction; or ▪ if the first Period End Date has not yet occurred for a party, from the Effective Date of the Old Transaction ○ These cash flows are settled in full by the Transferee and the Remaining Party on the first Payment Date to occur under the New Transaction ○ The 2004 ISDA Novation Definitions use the full accrual method for both parties as a standard election and the definition for Full First Calculation Period applies as default ○ Parties may elect alternative arrangements. They may accrue their initial payment obligations under the New Transaction from a different date, eg the Novation Date. However, this requires agreement by the Remaining Party
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• **Timelines of Process**

<p>Guidelines on turnaround times</p> <p>(Business Days unless otherwise stated)</p>	<p>T(-x) Transferor contacts Remaining Party for consent to novate</p> <p>T Transferor confirms date of transfer (Novation Date) to Transferee and Remaining Party (« T »)</p> <p>T Remaining Party rebooks the trade with Transferee</p> <p>T+1 If applicable, Remaining Party recalculates exposure, initiating collateral process per terms of bilateral CSA or other collateral agreement</p> <p>T+5 Novation Confirmation (Novation Agreement) dispatched by T+5 business days latest</p> <p>T+30 All documentation fully executed by Transferor, Transferee and Remaining Party by T+30 calendar days</p> <p>These guidelines follow market established practice for confirming transactions set out in Sound Practices and Escalation Procedures published on ISDA’s website at www.isda.org. The published guidelines for Telephone Confirming Trades may also be relevant where parties wish to adopt this additional procedure</p>
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• **Transferring the Trade**

Provision of ‘original’ confirmation	<ul style="list-style-type: none"> ○ A Transferor should, if available and if so requested, supply an original trade Confirmation to a Transferee prior to a novation taking place ○ A review of the original Old Confirmation should be undertaken by the Transferee for structured trades ○ If no Old Confirmation is available, a detailed statement of principal terms is acceptable, eg Term Sheet
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Netting of trade positions	<ul style="list-style-type: none"> ○ Aggregation of trades with identical trade terms being novated from the same Transferee to the same Transferor should be at the discretion of the Remaining Party
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• **Renegotiation of Terms**

Mutual break-clauses	<ul style="list-style-type: none"> ○ Renegotiation of mutual break-clauses should be at the Remaining Party's discretion ○ In general market participants will consider renegotiating break-clause tenors to match their existing trading relationship with the incoming Transferee counterparty ○ Where a new break clause is added to a New Transaction, it is usual to run the first break date from: <ul style="list-style-type: none"> • the last common Payment Date to occur under the Old Transaction or, • if no Payment Date has occurred, from the Effective Date of the Old Transaction or, • if no Effective Date under the Old Transaction has occurred, from the Novation Date
Bilateral counterparty language	<ul style="list-style-type: none"> ○ Renegotiation of bilateral counterparty-specific language should be at the Remaining Party's discretion ○ A majority of participants are willing to consider amending vanilla deals (ie, without special terms) to include existing bilaterally agreed language with the incoming party. Examples are: Calculation Agent Collateral terms Calculation Agent City <p>Bilateral language in equity and commodity derivatives trades is typically agreed on a case-by-case basis</p>
Changes to other terms	<ul style="list-style-type: none"> ○ Any economic terms or special provisions should not be renegotiated. This includes conforming 'original' terms to market standards, eg, Business Days which may impact the risk and hedging of the trade for the Remaining Party ○ Any changes agreed to economic or, for example, fallback provisions which may have an economic impact should be specifically and separately agreed between the Transferee and the Remaining Party. ○ It is recommended that amendments to the terms of a New Transaction should fall outside the scope of the Novation process discussed here, and that these should be handled subsequently through each party's usual amended confirmation procedures

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• **Documenting the Transfer**

<p>Who prepares the documentation</p>	<ul style="list-style-type: none"> ○ The Remaining Party should document the Novation, unless otherwise agreed between the parties ○ The Remaining Party is a party to the original Confirmation and knows the terms of the original trade ○ Where the Remaining Party dispatches novation documentation within T+5 business days in ISDA standard format, best practice is to sign the Remaining Party's agreement ○ If the Remaining Party fails to send ISDA standard documentation after T+5 business days, either the Transferor or Transferee can dispatch the required documentation for the novation and assume responsibility for the execution process ○ It is recommended that a party assuming responsibility for documenting a novation after T+5 should notify the Remaining Party that it intends to do so
<p>Use of ISDA templates</p>	<ul style="list-style-type: none"> ○ As far as possible, the standard template in the 2004 ISDA Novation Definitions should be used for the novation of vanilla OTC derivative transactions ○ More structured deals or portfolio transfers may require the long-form ISDA Novation Agreement published in April 2002. This is available from ISDA's website at www.isda.org ○ In certain cases, bespoke amendments to ISDA standard documents may be required. These should be the exception rather than the rule
<p>Counterparty regulatory language requirements</p>	<ul style="list-style-type: none"> ○ Language covering counterparty regulatory requirements is recognised (eg, where one party acts through an agent, instructions are inserted to clarify requirements that all payments or deliveries go through that party's agent and not directly between Party A and Party B)
<p>Non-Reliance</p>	<ul style="list-style-type: none"> ○ Older agreements may not include this language. The consensus agreed is to elect for Non-Reliance to apply since this will not override bi-laterally agreed language agreed by parties in governing ISDA Master Agreements

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<p>Attach Old Confirmation or New Confirmation</p>	<ul style="list-style-type: none"> ○ The 2004 ISDA Novation Definitions offer an opportunity to attach the New Confirmation (ie, for the trade between the Remaining Party and the Transferee) to the Novation Confirmation ○ To document the novation of vanilla OTC derivative transactions, attaching the New Confirmation is considered best practice. This facilitates STP and the re-documentation of any Transferee bilateral terms ○ Sufficient details of the original trade should be included on the Novation Confirmation or other Novation Agreement to identify the Old Transaction accurately ○ Historically, participants have attached the original, or Old Confirmation, or a schedule to the standard ISDA long-form Novation Agreement. This alternative may still be appropriate for complex trades and bulk transfers
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• **Legally Executing the Transfer**

<p>Match documentation or execute</p>	<ul style="list-style-type: none"> ○ It is recommended that a Novation Confirmation (or Novation Agreement) should be executed by all three parties ○ Matching of Novation Confirmations (or Novation Agreements) is not considered accepted market practice
<p>Signing in counterparts</p>	<ul style="list-style-type: none"> ○ There is industry agreement that signing in counterparts is acceptable and preferable wherever possible
<p>Order for all three parties to sign</p>	<ul style="list-style-type: none"> ○ Parties are encouraged to sign the relevant Novation documents as soon as possible in order to complete the documentation process by T+30 calendar days at the latest ○ The party assuming responsibility for documenting the novation has responsibility for distributing fully executed copies to other parties. (Normally the Remaining Party will initiate the novation documentation and facilitate all signatures)
<p>Issuing separate Confirmations for New Transactions</p>	<ul style="list-style-type: none"> ○ Some market participants automatically generate and issue an independent Confirmation outside the documentation required for novation of the New Transaction. This practice should be discouraged

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- **Fees and Bilateral Arrangements**

Fees	<ul style="list-style-type: none">○ The outgoing Transferor and the incoming Transferee will typically agree a fee between them for the transfer of the trade○ Calculations regarding this fee and its value date are outside the scope of this guidance statement○ Fees and their settlement terms do not form part of the formal Novation Confirmation or Novation Agreement since these arrangements do not include the Remaining Party○ A sample fee letter is attached as Appendix 1 which, subject to individual requirements, may be used between the Transferor and Transferee if required to document these separate arrangements
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Appendix A

Example Fee Letter

To:
Attn:
Tel:
Fax:

[Date]

From:
Attn:
Tel:
Fax:

Dear Sir/Madam

Novation of OTC derivative Transaction

We refer to the Old Transaction identified below. We confirm our agreement that with effect from and including the Novation Date set out in the New Transaction below, you have novated the Old Transaction to us on the following terms and conditions:-

Old Transaction

Your Counterparty
Notional Amount
Effective Date
[Scheduled] Termination Date
Type of Transaction

New Transaction

Remaining Party
Novated Amount
Novation Date
Full First Calculation Period: Applicable/Inapplicable

Fees

Fee payable
Payable by
Payable to
Due date

In consideration for novating the Old Transaction, a Fee as identified above will be payable on or before the due date specified above in freely transferrable funds and in the manner customary for payments in the required currency.

This letter agreement may be executed in counterparts. Capitalised terms not otherwise defined in this letter agreement shall have the meaning given to them in the ISDA 2004 Novation Definitions. This letter agreement shall be governed by and construed in accordance with the laws of England.

Yours faithfully,

[Authorised Signatory]

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