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ISDA

The 2022 ISDA Securities Financing Transactions Definitions: Current and Future Use Cases

INTRODUCTION

On February 28, 2022, ISDA published the 2022 ISDA Securities Financing Transactions Definitions and related documents[1]. The new documentation allows firms to enter into derivatives and SFTs under a single ISDA Master Agreement. The publication followed an ISDA October 2020 whitepaper[2] that detailed a proposal to standardize documentation across repos[3] and stock loans (securities financing transactions (SFTs)) and derivatives.

The ISDA SFT documents are the product of a year-long drafting and comment process by an ISDA working group that included buy- and sell-side participants with both an SFT and derivatives focus. Early in the process, the working group identified a concrete set of use cases on which to focus the development of the new documentation, while leaving the architecture flexible enough to allow for other use cases and future standardized additions. From the outset, the working group strove to ensure that current SFT practices could be replicated using the ISDA SFT documents and did not seek to change how SFTs would be characterized, either legally or economically (including how collateral is calculated and posted).

The ISDA Master Agreement is a product-agnostic framework agreement. As such, it focuses primarily on the management of counterparty credit risk. Contract terms to define specific products and transactions are contained in definitional booklets and confirmations. The management of counterparty credit risk is critically important to both derivatives and SFTs, so there is significant opportunity for alignment.

By using a single ISDA Master Agreement, the ISDA SFT documents simplify and streamline the negotiation and management of SFT and derivatives documentation. When it comes to unexpected events – whether a counterparty default or disruption from geopolitical events – having a single set of terms, and applying close-out netting across both SFTs and derivatives, can mean a quicker and more consistent approach to managing counterparty risk.

A number of bespoke transactions involve the use of both SFTs and derivatives – corporate equity derivatives and repackagings are two examples. Parties are currently required to create their own bespoke documentation for these products from multiple sources. Using a single ISDA Master Agreement to document such transactions not only reduces the number of documents required but also applies common terms to each transaction type – something that does not happen today, resulting in potential basis risk.

This paper provides a brief overview of the SFT Definitions and the SFT Schedule Provisions, describes the use cases currently identified for these documents, and highlights some possible future developments. ISDA believes there is potential for further alignment between SFTs and derivatives that could be introduced as market demand warrants, including streamlining jurisdictional and market-practice differences to create greater efficiency in documenting and maintaining SFTs and derivatives. More details on the timeline of the drafting and publication of the ISDA SFT documents are included in the appendix.

[1] www.isda.org/2022/02/28/isda-publishes-documentation-to-align-derivatives-and-sft-markets/

[2] Available at www.isda.org/2020/10/05/collaboration-and-standardization-opportunities-in-derivatives-and-sft-markets/

[3] Repo is the colloquial term used to refer to a repurchase transaction

HOW TO USE THE NEW ISDA SFT DOCUMENTS

The new ISDA SFT publications comprise three documents that are designed to be used together:

- **SFT Schedule Provisions:** These are designed to be included as a new part of the schedule to an ISDA Master Agreement. The SFT Schedule Provisions adapt the terms of the ISDA Master Agreement to contemplate both SFTs and derivatives being governed by the ISDA Master Agreement and include SFT-specific elections.

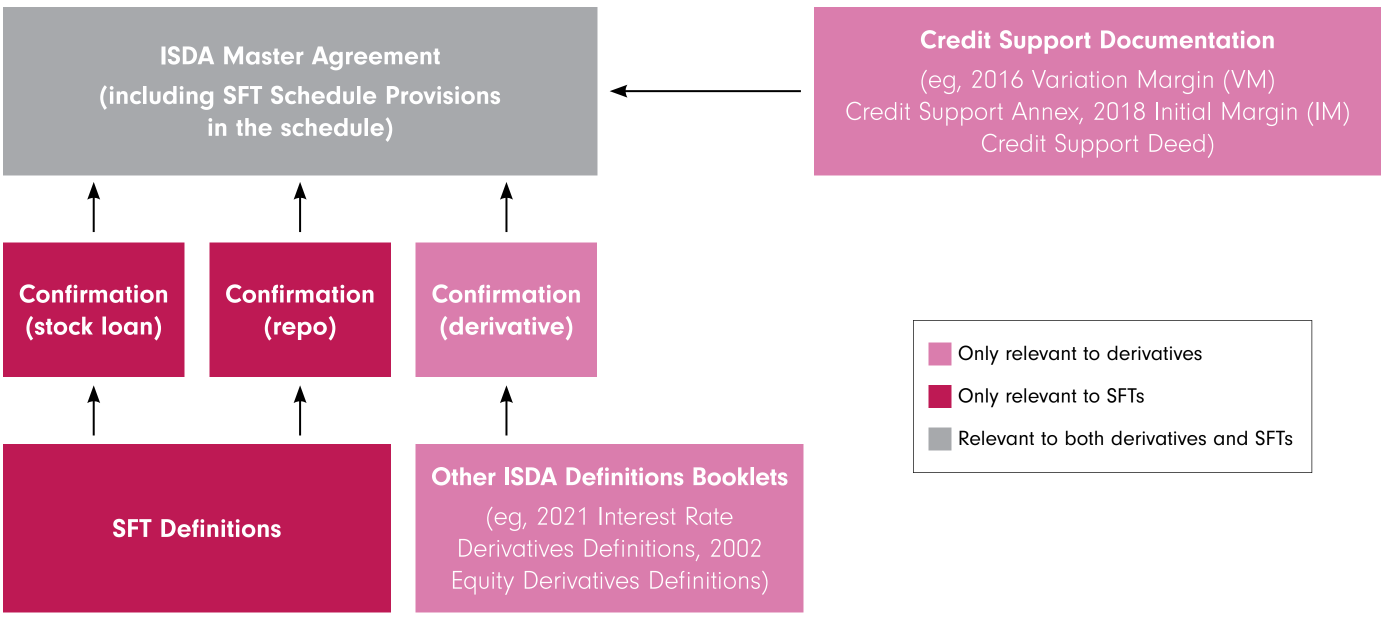
- **SFT Definitions:** These set out the operative provisions for SFTs. The SFT Definitions can be incorporated by reference into the SFT Schedule Provisions and/or into an individual SFT confirmation.

- **Forms of confirmation for stock loans and repos:** As is customary for ISDA documentation, parties will set out the economic terms for each SFT in a confirmation. ISDA has published forms of confirmation reflecting the standard economic terms of both stock loans and repos.

The ISDA SFT documents can be used with an ISDA Master Agreement governed by English, New York, French or Irish law. The ability to have the same form of documents available for use for stock loans, repos and derivatives under a variety of governing laws provides market participants with an enormous amount of flexibility.

In light of the exit of the UK from the EU, the ISDA Master Agreement currently provides the only standardized option for documenting repos, stock loans and derivatives under a single document based on an EU governing law. In addition, ISDA's opinions already cover the Irish and French law ISDA Master Agreements and are being expanded to include the ISDA SFT documents.

Figure 1: Document Architecture



The ISDA SFT documents enable parties to enter into repos and stock loans that reflect current industry standard economic terms for these transactions, without reclassifying them as derivatives. Parties can use the various standard elections and other functionality set out in the ISDA SFT documents to tailor their particular repo or stock loans to the standard practices prevalent in either US or international markets (including the ability to post collateral for stock loans by way of a New York law pledge).

By utilizing the ISDA SFT documents, parties are more easily able to negotiate bespoke structured transactions without having to make substantial changes to a master agreement. The ISDA SFT documents build on the framework of the ISDA Master Agreement, providing for representations and warranties, close-out mechanisms, events of default and other relationship-level contractual arrangements across stock loans, repos and derivatives. If desired, the SFT documents provide flexibility for parties to customize these standardized provisions for their relationship.

In a default scenario, the ISDA SFT documents allow close-out netting across portfolios of both SFTs and derivatives, while continuing to retain the key economic differences between the portfolios. On the other hand, in certain scenarios that have a significant impact on the trading relationship but do not involve a default, the ISDA SFT documents give the flexibility, where appropriate, to close out SFTs without closing out the derivatives portfolio, or vice versa.

More detailed information on each of the ISDA SFT documents is included in two guides published by ISDA: *Overview of the 2022 ISDA Securities Financing Documents* and *Technical Guide to Completing the 2022 ISDA Securities Financing Transactions Schedule Provisions*. The overview guide and technical guide are available on ISDA's website[4].

The overview guide provides a summary of the key concepts (including how margining and close out work) embedded in the ISDA SFT documents. It sets out how the SFT Schedule Provisions and SFT Definitions work together to allow market participants to document repos or stock loans under an ISDA Master Agreement while providing considerable flexibility to negotiate the terms of the transactions to meet their commercial needs. The technical guide explains the specific elections that are available in the SFT Schedule Provisions and how these interact with relevant provisions in the SFT Definitions.

[4] www.isda.org/book/overview-of-the-2022-isda-securities-financing-documents/
www.isda.org/book/technical-guide-to-completing-the-2022-isda-securities-financing-transactions-schedule-provisions/

CURRENT USE CASES

ISDA members have identified the following as potential use cases and benefits that the market can currently gain from utilizing the ISDA SFT documents.

Simplification and Streamlining of Documentation

Prior to publication of the ISDA SFT documents, parties wishing to transact derivatives, stock loans and repos would need to enter into three separate master agreements. This can now be done under one ISDA Master Agreement. This simplifies the negotiation process and provides greater consistency of terms across derivatives and SFTs.

For example, parties can use a single set of representations, events of default and tax provisions. This type of consistency could reduce legal costs, as parties only need to negotiate one master agreement rather than multiple versions. It could also reduce operational costs – systems could be programmed to reflect one documentation standard with consistent definitions, which could facilitate automation and straight-through processing. As an example of this work, ISDA continues to develop the Common Domain Model (CDM), which models financial transactions in representative machine-readable code. This can be useful for reporting and, in the future, could create operational efficiencies in managing derivatives and SFT transactions and their related collateral.

Specific areas where this simplification and streamlining could be of benefit are:

- **Equity prime brokerage relationships:** Prime brokers often enter into a variety of agreements with clients, including an ISDA Master Agreement (which usually involves a portfolio swap annex or portfolio swap master confirmation) and documentation to provide securities lending services and rights of rehypothecation for the prime broker. Using the ISDA SFT documents would enable prime brokers to streamline their client documentation packages while increasing conformity of terms.

- **Emerging markets:** There may be less familiarity with industry standard derivatives and SFT documentation in certain emerging markets. In those jurisdictions, market participants may find it appealing to familiarize themselves with only one form of master agreement that allows them to document both derivatives and SFTs with their US and global counterparties, rather than using multiple products and/or jurisdictional-specific documents. This is without considering the additional benefits of having a single process to close out derivatives and SFTs and having all transactions within a single close-out netting set (see *Close Outs* and *China Netting* sections).

Close Outs

The COVID-19 pandemic and Ukraine crisis have prompted market participants to look at the termination provisions in their documentation. Key aspects have included the way in which events of default operate, the availability of illegality and force majeure provisions, the available methods for the service of notice and the timings and process for closing out transactions.

Having all transactions (whether derivatives and/or SFTs) under a single master agreement should simplify the process when it comes to close outs and understanding the effect of sanctions, currency controls or other new laws on SFTs and derivatives. Having one master agreement means there is only one set of provisions to understand, reducing the time needed for legal review of affected documents. This, in turn, means an ability to act quicker. The speed with which one can act is often vital at a time of crisis, when market participants are particularly vulnerable to market volatility.

A critical element in the development of the ISDA SFT documents was recognition that the speed at which transactions can be unwound may be different for derivatives and SFTs. The ISDA SFT documents allow for the unwinding of SFTs to commence more quickly than the close out of derivatives under the same ISDA Master Agreement, while preserving close-out netting across both derivatives and SFTs. For example, parties can agree to allow SFT collateral to begin to be sold prior to notice being given, while derivatives continue to be valued only on the day on which notice is effective.

A major benefit is that both derivatives and SFTs will form part of a single netting set. This means a single net termination amount will be determined, which serves as an important additional credit risk mitigant.

Cross-product Structured Transactions

Some structured transactions involve both a derivative and an SFT. Documenting both under a single ISDA Master Agreement will result in the benefits described in the previous sections.

Two examples are set out in the following sections.

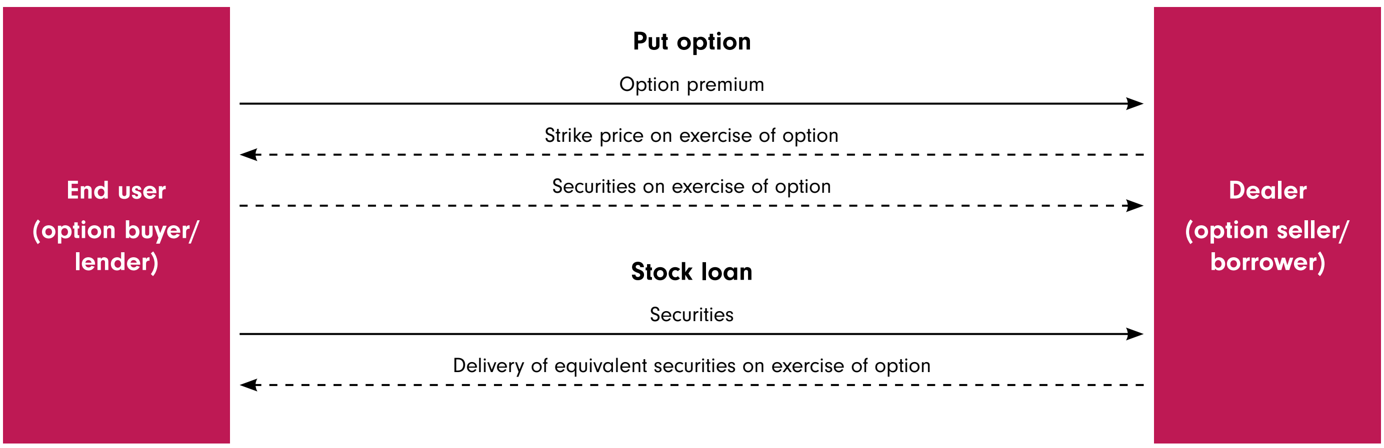
Corporate Equity Derivatives

Corporate equity derivatives are used by investors (such as hedge funds and private equity firms) to raise finance to acquire a physical holding of shares, monetize an existing position of shares or gain economic exposure to shares without physically acquiring them.

For example, if an end user buys a put option, the dealer will generally establish a short position in the shares as a hedge against the share price falling below the option strike price. The dealer can achieve this by borrowing the shares under a stock loan and immediately selling in the market. If and when the option is exercised, the dealer can purchase the shares in the market to return under the stock loan. The difference between the sale price and the purchase price helps to cover the dealer's position. In some circumstances, the end user actually owns the stock and can cheapen the cost of the put option it is buying by providing the stock loan without requiring collateral or a stock loan fee.

It is not uncommon for the dealer and end user to enter into a master netting agreement, meaning the termination values under the ISDA Master Agreement for the put option and the relevant master agreement for the stock loan can be netted. With the ISDA SFT documents, both transactions could be documented under a single ISDA Master Agreement.

Figure 2: Put Option Hedged by a Stock Loan



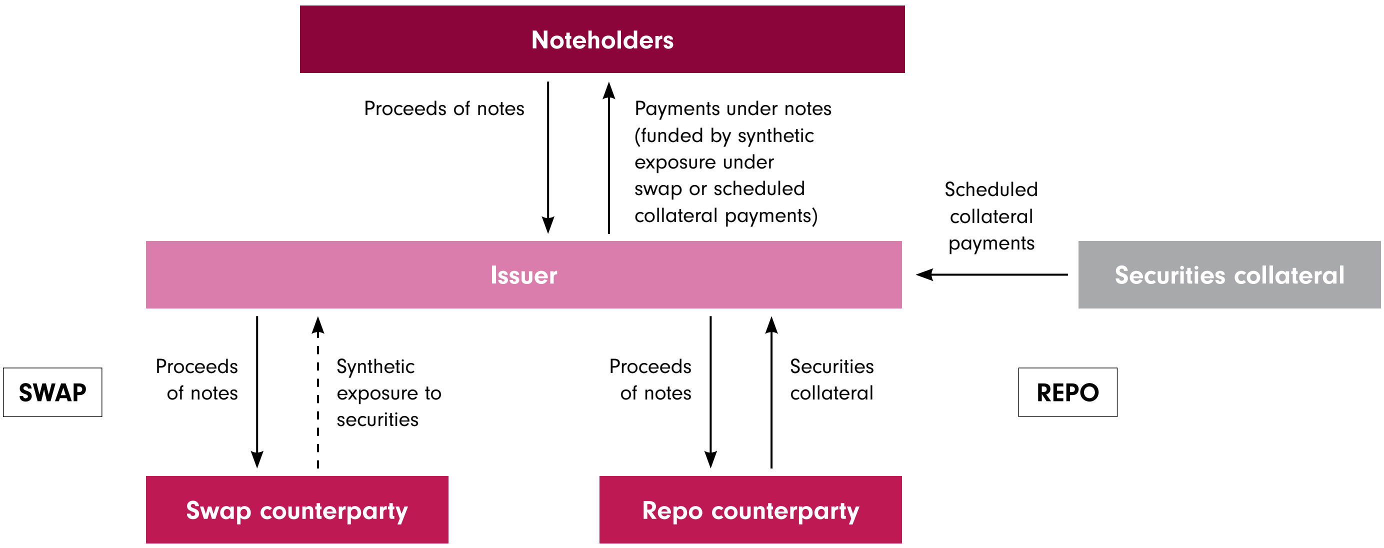
Repackaged Notes

A number of note repackaging programs involve the use of swaps and/or SFTs.

Under these programs, an entity (usually a special purpose vehicle (SPV)) will issue notes secured on collateral. This is typically in the form of securities acquired by the SPV, although a synthetic exposure to the securities may instead be created via a swap. The SPV may also acquire the securities from a seller under a repo by paying out the note proceeds as buyer under the repo. There may additionally be SFTs in place to enable the entity that acts as arranger and/or swap counterparty to borrow securities acquired by the SPV as collateral.

There are currently separate sets of terms for the swap and SFT documentation under a note program – despite the fact that a single entity would normally act as both swap counterparty and repo counterparty. This could be consolidated into a single set of terms using the ISDA SFT documents.

Figure 3: Repackaging Program



China Netting

On November 23, 2021, the China Banking and Insurance Regulatory Commission (CBIRC) issued a notice[5] and Q&A[6] providing clarity on the enforceability of close-out netting under People's Republic of China (PRC) law.

Specifically, the CBIRC notice and Q&A expressly waived the requirement to obtain written legal opinions under Article 4 of the Capital Measurement Rules for Derivatives Counterparty Credit Risk when a PRC commercial bank calculates its regulatory capital requirements for counterparty credit risk if:

- The counterparty to the commercial bank is a financial institution, the establishment of which has been approved by a PRC financial regulator; and

[5] Notice on Issues Concerning the Measurement Rules for the Default Risk Assets of Derivatives Counterparties (No. 124 [2021] of the General Office of the CBIRC), www.cbirc.gov.cn/cn/view/pages/govermentDetail.html?docId=1020670&itemId=861&generaltype=1

[6] www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=1020671&itemId=915

- The netting agreement between the parties falls within a short list of agreements, which includes the ISDA 2002 Master Agreement.

Accordingly, commercial banks in the PRC and their counterparties that transact both derivatives and SFTs can benefit from the confirmation that close-out netting is enforceable if a single ISDA 2002 Master Agreement is used.

China's Futures and Derivatives Law (FDL), which took effect on August 1, 2022, provides express recognition at the national legislation level for the enforceability of close-out netting and the single agreement concept commonly used in over-the-counter derivatives documentation, such as the ISDA Master Agreement[7]. While SFTs are not specifically covered by the FDL, the protections for netting provided by the CBIRC will still be available to repos with Chinese financial institutions, provided the transactions are documented under the ISDA Master Agreement.

ISDA's Chinese law netting opinion (which was published on August 1, 2022) confirms the enforceability of close-out netting for derivatives and SFTs documented under an ISDA Master Agreement with counterparties based in the PRC.

Possible Future Developments for ISDA SFT Documents

While possible near-term use cases informed the drafting of the existing ISDA SFT documents, the architecture has been created to allow updates for new use cases or to include further standardized language to respond to market needs. This approach has allowed market participants to familiarize themselves with the core documentation proposition, as well as allow ISDA netting and collateral opinions to be updated to include the ISDA SFT documents.

As the adoption of, and familiarity with, the ISDA SFT documents increases and standardized practices develop, ISDA can update the documentation as necessary. ISDA's MyLibrary platform allows market participants to easily identify any changes to the ISDA SFT documents and understand which version applies to their transactions. Under the SFT Schedule Provisions, the updated ISDA SFT documents will automatically apply for newly entered transactions unless otherwise agreed. The changes would not automatically apply to legacy transactions entered into prior to the update.

ISDA believes certain developments in market practice could enhance efficiency in the SFT markets. While these may not require documentation changes, they are relevant for parties considering potential future use cases of the ISDA SFT documents.

The following possible extensions and future developments have been identified by ISDA members.

New Standardized Language for Specific Scenarios

If the market identifies a need for new standardized language relating to certain types of securities (eg, gilt securities) or specific jurisdictional regulatory requirements, these can be added as annexes to the existing ISDA SFT documents.

In addition, if specific tax representations or jurisdictional tax requirement language is developed by the market, this can be formalized as new tax annexes or provisions for inclusion in an updated version of the ISDA SFT documents. Market participants will have the flexibility to include their choice of any annexes in the SFT Schedule Provisions, depending on their requirements.

[7] See Section 3 of Chapter 2 of the FDL

Support for Segregated Collateral

In recent years, counterparties in the stock loan market have developed structures for holding collateral in third-party segregated custodial accounts, similar to the typical practice for regulatory initial margin for derivatives. Under a segregated account pledge structure, the stock borrower would post its collateral into a segregated account with a third-party custodian subject to a security interest in favor of the stock lender. This structure could easily be added to the ISDA SFT documents as an additional option.

Opportunities for Collateral Practice Alignment

ISDA has published the *Suggested Operational Practices for OTC Derivatives Collateral Process*[8] to encourage standardization and automation of collateral transfers to increase collateral management efficiency and reduce costs. With additional input from securities financing experts, automated workflows and straight-through processing could expand beyond derivatives to SFTs, resulting in holistic collateral operations that would allow firms to manage their capital and liquidity requirements across multiple collateralized products more efficiently. It would also allow better collateral inventory management and pre- and post-trade collateral optimization.

ISDA is collaborating with other trade associations to develop and implement data standards via the Common Domain Model (CDM). This will allow advancements to be implemented across multiple collateral products. These could include digital documentation and eligible collateral representations, which will improve onboarding time and reduce operational errors.

Basel Capital Framework

Given the ISDA Master Agreement now allows for netting of derivatives and SFTs, ISDA believes the Basel capital framework should be reconsidered. While the standardized approach for counterparty credit risk (SA-CCR) was finalized in April 2014, it is becoming evident that the framework needs to be revisited. For example, the current framework does not provide guidance on an exposure calculation across SFTs and derivatives in a standardized framework. In April 2022, ISDA requested that the Basel Committee on Banking Supervision revisit the SA-CCR rules[9].

[8] www.isda.org/a/FDEgE/2021-Best-Practices-for-the-OTC-Derivatives-Collateral-Process-6.7.21-FINAL.pdf

[9] Industry Letter to Basel on revisiting SA-CCR, www.isda.org/2022/04/21/letter-to-bcbs-on-revisiting-sa-ccr/

CONCLUSION

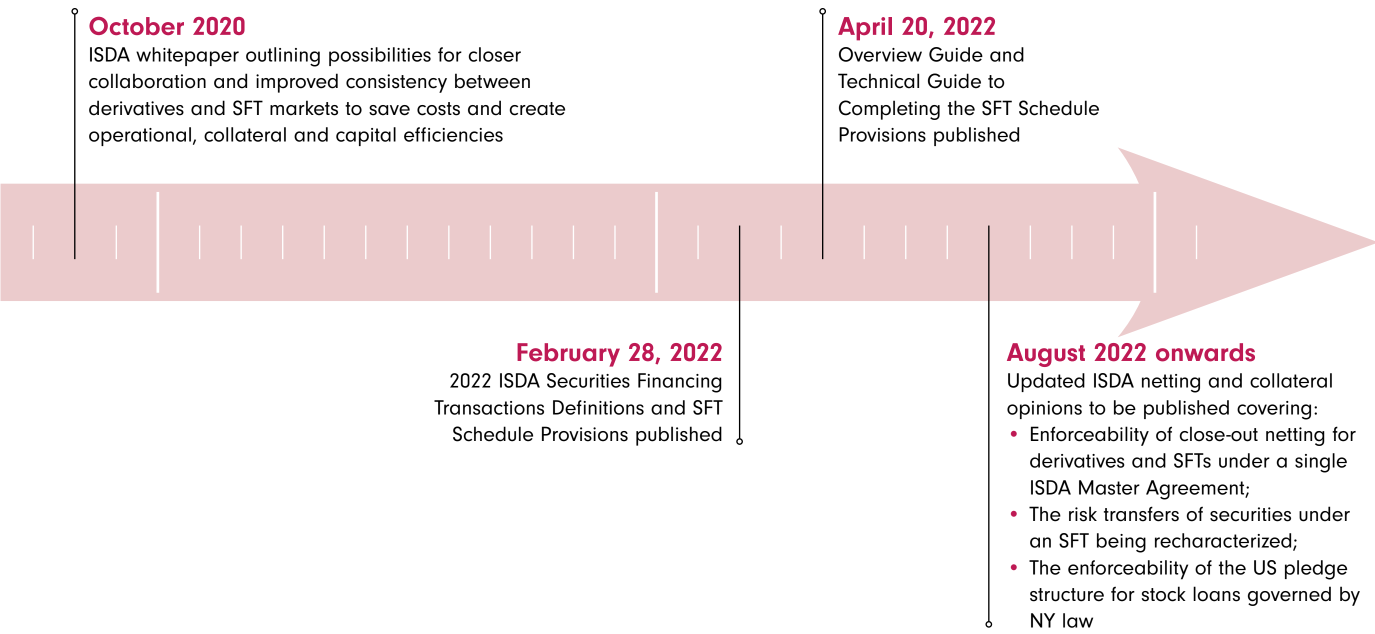
With the publication of the ISDA SFT documents, the market has an easy-to-use template for documenting derivatives and SFTs under one master agreement, with the ability for close-out netting across such transactions. ISDA will continue to expand its documentation and provide additional digitization options (such as further work on the CDM) to create more efficient and safer legal structures, as market demand warrants.

APPENDIX

SFT Documents Timeline and Format

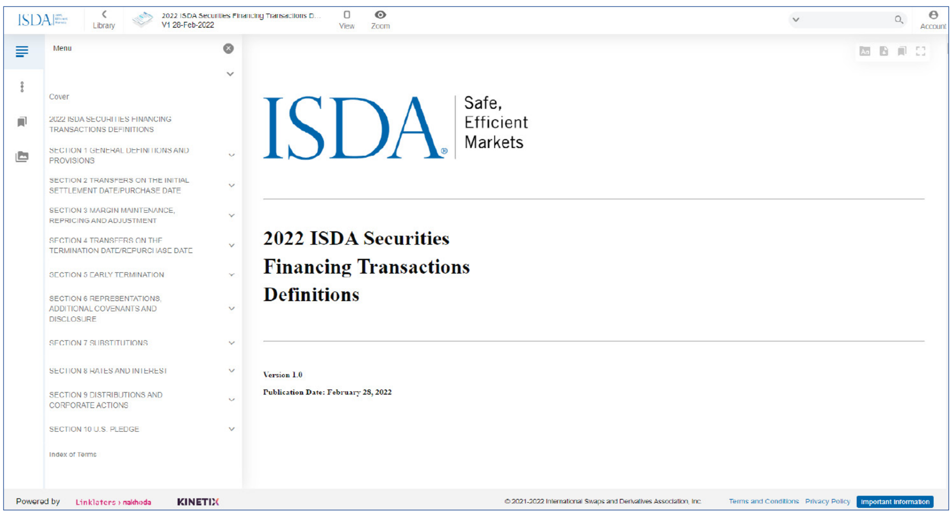
The ISDA SFT documents began to be produced shortly after the 2020 whitepaper and were finally published in February 2022.

Appendix Figure 1: Timeline



The SFT Definitions and the SFT Schedule Provisions are available on MyLibrary[10]. The SFT Schedule Provisions will also be available for negotiation on the ISDA Create documentation negotiation platform in 2023.

Appendix Figure 2: The SFT Definitions on MyLibrary



[10] https://mylibrary.isda.org

ABOUT ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 990 member institutions from 78 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org.
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