ISDA®
International Swaps and Derivatives Association, Inc.

ISDA Operations Committee - Interest Rates Products Working Group

Best Practice Statement

Cash Settlement Payment Dates for early termination options

Background:

The ISDA Operations Interest Rates Products Working Group (IRPWG) became concerned about the high number of outstanding confirmations due to mismatches on the Cash Settlement Payment Dates for early termination options. The issue mainly affected forward starting trades, trades with either a short or long first or last coupon and trades with different roll dates on each leg of the transaction, although vanilla trades were also impacted.

Best practice guideline:

The following best practice was formally agreed in March 2007:

The Cash Settlement Payment Dates for early termination options should be defined by reference to the **Trade Date** and not the Effective Date or any other date.

For novated trades, the **Novation Trade Date** (which is also the Novation Date) should be used.

Scope:

The above rule applies to all interest rate products <u>except</u> the following:
- one-way and Mandatory Early Termination clauses (due to pricing implications);
- cash-settled swaptions which are amended to physically-settled transactions upon expiry, in which case the Cash Settlement Payment Dates should be defined by reference to the Expiration Date.

Benefits:

The benefits of calculating the Cash Settlement Payment Date from the Trade Date are as follows:

i) Applying the tenor of the early termination option to the Trade Date is a straightforward rule unlikely to lead to any ambiguity.

ii) The credit risk on a trade exists from the Trade Date, so applying the tenor from the Trade Date accurately reflects credit department requirements.

iii) Trading systems can be automatically programmed to reflect this approach without the need for complex logic, thereby reducing the time spent on trading and middle office manual input.

iv) Reducing the amount of manual input required facilitates straight through processing and enables confirmations to be executed in a more timely manner.

Commentary:

As a result of the methodology described above, the Cash Settlement Payment Dates will not usually coincide with the Payment Dates under the Transaction and the last optional exercise date may fall just a few days before the Termination Date. The IRPWG considered a proposal to insert a tolerance period of 7 days prior to the Termination Date during which the Optional Early Termination provisions would be deemed inapplicable reflecting the view that these provisions are unlikely to be exercised so close to the termination of the trade. Consensus could not be reached on this point and therefore the proposal was not implemented.

While the IRPWG appreciated that some members would prefer to define the Cash Settlement Payment Date by reference to the Effective Date, it was widely agreed that these early termination options are rarely exercised in practice, and therefore from a risk point of view it was unreasonable to have large numbers of outstanding confirmations due to this issue.

It was also felt that in the event that an option was exercised, the additional time required for a trader to price an intra-coupon trade was negligible compared to the time spent dealing with requests relating to confirmation mismatches.

August 2007

Additional Clarification (i):

Application of mutual credit break clause to a Swaption

- ***If the Swaption is cash settled*** *(as per booking on Trade Date)*
  The break is applied from the Trade Date and is only applied should the credit tenor require a break before the Expiration Date.

- ***If the Swaption is physically settled*** *(as per booking on Trade Date)*
  The break is applied from the Trade Date and covers both the option and underlying swap up to the underlying swap Termination Date.

- ***If the trade is originally booked as cash-settled, but changed to physically-settled upon Expiration Date***
  A break clause / revised break clause would be applied from the Expiration Date as if such date was the Trade Date for the purposes of the ISDA ETOP Best Practice statement.

February 2008

Additional Clarification (ii):

Unadjusted Cash Settlement Payment Dates

In the event that the Cash Settlement Payment Date is schedule to fall on a non business day, specifically, but not limited to, a weekend, the applicable Business Day Convention might cause the Cash Settlement Payment Date to roll to the Termination Date. In this case the Early Termination Option should be documented as usual and the Cash Settlement Payment Date should be stated as the unadjusted date.

Example

Trade Date: 23rd March 2009

Effective Date: 25th March 2009

Termination Date: 25th March 2019

Cash Settlement Payment Date: 23rd March 2019(Saturday)

Business Day Convention: Following or Modified Following

The Cash Settlement Payment Date would therefore roll in line with the relevant Business Day Convention to the 25th March 2019, which is the Termination Date.

The relevant documentation should continue to include the Early Termination Option, and the Cash Settlement Payment Date should be documented as the

unadjusted date, 23rd March 2019, subject to adjustment in line with the applicable Business Day Convention.

March 2009