

## PART 8 - FORWARD RATE AGREEMENTS (FRAs)

### What is a FRA?

- [8.01] A forward rate agreement (FRA) is an agreement between two parties which requires one party to pay an amount to the other party on a certain future date. The amount to be paid and the party who must make the payment are determined by the difference between the contract rate and the interest settlement rate (ie the prevailing market rate at the time of settlement). There is no commitment by either party to lend or borrow the contract amount.

~~AFMA has published two addenda for FRAs. Addendum No. 6 is for A\$ FRAs. Addendum No. 12 is for Non-A\$ FRAs.~~

We have divided this part 8 into two sections commencing after [8.05]. Section A deals with A\$ FRAs; Section B deals with Non-A\$ FRAs.

### How to use this part of the guide

- [8.02] **Have you used ISDA documents before?** If you are not familiar with the ISDA documents, we recommend that you:
- (a) read the User's Guide (see [Volume 2.02]) and the ISDA Master Agreement (see [Volume 2.01]);
  - (b) read parts 3 and 5 of this guide;
  - (c) read this part of the guide.

If you are familiar with the ISDA documents, we recommend that you start by reading this part and refer to the other parts as necessary.

As stated previously, this guide is prepared on the assumption that you use the 1991 Definitions and the 1992 ISDA Master Agreement.

### Preliminary issues

- [8.03] **Do you want a separate ISDA Master Agreement?** Participants have the choice of using one ISDA Master Agreement for all Transactions including FRAs or using a separate ISDA Master Agreement for FRAs only.

We consider that using one agreement is preferable for the following reasons:

- (a) using one agreement for all Transactions simplifies documentation and reduces the number of agreements required;
- (b) it gives the parties the option of specifying net payments for corresponding payment dates for all Transactions giving them the ability to reduce the settlement risk with the counterparty; and

- (c) as all Transactions would then be regulated by the same agreement, the amount payable on early termination will be payable by reference to aggregate net exposures under all Transactions and therefore would not exclude amounts payable in connection with FRAs.

However, even where separate ISDA Master Agreements are used in respect of different kinds of Transactions, it is possible for the parties to provide that a single net amount will be payable between the parties should an Early Termination Event occur. Suggested wording to achieve this is contained in [18.22].

- [8.04] **Gaming and wagering and contracts of insurance.** See our comments in [3.16]. The same issues arise in relation to FRAs and our conclusion in relation to FRAs is the same.

**Tax consequences.** This guide has not been prepared with a view to participants being able to achieve any particular tax consequence in entering into Transactions. Accordingly, participants must separately consider the tax consequences of following the recommendations in this guide.

## Market conventions

- [8.05] FRAs are governed by various Australian market conventions published from time to time by organisations such as AFMA and Australian Treasury Operations Association (ATO). Participants are expected to comply with those conventions.

## SECTION A - A\$ FRAs

### How to document A\$ FRAs

- [8.06] **\*\*[8.06] - [8.12] are relevant only to A\$ FRAs\*\*.** To document A\$ FRAs under Australian law using the ISDA Master Agreement you should: ensure that you have executed an ISDA Master Agreement with your counterparty. Recommendations for completing the schedule to an ISDA Master Agreement are set out in part 5 of this guide.

~~? — ensure that you have executed an ISDA Master Agreement with your counterparty. Recommendations for completing the schedule to an ISDA Master Agreement are set out in part 5 of this guide; and~~

~~? — attach "September 1992 Australian Addendum No. 6 — A\$ Forward Rate Agreements" to your ISDA Master Agreement.~~

- [8.06A] Until 1 January 2002 AFMA recommended using Australian Addendum No. 6 - A\$ Forward Rate Agreements. This is no longer recommended for the following reasons:

(a) Paragraph (1). The designation by paragraph (1) of any A\$FRA as a Transaction under the ISDA Master Agreement is not addressed by ISDA Definitions. Parties should carefully consider whether they require such a clause. [5.34](4) provides suggested wording for an equivalent of this paragraph. Parties wanting to use such a clause should include it in Part 5 of the Schedule to their ISDA Master Agreement.

(b) Paragraph (2). Unnecessary. The 2000 ISDA Definitions contain equivalents.

Care! If FRAs are confirmed through Austraclear, parties should consider whether to include a clause in their Schedule incorporating a dictionary of comparative terms. See [U1.11] for a list of comparative terms and [6.35] for

an example of a letter acknowledging that transactions may be confirmed through Austraclear ([6.35] relates to swaps and would need to be amended to cover FRAs).

The “Settlement Sum” definition was incorporated into the Addendum to reflect the method normally used in Australia and New Zealand for calculating AUD FRAs and NZD FRAs. The “Settlement Sum” definition is not equivalent to “FRA Amount” in the 2000 ISDA Definition (The 2000 ISDA Definitions use the “swap basis” calculation method). The suggested clause at [5.34](5) sets out a suggested additional clause which can be inserted in a Confirmation or the Schedule to an ISDA Master Agreement when parties want to continue to use the “Settlement Sum” formula.

(c) **Paragraph (3).** It appears that there may be some variances in practice in calculating the Interest Settlement Rate when it is AUD-BBR-BBSW if the Calculation Period is other than 1, 2, 3, 4, 5 or 6 months. AFMA recommends that parties clarify in their confirmations or elsewhere when the Reset Date is to occur and what Designated Maturity is to apply depending on the length of the Settlement Period.

(d) **Paragraph (4).** Unnecessary. Covered by Section 3.6 of the 2000 Definitions.

(e) **Paragraph (5).** Unnecessary. The suggested clause at [5.34](5) incorporates this wording.

(f) **Paragraph (6).** Unnecessary. If participants want to specify the method of payment, this can be done in the Confirmation or by standing payment instructions.

(g) **Paragraph (7).** Paragraph (7)(a) is unnecessary due to the way in which “Confirmation” is defined in the ISDA Master Agreement.

Paragraph (7)(b) is not necessary if the relevant ISDA Definitions are expressly incorporated either in Confirmations or the Schedule to the ISDA Master Agreement. However, if they are not expressly incorporated, parties should carefully consider whether they require such a clause. [5.34](4) provides suggested wording for an equivalent of this paragraph. Parties wanting to use such a clause should include it in Part 5 of the Schedule to their ISDA Master Agreement.

Paragraph (c) and (d) are **not** addressed by the ISDA Definitions. See comments at [8.06A](b) under the paragraph headed **Care!**.

[8.07] **For historical comparison purposes, b**Behind the yellow sheet at [8.12] is a copy of Australian Addendum No. 6.

Our commentary on the paragraphs in Australian Addendum No. 6 ~~are~~ **that applied up to 31 December 2001** is as follows:

(a) **Paragraph (1).** This states that by incorporating Australian Addendum No. 6 in their ISDA Master Agreement the parties agree that every A\$ FRA between them is governed by the ISDA Master Agreement whether or not its confirmation refers to the Master Agreement or Australian Addendum No. 6 and whether or not the parties state in their confirmation that the A\$ FRA is governed by the ABAFRA Terms.

In the May 1990 Dealing Conventions and Market Terminology booklet published by AFMA the "ABAFRA Terms" are set out. Until the publication of Australian Addendum No. 6 in this guide, virtually all A\$ FRAs were governed by the ABAFRA Terms. However, given the general market trend towards documenting all derivatives under the ISDA Master Agreement, AFMA's FRA committee has resolved to encourage the market to cease using the ABAFRA Terms and instead to document A\$ FRAs under an ISDA Master Agreement. The ABAFRA Terms will not be updated.

The wording of paragraph (1) recognises the practical issues involved in making such a change. It is drafted on an assumption that once two parties agree to add Australian Addendum No. 6 to their ISDA Master Agreement, all **past and future** A\$ FRAs between them are intended to be governed by the ISDA Master Agreement. The approach has been specially approved by AFMA's FRA committee and differs from the approach adopted for other Australian Addenda eg FX where prior transactions are not automatically covered.

Paragraph (1) recognises that at an operational level, there may still be instances, after the changeover, when Confirmations for A\$ FRAs either do not refer to the ISDA Master Agreement or continue to state that the FRA is governed by the ABAFRA Terms. Paragraph (1) states that even in those circumstances the A\$ FRA will be governed by the ISDA Master Agreement and not the ABAFRA Terms.

Of course, it is still possible to document A\$ FRAs under the ABAFRA Terms. If you do not have an ISDA Master Agreement with a counterparty or, for some reason, you do not want to add Australian Addendum No. 6 to your ISDA Master Agreement with a counterparty, you can continue to document A\$ FRAs under the ABAFRA Terms. However, AFMA's FRA Committee strongly encourages you, unless it is impractical to do so, to make the change to documenting A\$ FRAs under Australian Addendum No. 6.

### **Is there a substantive difference between Australian Addendum No. 6 and the ABAFRA Terms?**

In relation to the normal operation of an A\$ FRA, the answer is no. The formulae for calculating payments due under an A\$ FRA in the normal course are in essence identical. However, the provisions which apply on early termination are different. Under the ABAFRA Terms there is a concept of an Accelerated Settlement Date. This is not included in Australian Addendum No. 6. Instead, section 6 of the ISDA Master Agreement would apply meaning that the procedure for calculating a Settlement Amount for all Terminated Transactions would be followed. This involves obtaining mark to market quotations for each Transaction and netting off positive and negative quotations to arrive at a net exposure of one party to the other. This is the same procedure as would be followed if, say, interest rate swaps were terminated under an ISDA Master Agreement.

- (b) **Paragraph (2).** This sets out a series of definitions. It closely follows the definitions clause in the ABAFRA Terms. Here are some differences:

**"Business Day".** This definition no longer provides that it must be a business day in both Sydney and Melbourne. Instead it is linked to the city or cities where payments are or are potentially payable. In addition, the Reserve Bank of Australia must be conducting a clearing exchange in that city or those cities.

**"Interest Settlement Rate"**. This definition simply states the rate to be AUD-BBR-BBSW unless otherwise agreed. AUD-BBR-BBSW is set out on page 16 of the 1991 Definitions. In essence it is the same rate as the Interest Settlement Rate set out in the ABAFRA Terms. However, clause 3 of the ABAFRA Terms is not included in Australian Addendum No. 6. This is because:

- (i) Clause 3(a) is effectively built into the fall back mechanism in AUD-BBR-BBSW;
- (ii) Clause 3(b) is unnecessary. If AUD BBR BBSW will not provide an appropriate rate for your FRA and you know this when you enter into the FRA, you must agree an alternative Interest Settlement Rate and specify it in your Confirmation.

**"Maturity Date"; "Settlement Date"**. Each of these dates is subject to adjustment in accordance with the Modified Following Business Day Convention (see clause 4 of Australian Addendum No. 6). This term is defined on page 8 of the 1991 Definitions.

- (c) **Paragraph (3)**. This clarifies which rate on the BBSW screen is applicable to a particular A\$ FRA. There are two terms used in the definition of AUD-BBR-BBSW which need clarification in the context of A\$ FRAs. They are:
  - (i) Reset Date which is the Settlement Date of an A\$ FRA; and
  - (ii) Designated Maturity which varies depending on the length of the Settlement Period.
- (d) **Paragraph (4)**. This provides for the Settlement Date or Maturity Date to be adjusted in accordance with the Modified Following Business Day Convention (defined on page 8 of the 1991 Definitions).
- (e) **Paragraph (5)**. This is equivalent to clause 2 in the ABAFRA Terms and sets out the basic payment obligation under an A\$ FRA.
- (f) **Paragraph (6)**. This clarifies the required payment method.
- (g) **Paragraph (7)**. This contains an acknowledgment of the various methods available for confirming A\$ FRAs and deems each to be a Confirmation.

It also contains the wording which is in the opening part of the Confirmations recommended by ISDA (see Exhibit 1 to the 1991 Definitions (p.57)). This is designed to remove the necessity for inserting, and recognises that it is impractical to insert, these words on all types of Confirmations.

It also contains wording which recognises that standard terminology is not used in all types of Confirmations.

## **Guide for completing Confirmations for A\$ FRAs**

- [8.08] (a) **Confirmation methods**. The following methods can be used to confirm. It is up to the parties to agree which method or methods they will use:

Austraclear  
Telephone  
Telex  
Letter  
Swift MT340 message  
Reuters direct dealing system  
Telerate trading service  
Facsimile

Following is a recommended wording for Austraclear and letters. However this wording and all confirmation procedures must be completed in accordance with market conventions.

- (b) **Have you signed an ISDA Master Agreement?** Although not recommended, it is recognised that Transactions might be entered into before the parties have signed an ISDA Master Agreement. If that is the case, we recommend that you insert the following paragraphs in the Confirmation or exchange letters agreeing to the substance of the following:

"You and we agree promptly to negotiate and sign a 1992 multicurrency - cross border version of the ISDA Master Agreement (as published by International Swaps and Derivatives Association, Inc.). Once an agreement based on that document is signed, this Confirmation is to supplement, form part of, and be subject to that agreement as amended and supplemented from time to time. All provisions contained in that agreement govern this Confirmation except as expressly modified below.

Until the agreement is signed, this Confirmation supplements, forms part of, and is subject to the terms contained in that document as if you and we had signed that document without amendment except that:

- (a) the Termination Currency is to be Australian dollars; and
- (b) the Governing Law is to be the laws of the state of [New South Wales]; ~~and~~
- ~~(c) September 1992 Australian Addendum No. 6 — A\$ Forward Rate Agreements as published in AFMA's 1997 Guide to OTC Documents is deemed to be incorporated in the document."~~

You must appreciate that this is not a complete substitute for signing an ISDA Master Agreement because there are numerous variables in the ISDA Master Agreement which will not operate until an election has been made. These are easily identified by looking through the Schedule to the ISDA Master Agreement. You should negotiate and sign an ISDA Master Agreement as soon as possible after adopting this approach.

[8.09] **Austraclear**

- (a) FRAs between full members of Austraclear should be confirmed through Austraclear unless otherwise agreed at the time of dealing.
- (b) Information to be entered

<b>Menu:</b>	FRTRADE - Forward Rate Agreement Entry
<b>Side of the trade:</b>	"B" if you are the Borrower "L" if you are the Lender
<b>Other member:</b>	Counterparty mnemonic
<b>Deal Date:</b>	Date transaction is entered into
<b>Settlement Date:</b>	
<b>Maturity Date:</b>	
<b>Use BBSW (Y/N):</b>	"Y" unless a rate other than AUD-BBR-BBSW is to be used
<b>Amount:</b>	Contract Amount
<b>Rate:</b>	Contract Rate
<b>Comment:</b>	Details of Interest Settlement Rate if it is to be other than AUD-BBR-BBSW

- (c) The A\$ FRA is given a number when this information is entered. It will be listed in Austraclear as "Confirmed" once both parties have entered details and all details match.

[8.10] **Letter**

- (a) Normally this form of confirmation would not be used if both parties are full members of Austraclear.
- (b) Suggested form of letter:

[Letterhead of Party A]	[Date]
[Name and Address of Party B]	
Dear	
<b>Forward Rate Agreement</b>	
The purpose of this letter is to confirm the terms and conditions of a forward rate agreement entered into between us on the Deal Date specified below.	
Our reference:	
Deal Date:	
Contract Amount:	
Settlement Date:	
Maturity Date:	
Settlement Period (days):	
Contract Rate:	
Borrower:	
Lender:	
Please confirm that this letter correctly sets out the terms of our agreement by executing the copy of this Confirmation enclosed for that purpose and returning it to us.	
	Yours sincerely [name of party preparing Confirmation]
	By: Name:
	Title:
Confirmed as of the date first written: [name of other party]	
	By: Name: Title:

[8.11] **Settlement Date confirmation**

Some parties may choose on the Settlement Date to confirm the Interest Settlement Rate and Settlement Sum either by Austraclear or letter. If this procedure is to be adopted, the parties should agree which party or parties are to issue such a confirmation on the Settlement Date. A suggested form of letter confirmation follows. It should be appropriately amended if other forms of confirmation are used.



[Letterhead of Party A]

[Date]

[Name and Address of Party B]

Dear

**Settlement Date confirmation**

The purpose of this letter is to confirm the Interest Settlement Rate and Settlement Sum for the following forward rate agreement.

FRA Reference Number:      Borrower:  
Lender:

Deal Date:

Contract Amount:

Settlement Date:

Maturity Date:

Settlement Period (days):

Contract Rate:

Borrower:

Lender:

Interest Settlement Rate:

Settlement Sum:

Yours sincerely

[name of party preparing Confirmation]

By:

Name:

Title: