Credit Supernova

The 2014 ISDA Credit Derivatives Definitions

Mark Brown, Suzanna Brunton , Simon McKnight & Lala Phillips

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Objectives

The objectives of this session are:

> to introduce some of the key new definitions and provisions in the 2014 ISDA Credit Derivatives Definitions

> outline the timing for implementation of the 2014 Definitions and

> consider the impact of the 2014 Definitions on issuers and arrangers of credit linked notes

Outline of today's briefing

- Background
- Key provisions in the 2014 Definitions
  - Financial Reference Entity Terms
  - Asset Package Delivery
  - Sovereign Restructurings
  - Currency redenomination
  - Restructuring
  - Standard Reference Obligation and Substitute Reference Obligation
  - Successor provisions
  - Obligation and Deliverable Obligation
  - Other notable changes
- What happens now?
- Impact on Credit Linked Notes

Background

Background


Government bail-ins
EU Bank Recovery and Resolution Directive
Clearing
Auctions experience
2014 Definitions
Sovereign debt restructuring
Credit Events
Eurozone crisis
Successors

Key provisions in the 2014 definitions

The 2014 ISDA Credit Derivatives Definitions

- The 2014 Definitions revise, consolidate and simplify the 2003 ISDA Credit Derivatives Definitions
- July 2009 Supplement and 2005 Matrix Supplement provisions have been consolidated into the 2014 Definitions
- New provisions for Financial Reference Entities and Asset Package Delivery

Financial Reference Entity Terms

Financial Reference Entities

Background:

> Restructurings of financial entities during the crisis led to review of the suitability of the Restructuring Credit Event

> Credits Events highlighted problems with preserving deliverability of the obligations

> Bail-in legislation will make bail-in provisions more common – these would fail to trigger CDS under the 2003 Definitions and may prevent delivery

  > Exchange/expropriation of subordinated debt led to delivery of senior debt and low recovery by subordinated bondholders

Financial Reference Entity Terms

> New concept of Financial Reference Entity Terms (FRET) which may be specified in the confirmation for a CDS
  - application of FRETs to a CDS will switch on and/or impact the application of certain provisions in the 2014 Definitions
  - incorporation via Financial Transaction Types in the ISDA Credit Derivatives Physical Settlement Matrix (e.g. 'European Financial Corporate' Transaction Type)

> New Governmental Intervention Credit Event
> Asset Package Delivery
> Senior/Subordinated debt split
> Preservation of deliverability for express bail-in language

Governmental Intervention

> Government bail-ins of bank debt have tested the limits of the Restructuring Credit Event

> The result has been the introduction of a new Governmental Intervention Credit Event

> "Governmental Intervention" will be triggered where:

(i) as a result of the action or announcement of a Governmental Authority

(ii) pursuant to, or by means of, a restructuring and resolution law or regulation applicable to the relevant Reference Entity

(iii) certain binding changes are made to the Obligations of the Reference Entity

(iv) irrespective of whether such event is expressly provided for under the terms of the Obligation

Governmental Intervention (cont.)

- Degree of overlap with Restructuring Credit Event
- Governmental Intervention covers a broader range of changes which may be made to the terms of an obligation than Restructuring including:
  - expropriation, transfer or other event which mandatorily changes the beneficial holder
  - mandatory cancellation, conversion or exchange
  - any event analogous to any of the events specified
- The event only has to be binding – does not have to bind all holders
- No requirement for deterioration in creditworthiness
- No Multiple Holder Obligation requirement

Anticipatory bail-in provisions

- Provisions which anticipate a bail-in would prevent a Restructuring Credit Event but not a Governmental Intervention
- Debt with a bail-in provision written into its terms may still qualify as an Obligation and a Deliverable Obligation, notwithstanding that such term might otherwise cause it to fail one of the Obligation/Deliverable Obligation Characteristics
- Permitted Contingency - Express write-down provisions contemplating a bail-in will not be taken into account when calculating the Outstanding Principal Balance of a Deliverable Obligation

Senior/subordinated split

- Senior and subordinated CDS for a Reference Entity will be treated independently of each other for the purposes of:

  (i) Governmental Intervention

  (ii) Restructuring

  (iii) determining the relevant Successor(s)

- Governmental Intervention or Restructuring of a Subordinated Obligation will not trigger a Senior Transaction
- Governmental Intervention or Restructuring of a Further Subordinated Obligation will not trigger a Subordinated Transaction or a Senior Transaction
- Successor(s) for Senior Transactions will be determined by reference to Senior Obligations
- Successor(s) for Subordinated Transactions will be determined by reference to Subordinated Obligations

Asset Package Delivery

Asset Package Delivery for FRETs

- New Asset Package Delivery provisions
- The Asset Package Delivery provisions seek to preserve deliverability of the restructured obligations of a Financial Reference Entity (or a Sovereign)
- Asset Package Delivery will apply if an Asset Package Credit Event (APCE) occurs
- APCE does not need to be the Credit Event that triggers settlement BUT
- APCE must occur on or after the Credit Event Backstop Date for the triggering Credit Event

Asset Package Credit Event

> An Asset Package Credit Event is a:
  - Governmental Intervention in respect of a Financial Reference Entity
  - Restructuring Credit Event in respect of the Reference Obligation of a Financial Reference Entity where Governmental Intervention is specified in the Confirmation but such Restructuring does not constitute a Governmental Intervention or
  - Restructuring Credit Event in respect of a Sovereign

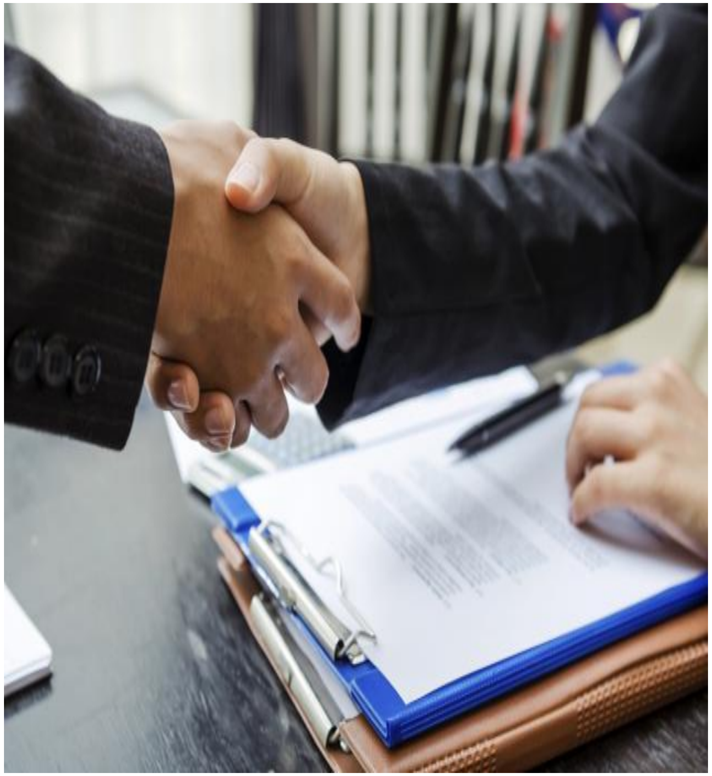
Asset Package Credit Event: restructuring of Reference Obligation

> Restructuring of Financial Reference Entity often occurs without actual government intervention

> Asset Package Credit Event therefore includes Restructuring Credit Event if FRETs and Governmental Intervention apply

> The Restructuring must occur in respect of the Reference Obligation

> The Asset Package is the package resulting from the Reference Obligation



Asset Package for Financial Reference Entities

- The Asset Package following a Governmental Intervention is the package resulting from a Prior Deliverable Obligation
  - Prior Deliverable Obligation - an existing obligation of the Reference Entity which immediately prior to the relevant bail-in event constituted a Deliverable Obligation
- The Asset Package following a Restructuring in respect of the Reference Obligation is the package resulting from the Reference Obligation
- The Asset Package which results from the Prior Deliverable Obligation or Reference Obligation will be deliverable into the relevant Auction or under a CDS
- The Asset Package Delivery provisions apply even where there are effectively no resulting assets e.g. the bonds have been expropriated. In this situation, the asset package is deemed to be zero

Sovereign Restructurings

Sovereign Restructuring Credit Event

> Restructuring Credit Event in respect of a Sovereign Reference Entity is also an Asset Package Credit Event

> The Asset Package Delivery provisions which apply to Financial Reference Entities therefore also apply following a Sovereign Restructuring BUT

  – Asset Package Delivery for Sovereigns ONLY applies following a Restructuring

  – the Asset Package is based on the Package Observable Bonds not on the Prior Deliverable Obligations

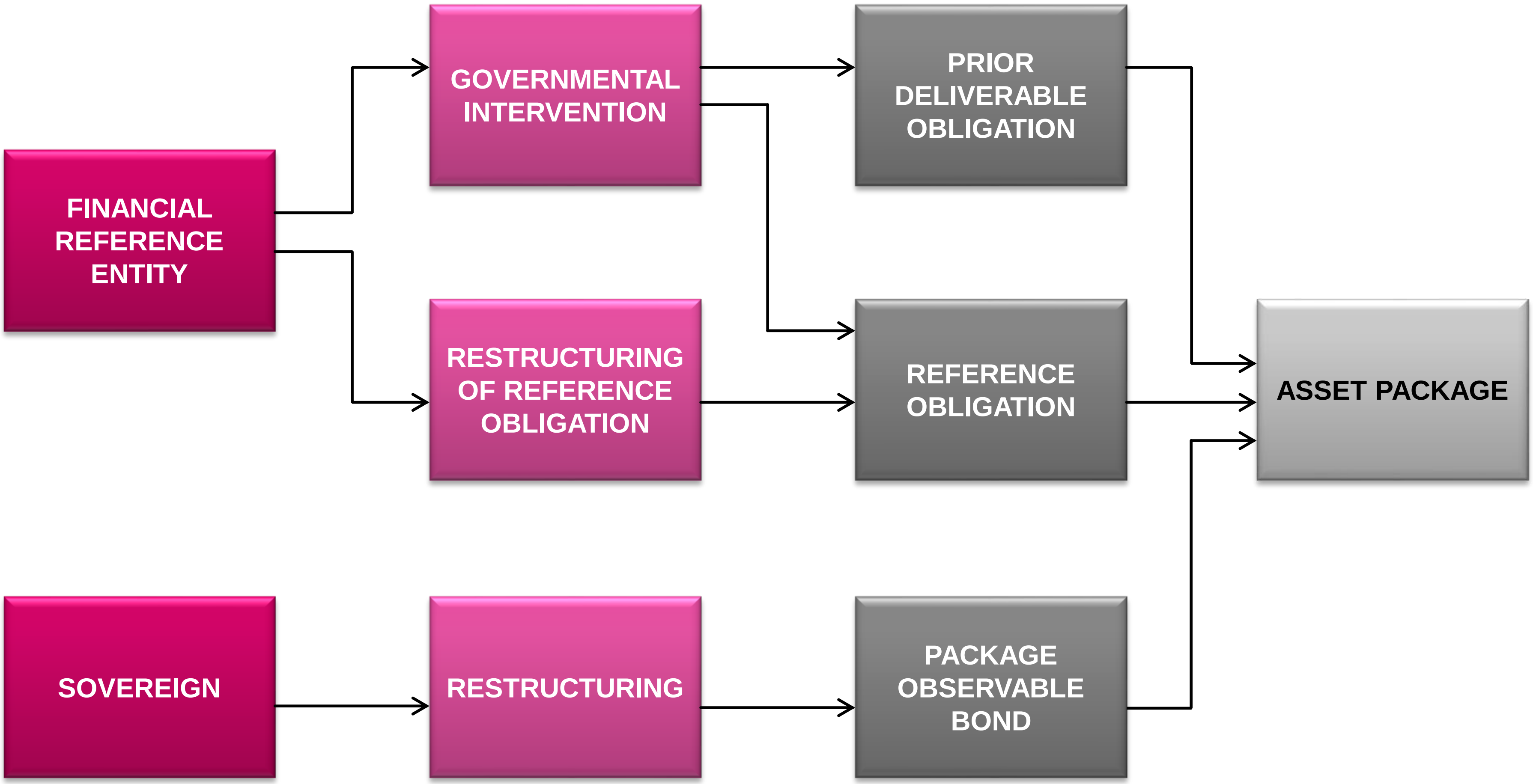
  – only applies if one or more Package Observable Bonds exist

Sovereign Asset Package Delivery

> Package Observable Bonds

- benchmark obligations of the relevant Sovereign which are identified by ISDA for these purposes and published on its website
- the relevant Package Observable Bond must have constituted a Deliverable Obligation immediately preceding the date on which the relevant Asset Package Credit Event was legally effective
    > the list of Package Observable Bonds for a particular Sovereign will be selected in accordance with criteria to be set out in the DC Rules and published on the ISDA website

Asset Package Delivery: overview



Currency redenomination

Currency redenomination

- Eurozone crisis raised questions as to whether a redenomination into a local domestic currency would trigger a Credit Event
  - Answer depended on what the new currency of denomination was
- Also raised the question of whether redenominated obligations would be Deliverable Obligations
- These questions have been addressed in the 2014 Definitions

Currency redenomination (cont.)

- A redenomination into local domestic currency will be a Restructuring unless the new currency is in a specified list of permitted currencies
  - fixed list of 6 permitted currencies set out in the definition of Restructuring for this purpose (includes any successor currency thereto)
- The redenomination still needs to occur as a result of a deterioration in creditworthiness of the Reference Entity
- Special rules apply for redenomination out of euros

Currency redenomination – Euro exit

- A redenomination out of euros will not be a Restructuring if:
  - (i) the redenomination results from action of a Governmental Authority of an EU Member State
  - (ii) there was a freely available market rate of conversion between euros and the other currency at time of redenomination, and
  - (iii) there is no write-down of interest, principal or premium as determined by reference to such market rate of conversion
- No requirement for a deterioration in creditworthiness where redenomination out of euros results from action of a Governmental Authority of an EU Member State

Currency redenomination – Deliverable Obligations

- Will the redenominated Obligations be Deliverable Obligations?
  - Under 2003 Definitions if Specified Currency is a Deliverable Obligation Characteristic and the new currency is not a Specified Currency (usually Standard Specified Currencies) then the obligation will not be deliverable
  - Standard Specified Currencies under 2014 Definitions includes successor currency to euro in Germany and France and any successor currency to the euro as a whole
  - Specified Currency - amended to provide that redenomination out of euro as a result of action taken by a Governmental Authority of general application in the jurisdiction will not prevent that obligation from being deliverable
- Redenomination out of any other currency into a non-Standard Specified Currency results in the obligation being non-deliverable

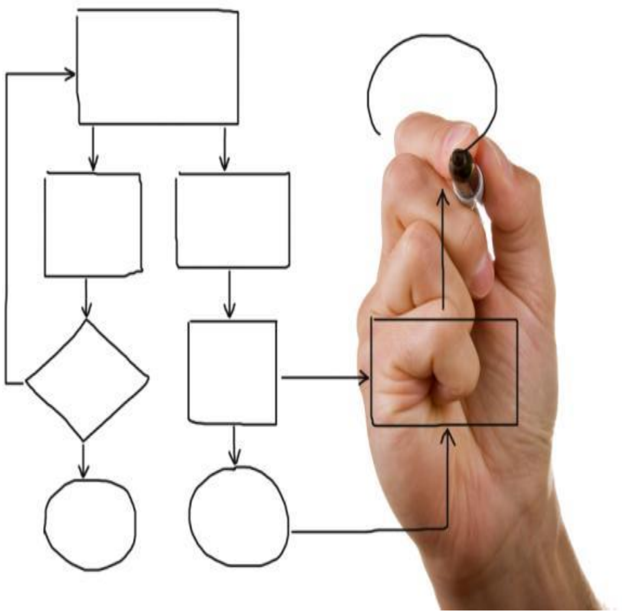
Currency redenomination – Failure to Pay?

- Clarification that a 'good' redenomination followed by currency depreciation will not be a Failure to Pay Credit Event
- A redenomination imposed by a Governmental Authority which does not itself constitute a reduction in principal, premium or interest (as determined by reference to the freely available market rate of conversion at the time of redenomination) will not subsequently be a Failure to Pay Credit Event if that new currency depreciates against the old currency

Restructuring

Restructuring

- The Restructuring Credit Event has been revised
  - a write-down of interest, principal or premium can occur by way of redenomination
  - addresses redenomination out of euro
  - a bond exchange can constitute a restructuring if, on comparison of the terms of the new bond to the old bond, one of the events in the definition of Restructuring has occurred

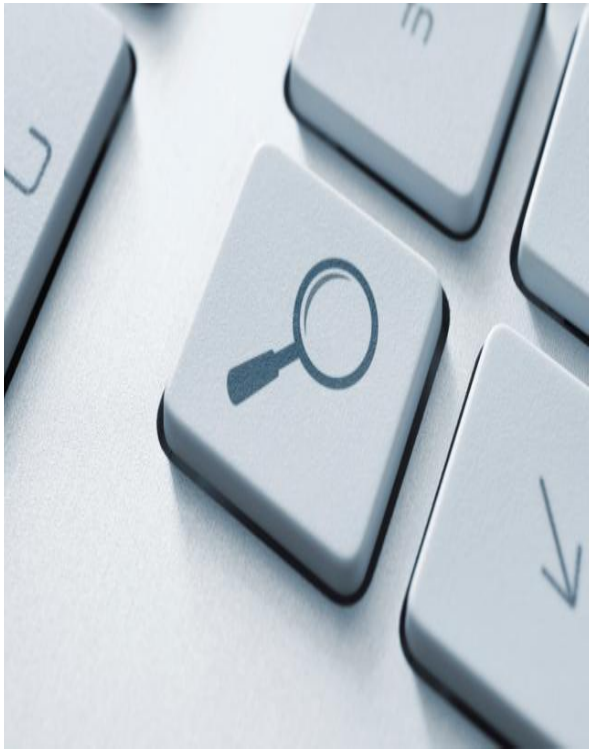


Old R, Mod R and Mod Mod R

- Old R no longer requires delivery of a Credit Event Notice following a DC Credit Event Announcement
- No Enabling Obligation requirement when determining the maturity date of the Deliverable Obligations for a Mod R and Mod Mod R
  - CDS will apply the Auction Final Price for the Auction where its Scheduled Termination Date falls into the relevant date range for such Auction
- Mod Mod R - a Restructured Bond or Loan will now be delivered into the maturity ‘bucket’ into which its pre-Restructuring maturity date fell (or into which its restructured maturity date falls, if earlier), provided that it matures prior to the 10-year Limitation Date
- Reduction in number of maturity ‘buckets’ and maximum number of Auctions for Mod Mod R

Standard Reference Obligation and Substitute Reference Obligation

Standard Reference Obligation



- New Standard Reference Obligation provisions
- Parties will no longer need to specify a Reference Obligation for their CDS
- the Reference Obligation will be the obligation specified as the Standard Reference Obligation for the relevant Reference Entity for the relevant Seniority Level on a SRO List to be published by ISDA
- Rules for determining the Standard Reference Obligation (and any Substitute Reference Obligation) for a particular Reference Entity at any time not yet published
- Senior Level and Subordinated Level
- Facilitates clearing of CDS

Standard Reference Obligation (cont.)

- Standard Reference Obligation results in fungibility of trades and removes basis risk for parties hedging CDS on the same Reference Entity
- Parties can elect disapply provisions and specify an alternative Non-Standard Reference Obligation
  - Non-Standard Reference Obligation cannot be an obligation of an entity other than the Reference Entity unless the parties expressly override the provision of the 2014 Definitions on this point
  - Choosing a Non-Standard Reference Obligation may have consequences for clearing the transaction

Substitute Reference Obligation

> New definition of Substitution Event for Non-Standard Reference Obligation

> Substitution Event

  (i) redemption in whole of the Non-Standard Reference Obligation

  (ii) a reduction in the aggregate amounts due under the Non-Standard Reference Obligation to below USD 10,000,000 and

  (iii) Non-Standard Reference Obligation ceases to be an obligation of the relevant Reference Entity other than due to the existence or occurrence of a Credit Event

> The Substitute Reference Obligation provisions seek to preserve the same deliverability analysis in respect of the Substitute Reference Obligation as applied to the original Reference Obligation

Substitute Reference Obligation (cont.)

- Detailed selection criteria for the Substitute Reference Obligation for a Non-Standard Reference Obligation are set out in the 2014 Definitions
- Equivalent Substitute Reference Obligation provisions will apply to the Standard Reference Obligation and will be set out in the DC Rules
- If a Substitution Event occurs in respect of the Reference Obligation and such obligation satisfied the Deliverable Obligation Category and Characteristics when issued and immediately prior to the date of the relevant Substitution Event, any substitute Reference Obligation must also satisfy such Deliverable Obligation Category and Characteristics
- If the Reference Obligation did not satisfy the Deliverable Obligation Characteristics, the Substitute Reference Obligation should be an obligation which fails the deliverability criteria on the same ground
  - failing which, an obligation which is a Deliverable Obligation will be selected
- The provisions generally look for a Bond first as the Substitute Reference Obligation, failing which a Loan will be selected

Successor provisions

Universal Successor

- New definition of a Universal Successor
- An entity which assumes all obligations (including at least one Relevant Obligation) of a non-Sovereign Reference Entity in circumstances where the Reference Entity has ceased to exist or is in the process of being dissolved
- Applies to such successions from and including 1 January 2014
- Universal Successor exempt from 90 day look-back period
- Reference Entity must not have issued/incurred any Borrowed Money obligation following date of assumption

Steps Plan

> New concept of a Steps Plan for corporates

> Concept of a Succession Event removed entirely from the 2014 Definitions – no requirement for corporate event in addition to movement of debt

> Aggregates all individual transfers of debt which take place as part of a pre-determined transfer plan when determining whether or not sufficient debt has been transferred to enable a Successor to be determined (n.b. evidence requirement and new Eligible Information concept)

> New definition of Succession Date which, for the purposes of a Steps Plan, will generally be the effective date of the final transfer pursuant to such Steps Plan

Sovereign Succession Event

- The 2014 Definitions retain the concept of a Succession Event for Sovereigns - a Sovereign Succession Event
- Methodology for determining a Successor aligned to the threshold methodology applied to corporate Reference Entities
- CDS referencing a Sovereign Reference Entity in relation to which a Sovereign Succession Event occurs will follow the entity/entities to which the debt is transferred, depending on the percentage of the debt transferred
- Universal Successor provisions do not apply to Sovereign Reference Entities

Obligations and Deliverable Obligations

Qualifying Guarantee

- Amendments to the definition of **Qualifying Guarantee**
- A guarantee with the following provisions may now qualify as a Qualifying Guarantee:

  (i) a Fixed Cap

  (ii) a provision providing for a Permitted Transfer of the guarantee

  (iii) provisions providing for a release as a result of a Governmental Intervention (if the Reference Entity is a Financial Reference Entity)

  (iv) Solvency Capital Provisions which anticipate a release from payment to meet Solvency II requirements and/or

  (v) a release provision which has been 'switched-off' by the occurrence of a bankruptcy or failure to pay by the Underlying Obligor
- Statutory guarantees are expressly included within the definition of Qualifying Guarantee

Outstanding Principal Balance

New definition of Outstanding Principal Balance

> Three-step process which asks:

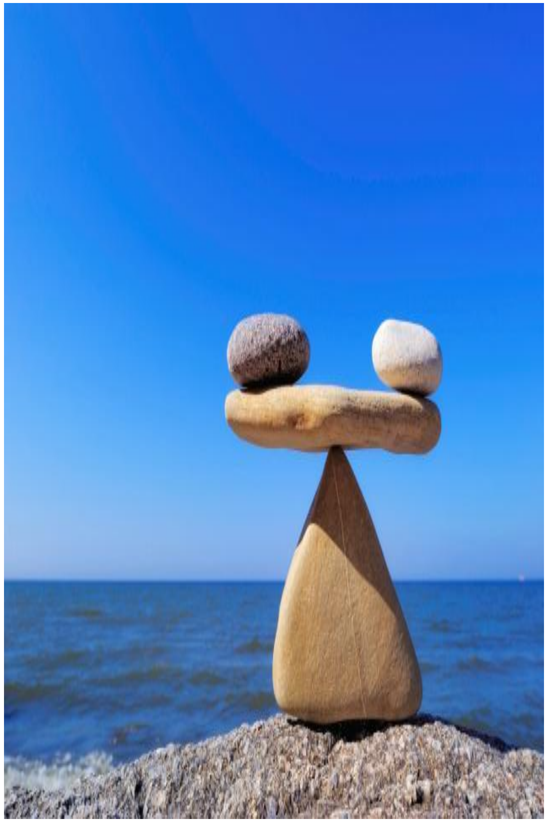
(i) what is the principal due?

(ii) what amount of that is non-contingent?

(iii) if such non-contingent amount was payable today, what is the Quantum of the Claim in respect thereof?

> Permitted Contingencies include Solvency Capital Provisions and provisions anticipating a Governmental Intervention

> The Not Contingent Deliverable Obligation Characteristic has been removed from the 2014 Definitions



Other notable changes

Other notable changes

> Subordinated European Insurance Terms:
  - subordinated debt containing provisions contemplating a deferral of maturity to comply with solvency requirements (Solvency Capital Provisions) will not fail the Maximum Maturity Deliverable Obligation Characteristic
  - Solvency Capital Provisions are a Permitted Contingency taken into account in determining the Outstanding Principal Balance of a Deliverable Obligation

> Event Determination Date split into two separate provisions:
  - market standard trades which provide for Auction Settlement to apply and for both parties to the trade to be a Notifying Party (Event Determination Date) and
  - all other trades (Non-Standard Event Determination Date)

Other notable changes (cont.)

- Conditions to Settlement are no longer required
  - Settlement is triggered by an Event Determination Date and (if applicable) delivery of a Notice of Physical Settlement
- Not Domestic Issuance Deliverable Obligation Characteristic no longer applies to Loans
- Escrow and novation provisions have been removed entirely
- 2014 Definitions contemplate transactions with only one Reference Entity and one Reference Obligation
- Seller only triggered transactions removed

What happens now?

What happens now?

> The 2014 Definitions will be used for new CDS transactions from the roll date for iTraxx and CDX transactions in September 2014

> ISDA Protocol allowing parties to amend existing CDS transactions for certain 2014 provisions

> DC Rules and supporting documentation to be updated

> Review and update template documentation and operational systems for September 2014

> Identify existing transactions and non-ISDA Protocol transactions

> Bifurcated market from September 2014 onwards

> Impact on Auctions?

Impact on Credit Linked Notes

Impact on Credit Linked Notes

> Impact of the 2014 Definitions on the terms, availability and cost of hedging transactions for CLNs outstanding in September 2014 and new issuances

> CLN programmes with terms based on the 2003 Definitions - consider when and how to amend for the 2014 Definitions:

– update in September 2014 or

– include both sets of CLN terms and conditions at the next update?

> Hedging transactions for existing and fungible issues which need to be under the 2003 Definitions

> Basis risk

Any questions?

Or comments, or observations?

> Remember to sign the CPD register

> Your feedback is appreciated – please leave on your chair, or at the desk outside.

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Linklaters LLP

One Silk Street
London EC2Y 8HQ
Tel: +44 20 7456 2000
Fax: +44 20 7456 2222

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