

## **Commentary on Supplement Relating to Successor and Credit Events to the 1999 ISDA® Credit Derivatives Definitions**

The “G6” subcommittee of the Credit Derivatives Market Practice Committee has met and discussed those issues that were previously identified as issues that could be addressed and resolved in the short-term. The issues relating to the definition of Successor in the 1999 ISDA Credit Derivatives Definitions (the “Definitions”) are separately being reviewed by the G6 while those issues relating to the loan settlement issue will be the subject of further consideration.

Once the G6 considers issues as well as possible solutions, these are then circulated by the members of the G6 to their constituents for consideration and comment. When a consensus is reached by the G6 and their constituents on these and other issues, the recommendations are provided to the Credit Derivatives Market Practice Committee and to the Documentation Committee. Once consensus has been reached, the recommendations will be published in the form of a Supplement to the Definitions. A Commentary will also be prepared in regard to all issues dealt with in the Supplement and, if appropriate at that time, upon issues where no changes to existing language were recommended, but issues were discussed, or where recommended changes to existing language were not agreed upon by the membership.

Below is a summary of the recommendations of the G6 in regard to the short-term issues. This summary addresses each of the short-term issues reviewed by the G6 whether or not changes to address the specific issue have been recommended by the G6.

- Successor. Section 2.2 of the Definitions provides that Successor means, in relation to a Reference Entity that is not a Sovereign, a successor to that Reference Entity that assumes “all or substantially all of the obligations” of the Reference Entity by way of a merger, consolidation, amalgamation, transfer or otherwise, as determined by the Calculation Agent (after consultation with the parties).

Issues came to light when National Power, an English company which was identified as the Reference Entity in connection with a number of credit default swaps, demerged. This resulted in debate as to the identity of the Reference Entity following the demerger.

As a result of its discussions, the G6 recommends that, instead of the “all or substantially all” language in Section 2.2, a revised definition of Successor should set forth clear numerical thresholds. The G6 recommends that the definition of Successor be amended to state that, if an entity succeeds to 75 percent or more of the Bonds and Loans of the original Reference Entity, then the sole Successor would be that entity. The G6 agreed that in any circumstance where the analysis focuses on a percentage of obligations, the appropriate focus is on Bonds and Loans that fall within the category of Obligations. This would be the case even if Obligations were defined broadly to include, for example, Borrowed Money, since it is expected that information on Bonds and Loans of the Reference Entity would be most readily obtainable.

The G6 considered two possible approaches in the event that the 75 percent threshold test is not met, such that no Successor can be identified under that approach. The two options are:

1. Follow the original Reference Entity; or
2. Divide the relevant transaction into a series of single name credit default swaps based on the number of entities resulting from the relevant event, subject to certain minimum requirements (e.g., an entity would have to succeed to or, in the case of the Reference Entity, retain more than 25 percent of the Bonds and Loans).

The first possible approach would provide certainty, but, depending on the facts and circumstances, it might not produce a result that is practical or that makes commercial sense.

Accordingly, the G6 recommended to the Credit Derivatives Market Practice Committee the second approach. Under the second possible approach, if one or more entities succeed to or, in the case of the Reference Entity, retain more than 25 percent of the Bonds and Loans of the original Reference Entity, but none reaches the 75 percent threshold, those entities will be the Successors, and the original transaction will be divided into the same number of new transactions as there are Successors, with each Successor being the Reference Entity for one of the new transactions. If the 25% threshold test is not exceeded, two results could occur: First, if the Reference Entity continues to exist, there is no Successor and the Reference Entity remains unchanged. Second, if the Reference Entity ceases to exist, the entity that succeeds to the greatest percentage of Bonds and Loans of the Reference Entity is the sole Successor. If there are two entities that succeed to the same percentage of Bonds and Loans, then the Successor is the entity succeeding to the greatest percentage of obligations. The determination of Successor is illustrated in examples provided in Annex 1 to this Commentary.

- Changes to Bankruptcy Credit Event. The definition of Bankruptcy Credit Event in Section 4.2 of the Definitions is one of six Credit Events that can be incorporated by counterparties into a Credit Derivative Transaction. The definition of Bankruptcy in the Definitions is identical to that in Section 5(a)(vii) of the ISDA Master Agreement (Multicurrency-Cross Border) (the “Master Agreement”). Questions have been raised, particularly by the rating agencies, as to whether the definition of the Bankruptcy Credit Event in the Definitions is appropriate in regard to two subsections in particular.

***Section 4.2(i)***

Section 4.2(i) of the definition of the Bankruptcy Credit Event provides that “any action [by the Reference Entity] in furtherance of, or indicating its consent to, approval of, or acquiescence in, any of the foregoing acts” is itself a Bankruptcy Credit Event that triggers Settlement under the Credit Derivative Transaction. The same language is found in the definition of Bankruptcy in the Master Agreement, in which case the Bankruptcy of a party permits early termination by the Non-defaulting Party of all Transactions governed by the Master Agreement between two parties. Rating agencies, in particular, have noted that the different purpose of the Bankruptcy Credit Event from the Bankruptcy Event of Default

makes the inclusion of this language inappropriate as a Credit Event in that the occurrence of such acts will not necessarily precipitate, or lead to, a default.

Further, concerns have been raised regarding the breadth and ambiguity of the circumstances that the phrase in Section 4.2(i) could encompass. As a result, the occurrence of such circumstances may not lead to the adjudication of bankruptcy of the Reference Entity and may therefore be inappropriate in cases where the intent of the Credit Derivative Transaction is to transfer default risk. For example, while a Reference Entity may explore the possibility of filing for bankruptcy through discussions with counsel, it may make no filings in that regard and may therefore continue to exist without the occurrence of a default after such discussions. However, such discussions could be seen to be “in furtherance” of making a voluntary filing and therefore constitute a Credit Event in and of themselves, leading to Settlement if all other Conditions to Payment are met.

On the other hand, where a Buyer is seeking protection in regard to Payment Obligations, including obligations under derivative transactions, consistency among the definitions of Bankruptcy in the Master Agreement and the Credit Events is useful and relevant. As this is a relatively rare situation, the G6 did not consider this to be a sufficient rationale for retaining the existing language.

The differing purpose of the Bankruptcy Credit Event suggested to the G6 that this language is inappropriate in this context and is ambiguous and difficult to rely upon as a Credit Event trigger. The G6 therefore recommends that Subsection 4.2(i) be deleted from the definition of the Bankruptcy Credit Event in its entirety.

#### ***Section 4.2(b)***

The G6 further discussed two concerns raised primarily by rating agencies regarding Subsection 4.2(b) of the Bankruptcy Credit Event. Section 4.2(b) of the Bankruptcy Credit Event refers to situations where the Reference Entity “becomes insolvent or unable to pay its debts or fails or admits in writing its inability generally to pay its debts as they become due”. This language is identical to that found in the definition of Bankruptcy in Section 5(a)(vii) of the Master Agreement.

The first concern is that the language is unclear with regard to how “insolvency” is to be determined. Given this ambiguity, the timing at which the Credit Event can be said to have occurred may vary. However, the G6 felt that the retention of the reference to “insolvency” in this section remains sufficiently important to the market so that it should not be deleted or altered. Furthermore, it was felt that this event is an indication of default by the Reference Entity and properly falls within the intent of the Credit Derivative Transaction.

Second, the rating agencies raised a concern relating to the phrase “fails or admits *in writing* its inability generally to pay its debts as they become due”. Specifically, concern has been expressed that the admission of an inability to pay debts, even if made in writing, does not necessarily lead to a deterioration in credit, in that no failure to pay has yet occurred. Moreover, funding sources may be found by the Reference Entity such that no failure to pay

ever occurs. This language may also allow for any written statement of this nature to constitute a trigger. However, it was acknowledged that such a statement is a serious indication of credit concerns when made in certain contexts or fora, but may not be sufficient when made in other circumstances. Thus, a statement made to regulators was seen to be qualitatively different from a statement made to a creditor or other third party at a time when no payments are due.

The G6 therefore suggests amending the language of Section 4.2(b) such that only an admission in a judicial, regulatory or administrative proceeding or filing would constitute a trigger. Admissions made in these contexts were seen to be a more likely indicator of the occurrence of a Credit Event. Statements made in other contexts were considered to be a less reliable indication of a deterioration in credit quality.

The G6 did consider whether statements made in such proceedings or filings were a sufficiently reliable indicator of a deteriorating credit and, ultimately, the majority of the G6 determined that this was the case. However, some concern was noted to the effect that statements made in filings may not always be sufficiently serious and may not then indicate an impending deterioration in credit.

It should be noted that as a result of this change, the making of such an admission in another context, other than the proceedings and filings which are specifically referred to, will not be sufficient to trigger a Credit Event, even if such other context would normally constitute a Public Source. For example, an admission contained in a press release would not be sufficient until such time as the press release was, for example, included in a statement in a judicial, regulatory or administrative proceeding or included in a judicial, regulatory or administrative filing or the Credit Event requirements were otherwise met.

Generally, it should be noted that the implementation of any of the changes to the Bankruptcy Credit Event discussed above will result in a difference between the language of the Bankruptcy Credit Event and the Bankruptcy Event of Default in the Master Agreement. This difference will be highlighted in any Commentary related to these changes to ensure that parties who use Credit Derivative Transactions to hedge their exposure under Master Agreements are aware of this change.

- Currency of Payment. Section 4.7(a)(v) of the Definitions provides that a Restructuring, with respect to one or more Obligations, occurs if there is any change in the currency or composition of any payment of interest or principal.

The G6 suggests that a change in currency to that of a G7 member country or to that of a country that is an OECD member country with a local currency long-term debt rating equal to or more favorable than AAA from Standard and Poor's Corporation ("S&P"), Aaa from Moody's Investor Services ("Moody's") or AAA from Fitch IBCA, Duff & Phelps ("Fitch") should not constitute a Restructuring Credit Event (whether or not such change results from a deterioration in the creditworthiness or the financial condition of the Reference Entity and whether or not a loss or a reduction in principal amount occurs upon the currency conversion) as such currencies are sufficiently liquid.

For your information, the following is a list of OECD countries along with the most current credit rating assigned to each by S&P as of October 11, 2001 (obtained from [www.standardandpoors.com](http://www.standardandpoors.com)), Moody's as of August 28, 2001 (obtained from [www.moody.com](http://www.moody.com)) and Fitch as of October 16, 2001 (obtained from [www.fitchibca.com](http://www.fitchibca.com)).

Country	S&P		Moody's		Fitch	
	Local currency long-term debt rating	Foreign currency long-term debt rating	Long-term domestic currency	Long-term foreign currency	Long-term domestic currency	Long-term foreign currency
Australia	AAA	AA+	Aaa	Aa2	AAA	AA
Austria	AAA	AAA	Aaa	Aaa	AAA	AAA
Belgium	AA+	AA+	Aa1	Aa1	AA-	AA-
Canada	AAA	AA+	Aa1	Aa1	AAA	AA+
Czech Republic	AA-	A-	A1	Baa1	A	BBB+
Denmark	AAA	AAA	Aaa	Aaa	AAA	AA+
Finland	AA+	AA+	Aaa	Aaa	AAA	AAA
France	AAA	AAA	Aaa	Aaa	AAA	AAA
Germany	AAA	AAA	Aaa	Aaa	AAA	AAA
Greece	A	A	A2	A2	A	A
Hungary	A+	A-	A1	A3	A+	A-
Iceland	AA+	A+	Aaa	Aa3	AAA	AA-
Ireland	AAA	AAA	Aaa	Aaa	AAA	AAA
Italy	AA	AA	Aa3	Aa3	AA-	AA-
Japan	AA+	AA+	Aa2	Aa1	AA+	AA+
Korea	A	BBB	Baa1	Baa2	A	BBB+
Luxembourg	AAA	AAA	Aaa	Aaa	AAA	AAA
Mexico	BBB+	BB+	Baa1	Baa3	BBB	BB+
The Netherlands	AAA	AAA	Aaa	Aaa	AAA	AAA
New Zealand	AAA	AA+	Aaa	Aa2	n/a	n/a
Norway	AAA	AAA	Aaa	Aaa	AAA	AAA
Poland	A+	BBB+	A2	Baa1	A+	BBB+
Portugal	AA	AA	Aa2	Aa2	AA	AA
Slovak Republic	BBB+	BB+	Baa2	Ba1	BBB+	BB+
Spain	AA+	AA+	Aa2	Aa2	AA+	AA+
Sweden	AAA	AA+	Aaa	Aa1	AAA	AA
Switzerland	AAA	AAA	Aaa	Aaa	AAA	AAA
Turkey	B-	B-	B3	B1	B-	B
United Kingdom	AAA	AAA	Aaa	Aaa	AAA	AAA
United States	AAA	AAA	Aaa	Aaa	AAA	AAA

It should be noted that using a reference to OECD member countries of a certain rating threshold would assume a determination of both the member countries of the OECD and their respective ratings as of the date on which the occurrence of the event is being evaluated. Parties need to take care to ensure that changes in either the member countries of the OECD or their respective ratings are appropriately monitored by them.

- Publicly Available Information. As a result of the discussion relating to Section 4.2(b) regarding the inclusion of a reference to filings discussed above, it was suggested that the definition of Publicly Available Information in Section 3.5 of the Definitions generally should provide that information contained in any judicial, administrative or regulatory filing or proceeding should be sufficient to constitute Publicly Available Information. There was a concern that the present language does not, for example, allow for publicly available filings with regulatory authorities to constitute Publicly Available Information unless the same are reported in a Public Source. The G6 felt that these filings or information provided in such proceedings should themselves be seen to be a sufficient basis for action. The G6 therefore recommends that the definition of Publicly Available Information be amended so as to clarify that statements made in filings with courts, regulators and administrative bodies, as well as orders of such bodies, should be sufficient to constitute Publicly Available Information.

Following discussions with Moody's, the G6 recommends that with respect to Credit Derivative Transactions in which the Buyer is the sole source of information in its capacity as trustee, fiscal agent, administrative agent, clearing agent or paying agent for an Obligation *and* a holder of the Obligations with respect to which a Credit Event has occurred, the Buyer shall be required to deliver an Officer's Certification. The Officer's Certification will certify the occurrence of a Credit Event with respect to a Reference Entity.

Annex 1

The examples below set forth what would happen in various scenarios involving the Reference Entity in a hypothetical credit default swap with a Floating Rate Payer Calculation Amount of \$100m. The examples apply the 75 percent threshold approach and the second approach described in the Commentary above with respect to determining the Floating Rate Payer Calculation Amount of each possible new transaction.

1. A single entity (“X”) succeeds to 80% of the Bonds and Loans of the Reference Entity (with the remainder of the Bonds and Loans going to one or more other entities). X has reached the 75% threshold, and is therefore the sole Successor. X becomes the Reference Entity for the \$100m credit default swap.
2. Two entities (“X” and “Y”) succeed to 30% and 50%, respectively, of the Bonds and Loans of the Reference Entity. The original Reference Entity continues to exist and retains 20% of the Bonds and Loans. No single entity has reached the 75% threshold, but X and Y (and not the Reference Entity) have both exceeded the 25% threshold. The original credit default swap will be split into two new credit default swaps, one with X as the Reference Entity and one with Y as the Reference Entity. The Floating Rate Payer Calculation Amount for each new transaction will be \$50m.
3. An entity (“X”) succeeds to 70% of the Bonds and Loans of the Reference Entity, and the Reference Entity continues to exist and retains 30% of the Bonds and Loans. X and the Reference Entity have both exceeded the 25% threshold. The original credit default swap will be split into two new credit default swaps, one with X as the Reference Entity and one with the original Reference Entity as the Reference Entity. The Floating Rate Payer Calculation Amount for each new transaction will be \$50m.
4. Three entities (“X”, “Y” and “Z”) succeed to 30%, 35% and 35%, respectively, of the Bonds and Loans of the Reference Entity. No single entity has reached the 75% threshold, but X, Y and Z (the only entities succeeding to the Bonds and Loans of the Reference Entity) have all exceeded the 25% threshold. The original credit default swap will be split into three new credit default swaps, one with X as the Reference Entity, one with Y as the Reference Entity and one with Z as the Reference Entity. The Floating Rate Payer Calculation Amount for each new transaction will be \$33.33m.
5. Five entities each succeed to 20% of the Bonds and Loans of the Reference Entity. As no entity has reached the 75% threshold, and no entity has exceeded the 25% threshold, the original Reference Entity remains the Reference Entity, if this entity still exists. If the Reference Entity no longer exists, the entity which succeeds to the greatest percentage of Bonds and Loans (or, if two or more entities succeed to an equal percentage of Bonds and Loans, the entity from among those entities which succeeds to the greatest percentage of obligations) of the Reference Entity will be the sole Successor.

