

COMMENTARY ON SUPPLEMENT RELATING TO CONVERTIBLE, EXCHANGEABLE OR ACCRETING OBLIGATIONS

This note will explain the provisions set forth in the Supplement Relating to Convertible, Exchangeable or Accreting Obligations dated November 9, 2001 (the "Supplement").

1. General Considerations. The Supplement is structured as a supplement or addendum to the 1999 ISDA® Credit Derivatives Definitions (the "Definitions") and can be incorporated in a Confirmation by adding the language set forth in the Attachment. Parties should consult with their advisers as to the advisability of including the Supplement in any particular Credit Derivative Transaction.

The Supplement addresses the treatment under the Definitions of certain types of convertible and exchangeable obligations, as well as the treatment of accreting obligations, such as zero coupon bonds, low coupon bonds issued at a discount and non-discounted bonds that accrete during their term. Parties should note that the Supplement has been drafted to address only Convertible Obligations, Exchangeable Obligations and Accreting Obligations (each as defined in the Supplement).

Nothing contained in the Supplement is intended to create a negative inference in respect of Credit Derivative Transactions that do not incorporate the Supplement.

In this note, the term "equity securities" refers to depositary receipts representing equity securities as well as equity securities.

2. Convertible Obligations and Exchangeable Obligations. Under Section 2.18(b)(vii) of the Definitions, "Not Contingent" means "any obligation (A) the payment or repayment of principal in respect of which is not in an amount determined by reference to any formula or index, or which is not subject to any contingency, and (B) which bears interest at either a fixed or floating rate that is paid on a periodic basis and computed on a benchmark interest rate plus or minus a spread, if any".

When specified by the parties to a physically settled Credit Derivative Transaction as a Deliverable Obligation Characteristic, "Not Contingent" (specifically, its requirement that an obligation should not be "subject to any contingency") is intended to prevent obligations from constituting Deliverable Obligations if the repayment of principal may not occur due to events either unrelated to the credit of the issuer or not within the control of the holder or a trustee or similar agent acting for the benefit only of holders. In other words, the definition of "Not Contingent" is concerned with whether the right to receive principal is contingent.

The Supplement draws a distinction between obligations that are convertible, in whole or in part, into equity securities of the issuer of such obligation solely at the option of holders or a trustee or similar agent acting for the benefit only of holders ("Convertible Obligations"), and obligations that are convertible in any other circumstances. The Supplement also draws a distinction between obligations that are exchangeable, in whole or in part, for equity securities of a person other than the issuer of such obligation solely at the option of holders or a trustee or similar agent acting for the benefit only of holders ("Exchangeable Obligations"), and obligations that are exchangeable in any other circumstances. For the avoidance of doubt, obligations that are convertible or exchangeable at the option of the issuer, or where the conversion or exchange is mandatory, do not qualify as Convertible Obligations or Exchangeable Obligations, respectively. If parties to a physically settled

Credit Derivative Transaction where "Not Contingent" is specified as a Deliverable Obligation Characteristic wish to confirm that an obligation that does not qualify as a Convertible Obligation or Exchangeable Obligation (each as defined in the Supplement) will constitute a Deliverable Obligation, they should consider specifying the obligation as a Reference Obligation.

Some convertible or exchangeable bonds contain provisions pursuant to which a trustee may exercise a conversion right. Provisions of this type are typically included to protect bondholders when they have failed to exercise a conversion right on a timely basis and exercise is clearly beneficial for them. An obligation with this provision that otherwise qualifies as "Not Contingent" should not be disqualified due to this feature because a trustee exercising this type of conversion right is acting only for the benefit of holders.

Section 1(a)(i) of the Supplement provides that an obligation shall not be disqualified from being a Deliverable Obligation under Section 2.18(b)(vii)(A) of the Definitions solely due to the fact that the obligation is a Convertible Obligation or an Exchangeable Obligation, so long as the right to either (A) convert or exchange such obligation or (B) require the issuer to purchase or redeem such obligation (if the issuer has exercised the right to pay the purchase or redemption price, in whole or in part, in equity securities), as the case may be, has not been exercised (or such exercise has been effectively rescinded) on or before the date of Delivery.

The condition contained in (A) above is intended to clarify that, once the obligation has been converted into or exchanged for equity securities or an irrevocable election to convert or exchange the obligation into or for equity securities has been made, the relevant obligation has become an equity obligation or a claim to receive equity securities and is not a debt obligation. As such, it no longer is a Deliverable Obligation. The condition contained in (B) addresses obligations which may be put to the issuer by holders but which also permit the issuer to pay the redemption price using equity securities. The right to put the obligations to the issuer is solely the right of the holders. The condition contained in (B) is intended to clarify that, if the issuer has announced its intention to pay the purchase or redemption price, in whole or in part, in equity securities, and the holder has chosen to exercise its put option (and has not effectively rescinded such exercise), the obligation will not be a Deliverable Obligation.

Note that Section 1(a)(i) provides that an obligation shall not be disqualified from being a Deliverable Obligation under Section 2.18(b)(vii)(A) of the Definitions *solely* due to the fact that the obligation is a Convertible Obligation or an Exchangeable Obligation. There may still be other reasons why the obligation will be disqualified from being a Deliverable Obligation under Section 2.18(b)(vii)(A) of the Definitions.

The Supplement also, in Section 1(b), provides that if a Reference Obligation is a Convertible Obligation or Exchangeable Obligation, then such Reference Obligation may be included in the Portfolio only, again, if the rights referred to in (A) and (B) above have not been exercised (or such exercise has been effectively rescinded) on or before the date of Delivery. Note that, in respect of Convertible Obligations and Exchangeable Obligations (each as defined in the Supplement) only, this overrides the rule in the Definitions that Reference Obligations constitute Deliverable Obligations in all circumstances.

3. Accreting Obligations. If the parties to a physically settled Credit Derivative Transaction have specified "Not Contingent" as a Deliverable Obligation Characteristic, then, in addition to the other

requirements of 2.18(b)(vii) of the Definitions, a Deliverable Obligation has to bear "interest at either a fixed or floating rate that is paid on a periodic basis".

Section 1(a)(ii) of the Supplement is intended to clarify that zero coupon bonds should be capable of constituting Deliverable Obligations even if the "Not Contingent" characteristic is specified as being applicable.

Accordingly, Section 1(a)(ii) of the Supplement provides that an obligation shall not be disqualified from being a Deliverable Obligation under Section 2.18(b)(vii) of the Definitions solely due to the fact that the obligation is an Accreting Obligation. The Supplement defines an Accreting Obligation as, broadly, any obligation the terms of which expressly provide for an amount payable upon acceleration equal to the original issue price of the obligation plus an additional amount that will or may accrete, whether or not (a) payment of the additional amount is subject to a contingency or determined by reference to a formula or index, or (b) periodic cash interest is also payable. This definition would not include, for example, a par obligation issued at a discount that provides for an amount payable upon acceleration equal to par because such an obligation does not provide for payment upon acceleration of an additional amount that will or may accrete.

Note that Section 1(a)(ii) provides that an obligation shall not be disqualified from being a Deliverable Obligation under Section 2.18(b)(vii) of the Definitions *solely* due to the fact that the obligation is an Accreting Obligation. There may still be other reasons why the obligation will be disqualified from being a Deliverable Obligation under Section 2.18(b)(vii) of the Definitions.

4. Outstanding Principal Balance. Market participants felt that it would be useful to clarify what constitutes the "outstanding principal balance" in respect of any Accreting Obligation. Section 2(a) of the Supplement provides that the outstanding principal balance will be equal to the "Accreted Amount", which is defined in Section 4 of the Supplement.

Accreted Amount means, broadly, with respect to an Accreting Obligation, an amount equal to (a) the sum of (i) the original issue price of the obligation and (ii) the portion of the amount payable at maturity that has accreted in accordance with the terms of the obligation, less (b) any cash payments made by the obligor thereunder that, under the terms of the obligation, reduce the amount payable at maturity (unless already accounted for). Note that the definition effectively provides that the "portion of the amount payable at maturity that has accreted" (referred to in (a)(ii) above) will be calculated in accordance with the terms of the obligation only if the obligation's yield to maturity is specified in, or implied from, the terms of the obligation. If the obligation is expressed to accrete pursuant to a straight-line method or if its yield to maturity is not specified in, nor implied from, the terms of the obligation, the "portion of the amount payable at maturity that has accreted" will be calculated using a rate equal to the expected yield to maturity of such obligation based upon its original issue price. The yield to maturity method is viewed as consistent with market practice for such obligations and the approach most likely to be applied in insolvency proceedings. In all cases, the Accreted Amount should be calculated as of the earlier of (A) the date on which an event occurs that fixes the amount of a claim in respect of principal and (B) the Physical Settlement Date or applicable Valuation Date, as the case may be.

The final sentence of the definition of Accreted Amount has the effect, in respect of any Accreting Obligation that is an Exchangeable Obligation, of excluding from the outstanding principal balance any amount that may be payable under the terms of the obligation in respect of the value of the equity securities into which the obligation is exchangeable. This provision has been included

because the terms of some exchangeable bonds provide that the holder is entitled, upon acceleration, to the greater of the face value of the bonds and the value of a specified number of equity securities. Some sellers of credit protection expressed the concern that this "greater of" formula may not be enforceable in all circumstances. If, upon a Failure to Pay (for example), a protection buyer were to deliver bonds taking into account the value of the equity securities into which the bonds are exchangeable, and the issuer of the bonds were then to become insolvent, protection sellers were concerned that they could be faced with an allowable claim in insolvency equal only to the face value of the bonds actually delivered.

Similarly, Section 2(b) of the Supplement clarifies what constitutes the "outstanding principal balance" in respect of any Exchangeable Obligation that is not an Accreting Obligation. Again, the outstanding principal balance shall exclude any amount that may be payable under the terms of the obligation in respect of the value of the equity securities into which the obligation is exchangeable.

5. Cash Settlement or Partial Cash Settlement of Accreting Obligations. Section 3 of the Supplement addresses the fact that the market convention when quoting a price for Accreting Obligations is to quote a price as a percentage of the face amount rather than as a percentage of the outstanding principal balance. If Cash Settlement or Partial Cash Settlement applies to a Credit Derivative Transaction, and such percentage is used in determining the Final Price, the Cash Settlement Amount would not correctly reflect the recovery value of the outstanding principal balance.

Accordingly, the Supplement provides that if any Quotation obtained with respect to an Accreting Obligation is expressed as a percentage of the amount payable in respect of such obligation at maturity, such Quotation will instead be expressed as a percentage of the outstanding principal balance in determining the Final Price.

Attachment to
Commentary on Supplement
Relating to Convertible, Exchangeable
or Accreting Obligations

Confirmation Introduction

In order to incorporate the Supplement Relating to Convertible, Exchangeable or Accreting Obligations into a Credit Derivative Transaction, the following paragraph may be included in the Confirmation of such Credit Derivative Transaction in place of the second paragraph of the EXHIBIT to the 1999 ISDA Credit Derivatives Definitions:

The definitions and provisions contained in the 1999 ISDA Credit Derivatives Definitions, as supplemented by the Supplement Relating to Convertible, Exchangeable or Accreting Obligations dated November 9, 2001 (the "Credit Derivatives Definitions"), as published by the International Swaps and Derivatives Association, Inc., are incorporated into this Confirmation. In the event of any inconsistency between the Credit Derivatives Definitions and this Confirmation, this Confirmation will govern.¹

¹ Parties that wish to incorporate any other Supplement to the Credit Derivatives Definitions into a Confirmation should adjust this paragraph accordingly.