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Eurozone Contingency Planning Update
Refreshed as of February 20, 2015

Back in 2012 ISDA worked with its counsel and a small discussion group of members to understand the implications for OTC derivatives contracts of the exit by a member state from the Eurozone, and to consider the steps that ISDA could take to help OTC derivatives market participants prepare for such a contingency. ISDA continues to believe that such an exit is unlikely, but since its effects could be significant, it is prudent to prepare for it.

Views on the potential risks and solutions are still evolving, and ISDA's work remains ongoing. We wish to provide members with an update on ISDA's contingency planning activities, along with some practical suggestions.

In 2011/2012, several law firms produced bulletins on these issues for their clients, and ISDA made some of these available on its website: http://www2.isda.org/functional-areas/legal-and-documentation/eurozone-contingency-planning/eurozone-briefings.

Uncertainty is an Obstacle to Effective Contingency Planning

The main impediment to effective planning for a Eurozone exit is the uncertainty over what may happen and in what form. In the absence of any facts, we must make assumptions as to the more likely scenarios and prepare for those. The scenario for which many market participants are preparing is that in which a member state:

1. announces its immediate or negotiated exit from the Eurozone,
2. creates a new replacement currency,
3. promulgates a currency law that redenominates (or purports to redenominate) certain Euro obligations into that new currency,
4. imposes exchange controls (and possibly border controls), and
5. declares additional bank holidays to give time to effect the exit and the redenomination.

It should be stressed that this is no more than an assumed scenario; many elements of it are uncertain. It is clear that a new currency law would need to be enacted to create the new currency and effect redenomination into it. It is conceivable but not certain that this currency law would prescribe other outcomes, such as to provide for continuity of affected contracts. However, the scope of any such currency law cannot be predicted. There may also be a supporting EU-wide law, though this cannot be guaranteed, and the timing and content of such a law cannot be predicted.

This uncertainty has significant consequences for contingency planning. Much depends upon the scope and content of a currency law. In particular, these factors will affect the extent of any purported redenomination and the degree of residual uncertainty around its application, including whether it would be recognised by other legal systems.

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A key consideration is that a scenario such as the above would create at least three classes of contracts: those directly affected (for example, because one or both counterparties are in the exiting member state or the derivative contract is governed by the law of that member state); those potentially directly affected (for example, because a supporting EU law may affect entities in other EU states) and those not directly affected (for example, contracts between entities unconnected with the EU). The impact on each class of contracts is potentially different (see "Redenomination Risk" below), implying that a party with derivatives positions currently assumed to be perfectly matched could find itself with a substantial mismatch.

Some members have asked whether ISDA will publish standard provisions that address what will happen to OTC derivative contracts upon a Eurozone exit and redenomination: for example providing in advance for contracts to be amended in a particular way in such event, or to provide a right of early termination. The members with whom ISDA discussed this identified the following factors:

1. Redenomination could impact parties to identically-drafted derivatives contracts in very different ways depending on the particular fact pattern. For example one party may use a derivatives contract to hedge an asset or liability that is subject to redenomination but the other may use a contract on identical terms to hedge an asset or liability that is not subject to redenomination. Their desired outcomes may be different.
2. The context-specific issues for derivative contracts make it impracticable to formulate a single proposed solution (or even a limited number) for any particular market.
3. Only a limited subset of derivatives contracts are at risk of redenomination of their payment obligations (see "Redenomination Risk" below).
4. It is in the market's best interest to have certainty of construction of derivatives contracts and, as far as possible, certainty of what would happen to those contracts in various scenarios.
5. Should a member state exit the Eurozone, any widespread exercise of rights of early termination and/or widespread refusal to make payments under EUR derivatives (for example on the basis of a claim that the Euro had fundamentally changed in nature) could create systemic issues.

For these reasons, ISDA does not currently plan to publish standard disruption or termination clauses in advance of any event occurring. There may be circumstances in which such clauses would be appropriate and market participants are of course free to agree upon such provisions bilaterally if they wish to do so.

Redenomination Risk

One of the main concerns that market participants have raised is redenomination by an exiting member state of Euro-denominated obligations connected with that member state into obligations denominated in its new currency. It is important to understand the scope of the issues that such action would raise. Although there are of course nuances, in general, the more of the following factors that are true in a particular relationship between two counterparties, the less likely it is that a Euro-denominated obligation would be re-denominated in the assumed scenario outlined above:

1. the parties are not incorporated in or acting from an office located in the exiting member state,
2. it is governed by a law other than the law of the exiting member state,
3. the contract governing it confers jurisdiction on the courts of a country other than the exiting member state,
4. the place of payment for the obligation is outside the exiting member state, and
5. the contract governing it does not define “Euro” by reference to the exiting member state.

One of the most important and effective steps that market participants can take now to protect themselves is to review their derivatives contracts and take steps to ensure that these conditions are met.

As regards the definition of the Euro in contracts, it is recommended that “Euro” be defined by reference to the currency of the European Union member states that have adopted the Euro in accordance with the relevant treaties. ISDA’s definitional booklets define Euro in this way, although older documents may refer to previous versions of the relevant treaties. Whilst this is unlikely to be fatal to any analysis, we recommend that market participants ensure that they are using the most recent version of the relevant documents.

Impact on Transactions

As noted above, only a relatively small subset of payment obligations under OTC derivatives contracts is at risk of redenomination. However, an OTC derivatives contract may still be affected by Eurozone exit and a redenomination of certain obligations even if the currency for payments under that transaction is unchanged. Take the following example:

- an English-law governed, Euro-denominated equity option
- between two parties outside an exiting member state
- over the shares of a company incorporated in the exiting member state.

There would be no change to the currency of payment obligations under that contract, but the currency in which the price of those shares is quoted would be redenominated. The consequences of this will depend to a large degree on the precise drafting of the derivatives contract. Local indices raise similar issues. It is likely that an otherwise identical option on the same shares, listed and cleared by an exchange in the exiting member state, would be redenominated and thus behave differently to the OTC equivalent. ISDA will co-ordinate with relevant trade bodies to reduce any inconsistencies to the extent possible.

In these circumstances, economic gains and losses could be crystallised, in ways that cannot currently be predicted. This economic effect may make it challenging to reach a consensus on a set of amendments, both before and after the fact. Moreover, each type of contract will have its own specific issues, which it would be impracticable to address individually.

ISDA recommends that market participants review their outstanding OTC derivatives contracts to identify such issues and to take steps now, possibly including renegotiating, closing out or re-booking transactions, to avoid them.

To assist with such a review, in 2012, ISDA obtained advice on potential issues on an asset-class basis. These memos are currently being reviewed and where necessary updated and ISDA will publish the updated and / or confirmed versions shortly, but to the extent that parties have not already conducted this review process, they should not delay in starting the process.

Many ISDA definitional booklets contain fallbacks that parties can elect to apply in various "disruption" type scenarios.

As part of their review of contracts parties should ascertain which fallbacks are selected and consider how those would operate under various assumed scenarios.

To assist with this, the asset class-specific memoranda referred to above address the more common of these. Please note that the disruption provisions in ISDA definitional booklets have not been drafted to cover a Eurozone exit scenario and it is unlikely that they will apply.

Capital Controls

Another major concern is the imposition of capital (including exchange) controls. These can take many forms. ISDA considers the effect that capital controls could have on the ISDA Master Agreement and on specific transactions.

Imposition of capital controls may render the payment or delivery obligations of a party subject to them illegal or impossible. Parties should consider whether, in any specific fact situation, the Illegality Termination Event under the ISDA Master Agreement may be triggered. In this regard, the Illegality Termination Event in the 2002 ISDA Master Agreement is an improvement on the corresponding provisions of the 1992 ISDA Master Agreement because it clarifies that any transaction-specific fallbacks should take effect before the Illegality provision applies, it removes the obligation to attempt to transfer transactions before relying on the Illegality Termination Event and it provides for deferral of payments and deliveries during a waiting period before the provision takes effect.

In July 2012, ISDA published a Protocol to facilitate the amendment of 1992 ISDA Master Agreements with the Illegality and Force Majeure provisions of the 2002 ISDA Master Agreement. This Protocol remains open for adherence and can be accessed on ISDA's website: *http://www.isda.org/2012illegalityProt/illegalityProt.html*.

Post-event Planning

ISDA has also been planning for the actions that we would take to assist the industry immediately following any exit event. We expect that ISDA would convene an industry-wide meeting/conference call on the day of, or (depending on timing) early on the day following, the announcement of the event. Details would be available on ISDA's website. The purpose of the call would be to urgently evaluate the situation, identify issues requiring decisions and action, particularly those issues requiring immediate decisions and action, and reach a consensus on the action to be taken. Such action may, for example, include publication of a protocol to facilitate contractual amendments necessary to address the specific situation.

In order to ensure that ISDA and the industry are as informed as possible, as quickly as possible, about the situation following any exit, ISDA has arranged for counsel in the Eurozone member states considered by members of our discussion group to be "at risk" of exit from the Eurozone to be on standby to provide us with a summary of the key terms of any currency law (which is likely to be in the local language, at least initially) on an urgent basis, followed by a more detailed analysis as soon as available.

Industry Co-ordination

ISDA plans to co-ordinate responses with trade associations representing other sectors of the financial markets in order to ensure consistency of approach and to avoid overlap.

Ongoing Review

ISDA continues with the preparations outlined above and to monitor the situation.