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Proposed Amendments to the 2014 ISDA Credit Derivatives Definitions Relating to Narrowly Tailored Credit Events – Outstanding Principal Balance

An ISDA working group comprising members of ISDA's Credit Steering Committee and additional ISDA members active in the CDS market has been discussing proposals to amend the 2014 ISDA Credit Derivatives Definitions (the "Definitions") to address issues relating to narrowly tailored credit events ("NTCEs"). NTCEs are arrangements with corporations that cause a credit event leading to settlement of CDS contracts while minimizing the impact on the corporation. ISDA published a statement from its Board of Directors in April 2018 noting concerns with the impact of such events on the efficiency, reliability and fairness of the overall CDS market.[1]

ISDA previously published proposals for changes to the Failure to Pay Credit Event definition and a clarification to the Outstanding Principal Balance ("OPB") definition. This document contains proposed amendments to the definition of OPB, which are being circulated for feedback. These amendments proposed for implementation together with the earlier proposals.

Capitalized terms used in this memorandum but not defined herein shall have the meaning given to such terms in the Definitions.

Please provide any feedback on the proposals contained herein by Monday June 17, 2019, by email to the ISDA Legal Department (isdalegal@isda.org) with the subject line "NTCE Proposal Feedback".

(a) Background

1. The definition of OPB in Section 3.8 of the Definitions determines the principal amount of a bond or loan that must be delivered to physically settle a CDS contract, including a Representative Auction-Settled Transaction in a CDS auction. Part of the OPB definition (the "Quantum of the Claim") provides for the OPB to be determined in accordance with any applicable laws that reduce or discount the size of the claim to reflect the original issue price or accrued value of the obligation.

2. If a bond is issued at a substantial discount to its principal redemption amount, but applicable laws would not reduce the size of the claim, it could be delivered for its full principal redemption amount for CDS purposes. This could create an incentive to procure the issuance of a bond at a discount for purposes of affecting the CDS Auction Final Price.

(b) Proposed Amendment to OPB Definition

1. The definition of OPB will be amended to provide that if applicable law does not reduce the claim in respect of a bond that is issued for less than 95% of its principal redemption amount, then the OPB will be determined using straight line interpolation between the issue price of the bond and its principal redemption amount. Equivalent provisions are also included for loans. These new terms do not apply to a bond or loan that has customary terms relating to the accretion of principal over time. The new terms also address exchanges and fungible tap issuances.

[1] ISDA Board Statement on Narrowly Tailored Credit Events dated April 11, 2018, available at: https://www.isda.org/2018/04/11/isda-board-statement-on-narrowly-tailored-credit-events/

2. This change would apply to corporate and financial Reference Entities but would not apply to sovereign Reference Entities.

3. The proposed amendment to the OPB definition, and a related change to the Credit Derivatives Determinations Committees Rules, is attached as Annex 1.

4. The changes would be made to existing transactions by an ISDA Protocol. For the changes to be effective, market participants would need to adhere to the Protocol.

Annex 1 - Proposed Amendment to Outstanding Principal Balance Definition and Section 3.3(h) of the Determinations Committee Rules

Outstanding Principal Balance Proposal

1. PROPOSED AMENDMENT TO SECTION 3.8 OF THE 2014 DEFINITIONS

The proposal is to amend Section 3.8 (Outstanding Principal Balance) of the 2014 ISDA Credit Derivatives Definitions by inserting the underlined wording as per the below:

Section 3.8. Outstanding Principal Balance

(a) The "Outstanding Principal Balance" of an obligation will be calculated as follows:

(i) first, by determining, in respect of the obligation, the amount of the Reference Entity's principal payment obligations and, where applicable in accordance with Section 3.12 (Accrued Interest), the Reference Entity's accrued but unpaid interest payment obligations (which, in the case of a Guarantee will be the lower of (A) the Outstanding Principal Balance (including accrued but unpaid interest, where applicable) of the Underlying Obligation (determined as if references to the Reference Entity were references to the Underlying Obligor) and (B) the amount of the Fixed Cap, if any);

(ii) second, by subtracting all or any portion of such amount which, pursuant to the terms of the obligation, (A) is subject to any Prohibited Action, or (B) may otherwise be reduced as a result of the effluxion of time or the occurrence or non-occurrence of an event or circumstance (other than by way of (I) payment or (II) a Permitted Contingency) (the amount determined in Section 3.8(a)(i) less any amounts subtracted in accordance with Section 3.8(a)(ii), the "Non-Contingent Amount"); and

(iii) third, by determining the Quantum of the Claim, which shall then constitute the Outstanding Principal Balance,

in each case, determined:

(A) unless otherwise specified, in accordance with the terms of the obligation in effect on either (I) the NOPS Effective Date (or if the terms of the obligation are amended after such date but on or prior to the Delivery Date, the Delivery Date), or (II) the Valuation Date, as applicable; and

(B) with respect to the Quantum of the Claim only, in accordance with any applicable laws (insofar as such laws reduce or discount the size of the claim to reflect the original issue price or accrued value of the obligation).

<u>For the purposes of Section 3.8(a)(iii)(B), "applicable laws" shall include any bankruptcy or insolvency law or other law affecting creditors' rights to which the relevant obligation is, or may become, subject.</u>[1]

[1] The clarification in this paragraph was included in the earlier proposals.

If "Fallback Discounting" is specified as applicable in the related Confirmation[2], then notwithstanding the above, if (i) the Outstanding Principal Balance of an obligation is not reduced or discounted under Section 3.8(a)(iii)(B) above, (ii) that obligation is either a Bond that has an issue price less than ninety-five per cent of the principal redemption amount or a Loan where the amount advanced is less than ninety-five per cent of the principal repayment amount and, (iii) such Bond or Loan does not include provisions relating to the accretion over time of the amount which would be payable on an early redemption or repayment of such Bond or Loan that are customary for the applicable type of Bond or Loan as the case may be,[3] then the Outstanding Principal Balance of such Bond or Loan shall be the lesser of (a) the Non-Contingent Amount; and (b) an amount determined by straight line interpolation between the issue price of the Bond or the amount advanced under the Loan and the principal redemption amount or principal repayment amount, as applicable.

For the purposes of determining whether the issue price of a Bond or the amount advanced under a Loan is less than ninety-five per cent of the principal redemption amount or principal repayment amount (as applicable) or, where applicable, for applying straight line interpolation:

(x) where such Bond or loan was issued as a result of an exchange offer, the issue price of the new Bond or Loan resulting from the exchange shall be deemed to be equal to the aggregate Outstanding Principal Balance of the original obligation(s) that were tendered or exchanged (the "Original Obligation(s)") at the time of such exchange (determined without regard to market or trading value of the Original Obligation(s)); and

(y) in the case of a Bond or Loan that is fungible with a prior debt obligation previously issued by the Reference Entity, such Bond or Loan shall be treated as having the same issue price or amount advanced as the prior debt obligation.

In circumstances where a holder would have received more than one obligation in exchange for the Original Obligation(s), the Calculation Agent will determine the allocation of the aggregate Outstanding Principal Balance of the Original Obligation(s) amongst each of the resulting obligations for the purpose of determining the issue price or amount advanced of the relevant Bond or Loan. Such allocation will take into account the interest rate, maturity, level of subordination and other terms of the obligations that resulted from the exchange and shall be made by the Calculation Agent in accordance with the methodology (if any) determined by the relevant Credit Derivatives Determinations Committee.

(b) "Quantum of the Claim" means the lowest amount of the claim which could be validly asserted against the Reference Entity in respect of the Non-Contingent Amount if the obligation had become redeemable, been accelerated, terminated or had otherwise become due and payable at

[2] The Physical Settlement Matrix will apply the provision to all Corporate and Financial Transaction Types. The provision will not apply to Sovereign Transaction Types.

[3] Consider whether an implementation date should be introduced such that only Bonds or Loans issued or restructured after the implementation date are subject to Fallback Discounting.

the time of the relevant determination, provided that the Quantum of the Claim cannot exceed the Non-Contingent Amount.

2. AMENDMENT TO THE CREDIT DERIVATIVES DETERMINATIONS COMMITTEES RULES

DC Rule 3.3(h) of the Credit Derivatives Determinations Committees Rules would also be amended as follows:

(h) **Determinations relating to the Outstanding Principal Balance.** In addition, when Resolving the Outstanding Principal Balance of a Deliverable Obligation, a Convened DC shall do so by Supermajority. In doing so, such Convened DC shall be entitled to assume that the Outstanding Principal Balance is par unless it has Eligible Information to the contrary. If the Deliverable Obligation is a Bond or Loan that was issued in exchange for Original Obligation(s) as part of an exchange that resulted in more than one new obligation, such Convened DC may also Resolve by Majority the methodology or specialist process to assess how the aggregate Outstanding Principal Balance of the Original Obligation(s) should be allocated amongst the obligations resulting from the Exchange.