

Proposed Amendments to the 2014 ISDA Credit Derivatives Definitions Relating to Narrowly Tailored Credit Events

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

This document contains proposed amendments to the Definitions addressing NTCEs. Although the working group has not yet completed its work and therefore may have additional proposals, the amendments described herein represent some of the most important aspects of the proposed changes agreed by the working group to date. As a result, ISDA is circulating the below proposal for feedback at this stage.

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 Wednesday March 27, 2019, by email to the ISDA Legal Department (isdalegal@isda.org) with the subject line "NTCE Proposal Feedback".

(a) Background

1. If a payment default is arranged in such a way that it will have no or minimal impact on a borrower or its general creditors in the cash market, but is a Credit Event for CDS contracts referencing the borrower as Reference Entity, it can create an incentive for the Reference Entity and CDS contract holders to engineer a payment default that does not reflect the normal incentives of borrowers and lenders. This divergence between the cash market and CDS market could reduce the efficiency of the CDS contract as a barometer of a Reference Entity's credit risk.

2. It is not possible to devise an exhaustive definition of narrowly tailored payment defaults, but a common feature that distinguishes them from regular payment defaults is that they do not result from or in the deterioration in creditworthiness or financial condition of the Reference Entity.

3. The cause of a payment default is not directly observable and must be inferred from the information available. This introduces an element of subjectivity, which in turn may create some level of uncertainty as to whether such payment default resulted from or in the deterioration in creditworthiness or financial condition of the Reference Entity. Uncertainty over whether an arrangement will lead to a Credit Event for CDS contracts reduces the expected benefit from a narrowly tailored payment default, and therefore reduces the incentive to create a NTCE. It is however

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/>

desirable that a regular payment default, including one that occurs in the context of a standstill agreement, should continue clearly to qualify as a Failure to Pay Credit Event for CDS contracts.

(b) Proposed Amendment to Failure to Pay Definition and Publication of Guidance Memo

1. The definition of the Failure to Pay Credit Event (Section 4.5 of the Definitions) will be amended to add a requirement that the relevant payment failure result from or in a deterioration in creditworthiness or financial condition of the Reference Entity. This requirement would apply to corporate and financial Reference Entities but would not apply to sovereign Reference Entities.
2. To provide additional clarity to apply the new test, a guidance memo will be published. The guidance memo will set out the purpose of this requirement and a non-exhaustive list of factors that should be taken into account in making a determination under the new test.
3. The proposed amendment to the Failure to Pay definition and text of the guidance memo 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.

(c) Proposed Clarification to Outstanding Principal Balance Definition

1. Section 2.10 of the Definitions requires the Outstanding Principal Balance to be determined using the “Quantum of the Claim”, which is determined in accordance with applicable law. Section 2.10 of the Definitions will be amended to add a clarification that “applicable law” includes any bankruptcy or insolvency law that would apply to the Reference Entity if it were to enter bankruptcy or insolvency proceedings. This would clarify that such rules will be relevant to determine the Quantum of the Claim where the Reference Entity is not currently in a bankruptcy or insolvency proceeding.
2. This clarification would be added to existing transactions by an ISDA Protocol. For this clarification to be added, market participants would need to adhere to the Protocol.
3. The proposed amendment to the Outstanding Principal Balance Definition is attached as Annex 2.

Annex 1 - Proposed Amendment to Failure to Pay Definition and Text of Guidance Memo

AMENDMENT TO 2014 ISDA CREDIT DERIVATIVES DEFINITIONS AND INTERPRETIVE GUIDANCE

1. AMENDMENT

1.1 The 2014 ISDA Credit Derivatives Definitions will be amended by amending the definition of “Failure to Pay” as per paragraph 1.2 below, and by adding a new Exhibit F containing the guidance note in section 2 below. The ISDA Credit Derivatives Physical Settlement Matrix will be updated so that “Credit Deterioration Requirement” is specified as applicable for all Corporate and Financial Transaction Types.

1.2 The amended definition is below (underlined text to be added):

“Section 4.5. Failure to Pay. “Failure to Pay” means, after the expiration of any applicable Grace Period (after the satisfaction of any conditions precedent to the commencement of such Grace Period), the failure by the Reference Entity to make, when and where due, any payments in an aggregate amount of not less than the Payment Requirement under one or more Obligations, in accordance with the terms of such Obligations at the time of such failure. If “Credit Deterioration Requirement” is specified as applicable in the related Confirmation, then, notwithstanding the foregoing, it shall not constitute a Failure to Pay if such failure does not directly or indirectly either result from, or result in, a deterioration in the creditworthiness or financial condition of the Reference Entity.

Guidance on the interpretation of “Failure to Pay” is set forth in Exhibit F.”

2. INTERPRETIVE GUIDANCE

Summary

2.1 This note (the **Guidance Note**) provides guidance on the interpretation of the definition of “Failure to Pay” in the 2014 ISDA Credit Derivatives Definitions (the **Definitions**), as amended by [...] (the **Amendment**) where “Credit Deterioration Requirement” is specified as applicable. This Guidance Note is only intended to assist in the determination of whether an event constitutes a Failure to Pay and is not an aid to interpreting the Definitions more broadly. Capitalized terms used but not defined have the meaning given to them in the Definitions.

Intention behind amendment to the definition of Failure to Pay

2.2 In April 2018, ISDA published a statement from its Board of Directors noting “press reports of instances of credit default swap (CDS) market participants entering into arrangements with corporations that are narrowly tailored to trigger a credit event for CDS contracts while minimizing the impact on the corporation, in order to increase payment to the buyers of CDS protection.” The ISDA Board of Directors was of the view that “narrowly tailored defaults [...] could negatively impact the efficiency, reliability and fairness of the overall CDS market.”

2.3 The U.S. Commodity Futures Trading Commission Divisions of Clearing and Risk, Market Oversight, and Swap Dealer and Intermediary Oversight also published a statement that the “CDS market functions based on the premise that firms referenced in CDS contracts seek to avoid defaults, and as a result, the instruments are priced based on the financial health of the reference entity. However, recent arrangements appear to involve intentional, or

‘manufactured,’ credit events that could call that premise into question”.¹ Similarly, the UK Financial Conduct Authority published a statement that “‘manufactured’, events [...] can severely harm confidence and trust in the credit derivatives market”.²

- 2.4 The Credit Deterioration Requirement related to Failure to Pay was introduced with the intention that a narrowly tailored payment default should not constitute a Failure to Pay Credit Event. It is not possible to devise an exhaustive definition of narrowly tailored payment defaults, but a common feature is that narrowly tailored payment defaults do not, directly or indirectly, result primarily from, or result in, a deterioration in the creditworthiness or financial condition of the Reference Entity. Accordingly, the Credit Deterioration Requirement excludes from the Failure to Pay definition any non-payments that do not directly or indirectly either result from, or result in, a deterioration in the creditworthiness or financial condition of the Reference Entity. This approach has the additional consequence of capturing other defaults that are caused for some reason unrelated to the creditworthiness or financial condition of the Reference Entity.
- 2.5 For simplicity, this Guidance Note assumes that the relevant Credit Derivatives Determinations Committee (the **Determinations Committee**), or upon referral to External Review, the External Review Panel, would be responsible for making the determination of whether or not an event constitutes a Failure to Pay. However, the principles set out in this Guidance Note should also apply if the question of interpretation is a purely bilateral matter and the relevant determination is not being made by the Determinations Committee or the External Review Panel.

Eligible Information

- 2.6 The Determinations Committee may take into account such Eligible Information as is available to it at the time of its determination, and the Determinations Committee is not obliged to conduct any investigation or solicit additional Eligible Information prior to making a determination when it is assessing (i) whether a Reference Entity experienced a deterioration in its creditworthiness or financial condition and (ii) whether the non-payment directly or indirectly resulted from, or resulted in, such deterioration. Eligible Information may include statements made by the Reference Entity but such statements will not necessarily be determinative.
- 2.7 The Determinations Committee may presume that the Credit Deterioration Requirement is satisfied in the absence of any Eligible Information to suggest the contrary.

Assessment of the Credit Deterioration Requirement

- 2.8 The Credit Deterioration Requirement, when specified as applicable, requires that a non-payment must directly or indirectly result from, or result in, a deterioration in the creditworthiness or financial condition of the Reference Entity in order to qualify as a Failure to Pay Credit Event. It should be noted that the financial condition of the Reference Entity at the time it fails to pay is not conclusive as to whether or not such non-payment resulted from, or resulted in, a deterioration in the creditworthiness or financial condition of the Reference Entity. Rather, there must be a causal link between the non-payment and the deterioration in

¹ Statement on Manufactured Credit Events by U.S. Commodity Futures Trading Commission Divisions of Clearing and Risk, Market Oversight, and Swap Dealer and Intermediary Oversight of April 24, 2018, available at <https://www.cftc.gov/PressRoom/SpeechesTestimony/divisionsstatement042418>.

² Market Watch December 2018, available at <https://www.fca.org.uk/publication/newsletters/market-watch-58.pdf>

the creditworthiness or financial condition of the Reference Entity. While the expectation is that the Credit Deterioration Requirement would generally be met by way of a non-payment resulting from such deterioration, the Credit Deterioration Requirement may also be met by a non-payment that results in such deterioration. This is intended to permit a Failure to Pay to occur where a technical, administrative or operational non-payment occurs that does not itself result from a deterioration in creditworthiness or financial condition, but the consequences of such non-payment result in a deterioration in the creditworthiness or financial condition of the Reference Entity.

- 2.9 Paragraphs 2.10 and 2.11 below respectively set out indicators that the Credit Deterioration Requirement may or may not be satisfied. However, the Determinations Committee will have regard to the broader context in which the non-payment occurred: the factors set out are not exhaustive and no single factor is necessarily conclusive.
- 2.10 Eligible Information that is indicative that the Credit Deterioration Requirement is not satisfied may, without limitation, include the following:
- (a) Subject to paragraphs 2.12 and 2.13 below, the non-payment arises directly from an arrangement or understanding (whether or not evidenced in writing) between the Reference Entity and one or more entities where an essential purpose of the arrangement or understanding is to create a benefit under a Credit Derivative Transaction referencing such Reference Entity to either a buyer or seller in such capacity by virtue of triggering a Credit Event due to such non-payment.
 - (b) An arrangement or understanding within the scope of sub-paragraph (a) above is entered into and, as part of such arrangement or understanding, the Reference Entity agrees to issue or incur either: (i) a new debt obligation which is likely to be the cheapest-to-deliver Deliverable Obligation in any Auction resulting from the Credit Event triggered by such non-payment (i.e. the new debt obligation would trade at a lower value compared to the other debt obligations that could be delivered into the relevant Auction); or (ii) a material amount of additional debt obligations that would constitute Deliverable Obligations in such an Auction.
 - (c) The non-payment did not result in the Reference Entity's other debt obligations generally being accelerated or becoming capable of being accelerated.³
 - (d) The Reference Entity had access to sufficient liquidity to meet its debt obligations as they were scheduled to fall due and there is no Eligible Information that such non-payment had a technical, administrative or operational cause.
 - (e) The non-payment was promptly cured following the expiry of the relevant grace period, including a Grace Period deemed under the Definitions.
 - (f) Subject to paragraph 2.12 below, the non-payment related only to debt obligations held by affiliates or other persons not likely to accelerate or take enforcement action.

³ This is relevant because the consequences of non-payment to the Reference Entity may be an indicator that a payment default was narrowly tailored and that the Credit Deterioration Requirement is not satisfied. However, a non-payment could also occur as a result of a deterioration in the creditworthiness or financial condition of the Reference Entity in circumstances where the non-payment does not exceed the threshold for cross-default. Accordingly, as with each of the other factors, this is only one of the factors to be considered.

2.11 Eligible Information that is indicative that the Credit Deterioration Requirement is satisfied may, without limitation, include the following:

- (a) The Reference Entity previously announced that it was in financial distress and/or seeking to restructure its debt obligations prior to the non-payment occurring, or other Eligible Information indicates that this is the case (such as the entry into the sort of forbearance, standstill or other similar arrangement with creditors described at paragraph 2.12 below).
- (b) The Reference Entity previously appointed professional financial advisors that specialize in restructuring and/or insolvency situations.
- (c) The non-payment occurs pursuant to the terms of a creditor process that is overseen by or approved by a court or independent insolvency official.
- (d) The non-payment related to debt obligations that were, at the time of the non-payment, held by a number of parties.
- (e) The non-payment occurred because the Reference Entity was not able to refinance (including as a result of general market conditions or external factors) in order to meet its debt obligations when due.
- (f) The payment date on which the non-payment occurred was a scheduled payment date under the terms of the debt obligation at the time such debt obligation was originally incurred; or if such payment date was amended, it was amended well before the date such non-payment occurred.
- (g) Regarding whether the non-payment directly or indirectly resulted in a deterioration in the creditworthiness or financial condition of the Reference Entity, following or as a result of the non-payment, any of the following occurs: (i) other debt obligations of the Reference Entity are generally accelerated or capable of acceleration; (ii) the Reference Entity fails to pay in respect of its other debt obligations; and/or (iii) a Bankruptcy occurs in respect of the Reference Entity.

Forbearance, standstill and other bona fide arrangements

2.12 If a Reference Entity enters into a forbearance, standstill or other similar arrangement with its creditors for *bona fide* commercial reasons related to a deterioration in its creditworthiness or financial condition, this would rarely result in a determination that the relevant non-payment by the Reference Entity did not directly or indirectly result from a deterioration in the creditworthiness or financial condition of the Reference Entity. Eligible Information that (i) a Reference Entity has entered into such arrangement with its creditors other than on arm's length terms, (ii) no written and binding agreement setting out the terms of such arrangement exists and/or (iii) such arrangement is not entered into between the Reference Entity and a significant portion of its creditors by value, may indicate that such forbearance, standstill or other similar arrangement has not been entered into for *bona fide* commercial reasons related to the credit deterioration of the Reference Entity.

2.13 Creditors who have hedged their exposure to a Reference Entity using Credit Derivative Transactions may be likely to reject any restructuring of the Reference Entity's debt obligations if the terms of such restructuring would impair the value of such Credit Derivatives Transactions. Accordingly, within the context of a *bona fide* debt restructuring, if the Reference Entity enters into an arrangement or understanding with such creditors that includes a failure to

make a payment with the purpose of causing settlement of such Credit Derivative Transactions so as to increase the likelihood of success of such *bona fide* restructuring, and in circumstances where without such restructuring the Reference Entity would be likely to enter into bankruptcy or similar proceedings, such arrangement or understanding should generally be considered to have the essential purpose of facilitating such restructuring rather than creating a benefit under a Credit Derivative Transaction as described in paragraph 2.10(a) above.

Annex 2 – Proposed Clarification to Outstanding Principal Balance Definition

DRAFT AMENDMENT TO 2014 ISDA CREDIT DERIVATIVES DEFINITIONS:

OUTSTANDING PRINCIPAL BALANCE

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).

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.

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