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MEMORANDUM

To	Kirsty Taylor
From	David Benton Shruti Ajitsaria Edward Morphett
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Subject	**Impact of a break up of the Eurozone on Credit Derivatives Transactions**

As part of ISDA's continuing discussions with its members in relation to the Eurozone crisis, ISDA has arranged for a number of product specific papers to be produced to assist members in their Eurozone contingency planning in the event that a Eurozone state were to exit from the Eurozone (the "**Exiting State**"). The papers highlight various issues that may arise as a result of redenomination legislation, capital and exchange controls and unscheduled bank holidays in relation to an Exiting State.

This paper focuses on Transactions which incorporate either (a) the 2014 ISDA Credit Derivatives Definitions ("**2014 Definitions**") or (b) the 2003 ISDA Credit Derivative Definitions as amended by the July 2009 Supplement (the "**Updated 2003 Definitions**").

One of the challenges in analysing the effects of a Eurozone exit is that there is no legal mechanism for such an exit in existing EU legislation. It is not clear to what extent such an exit would be consensual or unilateral, or would or would not be supported by EU legislation. For the purposes of the analysis in this paper, however, the following assumptions have been made:

(a) the Exiting State passes a law (the "**New Currency Law**") redenominating all obligations owed by and to it from the Euro into a new currency (the "**New Currency**");

(b) the Exiting State exits without EU consensus and over-arching EU legislation recognising the redenomination of debts effected by the Exiting State's New Currency Law; and

(c) the Exiting State introduces new capital and exchange controls.

The ISDA Credit Derivatives Determinations Committee (the "**DC**") will be ultimately responsible for making determinations as to whether or not a Credit Event has occurred with respect to a Reference Entity and which obligations of the Reference Entity will constitute Deliverable Obligations. Any such determination will be binding in respect of Credit Derivative Transactions which incorporate either the 2014 Definitions or the Updated 2003 Definitions. The DC may come to a different conclusion from the conclusions given in this paper and it is hard to predict what approach the DC would take (particularly as it is open to the DC to take a more purposive approach and to place a greater emphasis on market expectations than an English Court might).

A. THE POSITION PURSUANT TO THE 2014 DEFINITIONS

1. The definition of "Euro"

The Definitions provide that definitions of currencies shall have the meanings given to those terms in the 2006 Definitions. The 2006 Definitions contain the following defined terms:

Section 1.7(j) Euro "Euro", "euro", "€" and "EUR" each means the lawful currency of the member states of the European Union that adopt the single currency in accordance with the EC Treaty"; and

Section 1.12. EC Treaty. "EC Treaty" means the Treaty establishing the European Community (signed in Rome on March 25, 1957), as amended by the Treaty on European Union (signed in Maastricht on February 7, 1992) , as amended by the Treaty of Amsterdam (signed in Amsterdam on October 2, 1997) and the Treaty of Nice (signed in Nice on February 26, 2001).

It is our view that these definitions are sufficient to displace any suggestion that the intention was that payments should be made in the currency of a particular member state of the Eurozone. Accordingly in the case of the exit of an Exiting State and continuation of the Euro, Euro would mean Euro, and not any New Currency. This position is further clarified by the 2014 Definitions as set out in more detail in Section 2(a) below.

2. Credit Events under the 2014 Definitions

(a) Restructuring – Section 4.7(a)(v)

A change in the currency of any payment of interest, principal or premium to any currency other than the lawful currency of Canada, Japan, Switzerland, the United Kingdom and the United States of America and the Euro and any successor currency to any of these currencies will be capable of triggering a Restructuring Credit Event. The 2014 Definitions clarify that, in the case of the Euro, the successor currency shall mean the currency which succeeds to and replaces the Euro in whole.

As such, if the Exiting State exited the Euro and redenominated its debt obligations into New Currency, the New Currency would not constitute a successor to the Euro and so such event would be capable of triggering a Restructuring Credit Event provided that the other requirements were met. There are two deviations from the standard Restructuring Credit Event which will apply in these circumstances. Normally, in order to trigger a Restructuring Credit Event, the relevant event would need to result from a deterioration in creditworthiness of the Reference Entity. However, in the case of a Euro exit, it was felt that it would be difficult to judge whether a Restructuring was caused by a deterioration in credit in respect of a particular Reference Entity in circumstances where an entire country had left the Euro. Accordingly, this requirement has been switched off in this case.

Instead, the 2014 Definitions have introduced a requirement for the redenomination to constitute an implied haircut in order for a Euro exit to be capable of triggering a Restructuring Credit Event. Accordingly, Section 4.7(b)(ii) provides that (A) where the redenomination is a result of action taken by a Governmental Authority[1] of a Member State of the European Union which is of general application in its jurisdiction, (B) where a freely available market rate of conversion between Euros and such other New Currency existed at the time of such redenomination and, (C) if with reference to such market rate,

1 As defined in Section 4.9(b) of the 2014 Definitions.

it can be demonstrated that there was no reduction in the rate or amount of interest, principal or premium payable, a Restructuring Credit Event shall not occur.

Finally, if an Exiting State exited the Euro, but a particular obligation was governed by a law which did not recognise the applicable purported redenomination of such obligation, no Restructuring would occur as the amendment will not have occurred in a form which "binds all holders".

(b) Failure to pay – Section 4.5

A Failure to Pay Credit Event may occur if the Reference Entity fails to make a payment which is due in accordance with the terms of the Obligation at the time of such failure. Section 4.1 of the 2014 Definitions states that an event may constitute a Credit Event even if it arises as a result of a change in law. Accordingly, if an Exiting State redenominated all Obligations owed by it and to it from Euro into New Currency, a payment in New Currency would be capable of triggering the Failure to Pay Credit Event.

During discussions surrounding the drafting of the 2014 Definitions, a concern was raised that if redenomination into a New Currency did not trigger a Restructuring Credit Event, the protection buyer should not be able to trigger a Failure to Pay Credit Event if, following such redenomination, currency fluctuations between Euro and New Currency meant that a haircut existed at a later point in time.

Accordingly, Section 4.11 of the 2014 Definitions provides that if a country redenominates its currency from Euro to New Currency and a Reference Entity subsequently made payment in the New Currency when payment was actually required to be made in Euro, no Failure to Pay Credit Event would arise if (i) such redenomination occurs as a result of action taken by a Governmental Authority which is of general application in the jurisdiction of such Governmental Authority, (ii) a freely available market rate of conversion existed at the time of the redenomination and (iii) the redenomination itself did not constitute a reduction in the rate or amount of interest, principal or premium payable as determined by reference to such freely available market rate of conversion at the time of such redenomination.

We note that Section 4.11 refers to a Failure to Pay which is a result of a "redenomination". We think that this should be construed to mean a legally binding redenomination of an obligation. Accordingly, a purported redenomination of an obligation which is governed by a law which does not recognise such redenomination would fall outside the scope of Section 4.11 and, therefore, such a redenomination would be capable of triggering a Failure to Pay Credit Event, irrespective of whether or not there is an implied haircut. If the Issuer pays in New Currency when the obligation still requires payment to be made in Euro, then that would constitute a failure to pay "in accordance with the terms of such Obligation".

Note that this analysis is dependent on terms of the relevant obligation and accordingly, if, for example, the obligation permits the issuer to discharge its payment obligations by paying an equivalent amount in a different currency, a payment in such different currency without any implied haircut will not constitute a Failure to Pay Credit Event.

3. Deliverable Obligations

(a) Specified Currency - successor currency

If a Credit Event did occur, the next issue that the DC would consider is what would constitute a Deliverable Obligation. Assuming that the Deliverable Obligation Characteristics included "Standard Specified Currency", this would require the Obligation to be payable in the lawful currencies of Canada, Japan, Switzerland, France, Germany, the UK, the USA and the Euro and any successor currency to any of the aforementioned currencies. Again, the 2014 Definitions clarify that, in the case of the Euro, the successor currency shall mean the currency which succeeds to and replaces the Euro in whole.

As such, unless France or Germany left the Euro, any redenominated obligations would not themselves satisfy the relevant Deliverable Obligation Characteristics. However, in certain circumstances, Asset Package Delivery will apply, in which case the redenominated obligations may be capable of being Delivered into CDS. These circumstances, broadly speaking, are as follows:

(i) if the relevant Reference Entity is a Financial Reference Entity and the redenomination constitutes a Restructuring, in which case, the Asset Package relating to the Reference Obligation will be capable of being Delivered; or

(ii) if the relevant Reference Entity is a sovereign and the redenomination constitutes a Restructuring, in which case the Asset Package relating to any Package Observable Bonds[2] will be capable of being Delivered,

in each case, in full satisfaction of the CDS.

For these purposes, the Asset Package will constitute the redenominated Bond in an amount equal to what has been converted into the Outstanding Amount of the original Reference Obligation or Package Observable Bond which is specified in the Notice of Physical Settlement.

(b) Obligations originally denominated in Euro

The 2014 Definitions provide that "Specified Currency" shall include any obligation that was previously payable in Euro, regardless of any redenomination thereafter, provided that such redenomination occurred as a result of action taken by a Governmental Authority of a Member State of the European Union which is of general application in the jurisdiction of such Governmental Authority. However, it is important to note that this will not necessarily afford the protection buyer protection against devaluation. By way of example, where the CDS auction is to be settled in euro and the New Currency has devalued (which seems likely), the buyer of protection would be required to deliver increasingly greater principal amounts of the New Currency Obligation into any RAST (based on the spot rate typically set two business days before the auction). Accordingly, the Auction Price may well reflect the already devalued New Currency (and therefore be at or around par). The protection buyer's protection against devaluation on a redenomination is afforded in the 2014 Definitions by the Asset Package Delivery provisions described in paragraph (a) above.

(c) Section 3.5

In circumstances where Asset Package Delivery is not applicable, the 2014 Definitions have retained the concept of a Sovereign Restructured Deliverable Obligation, this being an Obligation of a Sovereign Reference Entity (a) in respect of which a Restructuring that is the subject of the relevant DC Credit Event Announcement has occurred and (b) which satisfies the applicable Deliverable Obligation Category and Characteristics immediately preceding the date on which such Restructuring is legally effective.

Section 3.5 of the 2014 Definitions operates such that a Sovereign Obligation will, in the case of a Restructuring Credit Event, constitute a Deliverable Obligation if it fell within the relevant Deliverable Obligation Category and satisfied the relevant Deliverable Obligation Characteristics immediately prior to the restructuring, even if it was restructured in such a way so that post-restructuring, it would no longer satisfy these requirements.[3]

This provision only applies to Sovereigns and could be applicable in a scenario where a country redenominated their currency into a New Currency in such a way that a Restructuring Credit Event occurred, but where New Currency was deemed not to be a successor currency to the Euro.

[2] These are the Bonds which will be chosen by the relevant DC in accordance with the rules of selection published by ISDA.
[3] Although note that it still needs to constitute an “Obligation”.

B. THE POSITION PURSUANT TO THE UPDATED 2003 DEFINITIONS

1. The definition of "Euro"

The Updated 2003 Definitions provide that definitions of Currencies shall have the meanings given those terms in the 2000 ISDA Definitions. The 2000 Definitions contain the following defined terms:

Section 1.7(i) Euro. "Euro", "euro", "€" and "EUR" each means the lawful currency of the member states of the European Union that adopt the single currency in accordance with the EC Treaty"; and

Section 1.12. EC Treaty. "EC Treaty" means the Treaty establishing the European Community (signed in Rome on March 25, 1957), as amended by the Treaty on European Union (signed in Maastricht on February 7, 1992) and as amended by the Treaty of Amsterdam (signed in Amsterdam on October 2, 1997).

Again, it is our view that these definitions are sufficient to displace any suggestion that the intention was that payments should be made in the currency of a particular member state of the Eurozone. Accordingly in the case of the exit of an Exiting State and continuation of the Euro, Euro means Euro, and not any New Currency.

2. Credit Events under the Updated 2003 Definitions

(a) Restructuring

(i) Section 4.7(a)(v) - Permitted Currency

One of the limbs of a Restructuring Credit Event is a change in the currency or composition of any payment of interest or principal to any currency which is not a Permitted Currency. For these purposes, Permitted Currency is defined as follows:

""Permitted Currency" means (1) the legal tender of any Group of 7 country (or any country that becomes a member of the Group of 7 if such Group of 7 expands its membership) or (2) the legal tender of any country which, as of the date of such change, is a member of the Organisation for Economic Cooperation and Development and has a local currency long-term debt rating of either AAA or higher assigned to it by Standard & Poor's, a division of The McGraw-Hill Companies, Inc. or any successor to the rating business thereof, Aaa or higher assigned to it by Moody's Investors Service, Inc. or any successor to the rating business thereof or AAA or higher assigned to it by Fitch Ratings or any successor to the rating business thereof."

As such, if a country chose to exit the Euro and redenominated their currency into New Currency and such country was either a G7 country or a country with AAA/Aaa rating, then the New Currency would constitute a Permitted Currency; otherwise, the New Currency would not constitute a Permitted Currency. Accordingly, if a non-G7 country without the requisite rating exited the Euro and successfully redenominated payment obligations with respect to one or more of its Obligations in a form that binds all holders, the first limb of a Restructuring Credit Event would be satisfied.

If a country exited the Euro and redenominated into a New Currency that was itself a shared currency (eg the so called southern states euro) and any country sharing the New Currency was a G7 country or a country with a AAA/Aaa rating, then the New Currency would constitute a Permitted Currency; accordingly, the Restructuring Credit Event would not be triggered in such case.

There has been some discussion of whether the G20 countries could constitute members of the G7 on the basis that the words in parenthesis refer to the expansion of the G7's membership. We do not think that this is a particularly tenable argument, firstly because the G20 was formally established in 1999 and as such would already have been in existence in 2003 when the Definitions were published, but also because the G20 is not merely an expansion of the G7 – it is, rather, a different group of states.

(ii) Section 4.7(b)(iii) – Deterioration in the creditworthiness or financial condition

Whether or not the second limb of the Restructuring Credit Event is satisfied, namely whether the event directly or indirectly arises from a deterioration in the creditworthiness or financial condition of the Reference Entity would be a question of fact to be determined at the time. In the context of a Sovereign Reference Entity exiting whilst in financial difficulties it should be fairly easy to identify that the event, namely the redenomination of certain Obligations directly or indirectly resulted from a deterioration in the creditworthiness or financial condition of the Sovereign itself. This may be less clear if the Sovereign redenominates by operation of law certain Obligations of its credit institutions - for example, the credit institution's deposits - which it is likely to do if the Sovereign exits the Euro. In these circumstances, again, it would be fact specific and may raise interesting questions, particularly where an otherwise financially stable bank has its deposits redenominated and the reason for such redenomination is the Sovereign's financial instability and subsequent exit from the Euro. The DC may well have to take a purposive construction of these provisions and the answer will be very fact specific.

(iii) Section 4.7 – Legally Binding

Again it is worth noting that if an Exiting State exited the Euro, but a particular obligation was governed by a law which did not recognise the applicable purported redenomination of such obligation, no Restructuring would occur as the amendment will not have occurred in a form which "binds all holders".

(b) Failure to pay – Section 4.5

Another interesting question that has been raised in this context is whether, if a country changed its currency from Euro to New Currency, a Failure to Pay Credit Event could occur on the basis that the Reference Entity had failed to make a payment which would, but for the operation of law, have been required to be made in Euro (hence invoking Section 4.1 of the Definitions). We note that there is an argument that as the definition of Restructuring clearly contemplates a change in currency of an Obligation, and sets out the parameters within which such a change in currency is intended to constitute a Credit Event, that such a scenario should be covered by reference to the Restructuring Credit Event rather than by reference to Failure to Pay. However, we think that the better argument is that such a redenomination should be capable of triggering a Failure to Pay. We think that the position may be slightly less clear in circumstances where there is no haircut and the answer may then depend on the terms of the underlying documentation.

In circumstances where the Exiting State exits the Euro, if any applicable purported redenomination of an obligation was not recognised by the governing law of such obligation, a Failure to Pay could still occur because it would constitute a failure to make a payment in accordance with the terms of the obligation. As previously noted, this could apply regardless of whether an implied haircut was applicable, but would depend on the exact terms and conditions of the relevant obligation.

3. Deliverable Obligations

(a) Specified Currency - successor currency

If a Credit Event did occur, the next issue that the DC would consider is what would constitute a Deliverable Obligation. Assuming that the Deliverable Obligation Characteristics included "Standard Specified Currency", this would require the Obligation to be payable in the lawful currencies of Canada, Japan, Switzerland, the UK, the USA and the Euro and any successor currency thereto.

Assuming again that a country redenominated its debt from Euro to New Currency, the question would then turn on whether New Currency constitutes a "successor currency" to the Euro. This is a difficult question and may largely depend on the particular facts at the time. If only one country redenominated their currency, one interpretation would be that New Currency is a successor to the Euro (albeit in part and despite the fact that the Euro is continuing and has not been replaced in whole). It seems to us that this argument may be more tenable in the context of a redenomination of currency by Germany than by, for example, Greece. The other interpretation is that successor means successor to the Euro as a whole and therefore New Currency debt would not be deliverable. This argument is more persuasive in the context of one country exiting the Euro. If, however, the Euro disintegrated in whole, it would seem that either each New Currency would constitute a successor currency or else no New Currency would constitute a successor currency, which would seem to us to tend towards the argument that each New Currency should constitute a successor currency.

(b) Section 2.16

The Definitions include a concept of a Sovereign Restructured Deliverable Obligation, which is an obligation of a Sovereign Reference Entity (a) in respect of which a Restructuring that is the subject of the relevant DC Credit Event Announcement has occurred and (b) described by the Deliverable Obligation Category specified in the related Confirmation, and, subject to Section 2.21(c), having each of the Deliverable Obligation Characteristics specified in the related Confirmation, in each case, immediately preceding the date on which such Restructuring is legally effective in accordance with the terms of the documentation governing such Restructuring, and without regard to whether the Obligation would satisfy such Deliverable Obligation Category or Deliverable Obligation Characteristics after such Restructuring.

Section 2.15(c) operates such that a Sovereign Obligation will, in the case of a Restructuring Credit Event, constitute a Deliverable Obligation if it satisfied the relevant Deliverable Obligation Characteristics immediately prior to the restructuring, even if it was restructured in such a way so that post-restructuring, it would no longer satisfy these Characteristics.

This exception applies to Sovereigns and not Corporates and would be applicable in a scenario where a country redenominated their currency into a New Currency in such a way that a Restructuring Credit Event occurred, but where New Currency was deemed not to be a successor currency to the Euro.

Whether the Reference Entity is a Sovereign or a Corporate, if the CDS auction is to be settled in Euro and the New Currency has devalued (which seems likely), the Buyer of protection would be required to deliver increasingly greater principal amounts of the New Currency Obligation into any RAST (based on the spot rate typically set two business days before the auction). Accordingly, the Auction Price may well reflect the already devalued New Currency (and therefore be at or around par).