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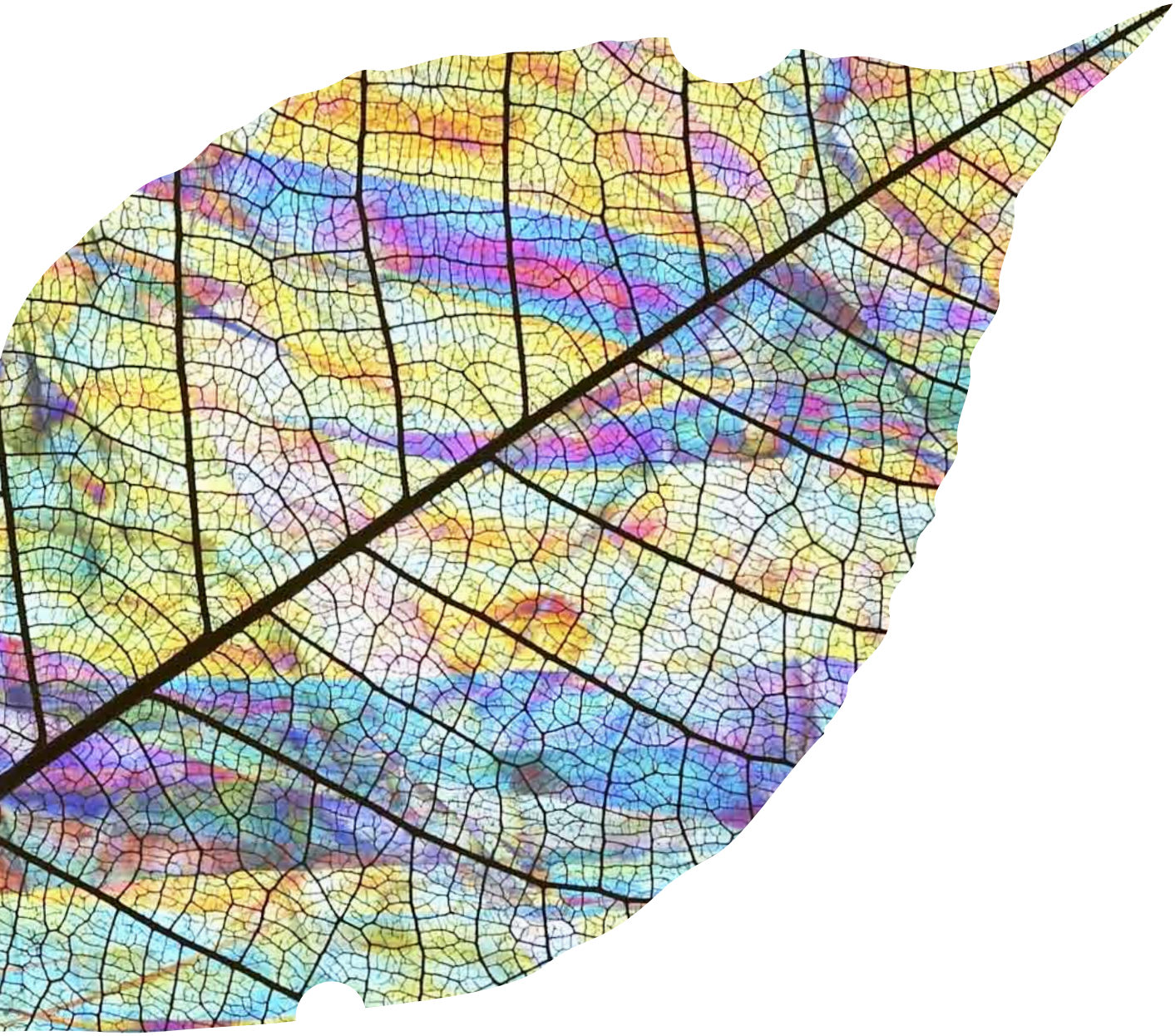

Sovereign state restructurings and credit default swaps

October 2011

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A&O Global Law Intelligence Unit

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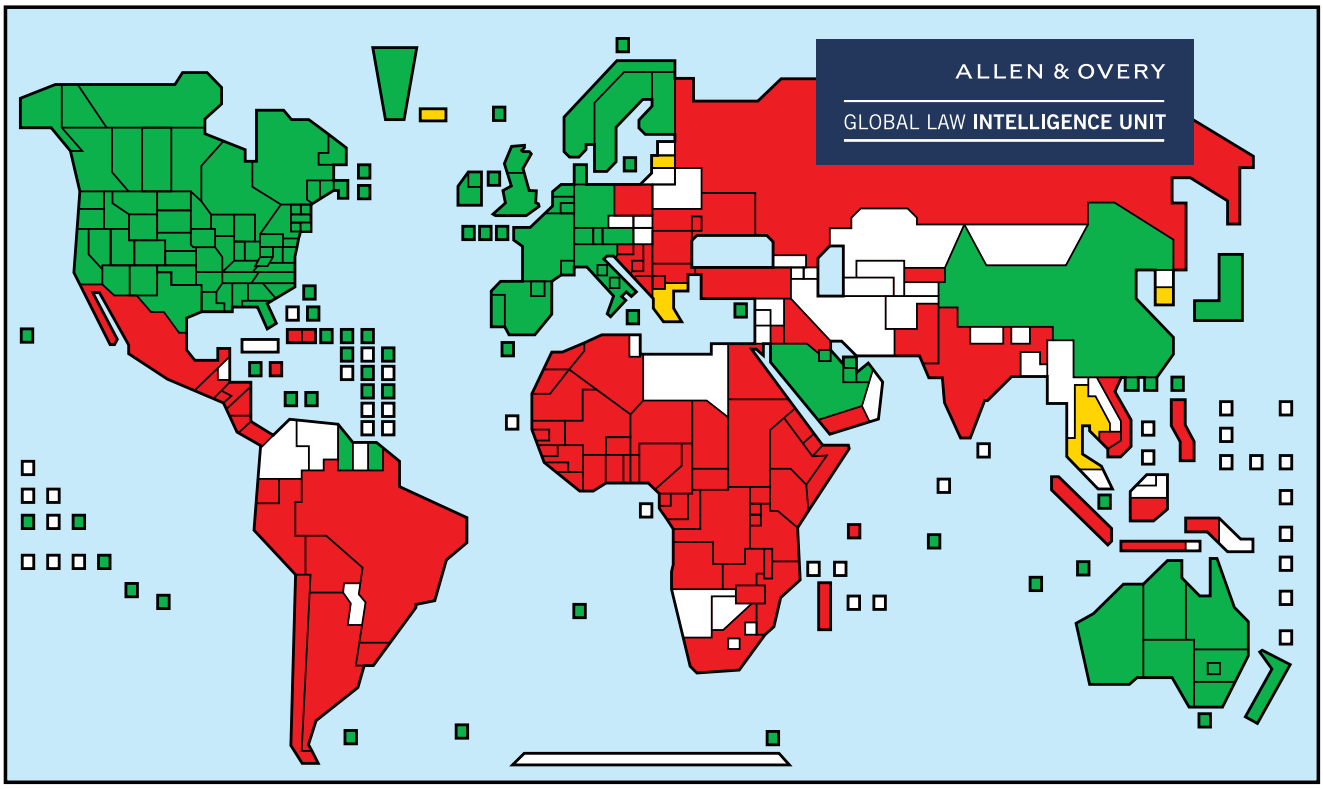
Purpose of this paper

The purpose of this paper is to examine the impact of a sovereign state restructuring on credit default swaps.

More than half of the world's sovereign states have been insolvent since 1980: see the map below. Sovereign insolvency is a frequent fact of life and further bouts of insolvencies at the state level around the world can be expected. Hence this paper is not just about those eurozone states which are currently encountering financial difficulties. It has a wider and more generic scope.

State insolvency: 1980-2010



Unable to pay due foreign currency loans at some time in this period
Solvent throughout this period
Crisis
Unallocated

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Credit default swaps sound arcane and esoteric. They are not, and we explain later how they work so that those unfamiliar with this field can follow this discussion.

Just as you can insure your house against a fire and your car against a crash, so you can insure your bonds against a collapse or, in the jargon, hedge them. It is reasonable that people should be able to protect their assets in this way and there is no reason why the protection should not also be available for financial assets as with all other assets. For reasons dealt with later, credit default swaps are not technically insurance for legal purposes and that is reasonable as well.

Background to state insolvency

States can become insolvent just as can any corporation or individual. They are insolvent when they are unable to pay their liabilities as they fall due. The liabilities with which we are mainly concerned here are bonds owed to domestic and foreign bondholders.

The bonds may be denominated in the domestic currency, in which case the bonds are typically governed by local law. Such bonds do not usually have protective clauses, such as (among others) events of default, waivers of sovereign immunity, negative pledges, pari passu clauses or collective action clauses permitting bondholder voting on debt restructuring.

Alternatively, the bonds may be denominated in a foreign currency, in which case they will often be subject to external law and jurisdiction, such as English law and courts, and contain a waiver of sovereign immunity, a pari passu clause, a negative pledge, events of default with a bondholder right to accelerate and sometimes collective action clauses.

Most of the bond debt of developed country sovereign states is in the domestic currency and is governed by local law. This is particularly the case in eurozone countries where typically over 95% of the debt of such countries as Greece and Portugal is payable in euro and governed by Greek or Portuguese law.

Implications of local governing law

The question of whether a bond is governed by local law or foreign law has crucial implications for the bargaining power of the parties. This is because if a bond is governed by local law, then the issuer state can theoretically change that law, eg to unilaterally reschedule the bonds, and this change will often be recognised by foreign courts. The result is that the bondholder is bound by a unilateral change, even if the bondholder brings action in foreign courts, since if the bondholder contracts under the law of the issuing state, he must accept that law as it is from time to time. The precise details of foreign recognition vary somewhat from country to country – for example, in the United States the test is not the governing law but rather where the bond is "located" – but commonly one arrives at a similar result.

If, however, a bond is governed by foreign law, then a law of the issuing state cannot change the bond. For example, Portugal cannot change Portuguese law to amend a bond governed by English law.

As we shall see, this situation has significant consequences for what happens to credit default swaps on a sovereign state rescheduling.

Nevertheless, the proportion of bonds governed by foreign law in the case of eurozone states is typically small so that the issuing state has considerable power to change its own obligations, at least in theory.

How does a state restructure its debt?

Unlike an ordinary domestic bankruptcy of a corporation, when a state becomes bankrupt there is no bankruptcy law. There are no applications for a bankruptcy proceeding, no freezes or stays on creditors, no realisations of the assets, no reorganisation plan, no bankruptcy courts or

judges or procedures. All there is is contract and agreement plus a few customs and conventions which have grown up historically. The outcome essentially depends on the realities and the bargaining position of the parties.

If a sovereign state is unable to pay its bonds as they mature, either it must be bailed out by borrowings from other sources or else it has to reschedule the debt. In practice, the borrowing from other sources will usually come from official sources, such as the IMF, other sovereign states or central banks. In the case of the eurozone, the European Central Bank is restricted from making direct loans to eurozone sovereign states, but it can buy the securities of sovereign states in the secondary market. Also in the case of the eurozone, a company has been established in Luxembourg authorised to finance eurozone states in trouble: it is proposed that as from mid-2013 this company will be replaced by an international organisation, formed by treaty between eurozone member states and also located in Luxembourg, to carry out the same tasks.

Exchange offers to bondholders

If continuing finance from official sources is not available, then the sovereign state in practice has to approach the bondholders with a rescheduling proposal. So far, since the late 1990s, these rescheduling arrangements have involved offers by the sovereign state to bondholders to exchange existing bonds into new bonds on rescheduled terms. This was, for example, the procedure followed by Pakistan, Ecuador, the Ukraine, Uruguay and Argentina since 1999.

The crucial point here is that it is not that the existing bonds are rescheduled, but rather the existing bonds are replaced by new bonds if the bondholders accept the offer.

In addition, the issuing state commonly declares that it will not pay bondholders who are eligible to accept the offer but do not. In other words, in order to incentivise bondholders to pay, the sovereign state declares that it will not pay creditors who hold out against the offer. If they want to be paid, they have to accept the rescheduled terms.

In practice, sovereign states can do this without exposing their assets to attachment by unpaid creditors of the state pursuant to court judgements for the unpaid debt. This is because it is almost invariably the case that the internal laws of most states do not permit creditors to attach domestic assets, which are therefore immune. Further, most states do not have significant external assets in their own name. The foreign reserves are held by the central bank which is often a separate legal entity and therefore insulated from creditor attachments for the debts of the sovereign state.

A primer on credit default swaps

This is an introductory explanation of credit default swaps and how they work, for the benefit of those who are unfamiliar with this market.

If a bondholder holds bonds of the sovereign state, then the bondholder can arrange for some third party to pay the bondholder on the occurrence of certain events ("credit events") that imply financial problems in the sovereign state, most obviously (but not only) a failure to pay on its debt. On the occurrence of one of these events, the third party makes a payment to the bondholder to reflect the drop in value of the bond caused by the circumstances surrounding the event compared to par. In return for this protection, the buyer pays the seller a fee, usually paid quarterly. In the original forms of these transactions, when the protection is triggered, the seller of protection pays money to the buyer of protection, and the buyer of protection delivers a complying obligation such as a bond, ie there is a swap of money and paper when there is a credit default. These days, however, credit default swaps are usually settled by the auction process described below rather than actually having a physical swap.

There is a large market for this protection and indeed there are so many dealers who are prepared to take on this risk that you can get daily quotes on the cost of the protection. The typical quote is so many basis points (a basis point is

one-hundredth of 1% .) per USD10,000,000 for five years. Thus, if the quote is 200 basis points, the cost is 2% of the debt for each year – a total cost over five years of 10% of the principal of the bond.

The bondholder or other participant who buys the protection is called the buyer of protection and the party who agrees to pay if there is a credit event is called the seller of protection. The debtor in respect of which protection is being bought – the issuer or the guarantor in the case of bonds and the borrower or guarantor in the case of loans – is called the reference entity. In the case of a sovereign credit default swap, the reference entity will usually be the sovereign state itself, or it may be a quasi-sovereign entity such as a state-owned company or a central bank. Of course, the reference entity is not party to the credit default swap or involved in any way, it merely serves as a point of reference to determine the parties' obligations.

When is protection triggered?

The protection is triggered if a credit event occurs during the agreed period. The credit events, in the case of sovereign states, will typically be: (1) a failure to pay any relevant debt by the sovereign state, (2) a repudiation or moratorium declared by the sovereign state in respect of any relevant debt, (3) a restructuring of any relevant debt, or (4) in the case of emerging market sovereigns, an obligation acceleration, where one or more obligations of the reference entity become due and payable before they would otherwise have become due and payable as a result of the occurrence of a default, event of default or other similar condition or event other than a failure to make any required payment. We consider the three main credit events (numbers (1) to (3) above) in detail below.

The credit event must occur in respect of certain "obligations" designated in the contract. The obligations are those that fall within the "obligation category" and satisfy the "obligation characteristics" (if any) specified in the confirmation. The categories will commonly be all "bonds" and "loans" but may also include any other "borrowed money". The relative size of the market makes bonds our main concern in this paper, rather than loans or other forms of borrowed money.

If "obligation characteristics" apply, they may require that debt must be "not domestic currency", "not domestic law" and "not domestic issuance" (ie intended primarily for sale in the domestic market of the issuing sovereign). These generally apply only to emerging market sovereigns, as opposed to eurozone sovereigns.

Obligations of the sovereign reference entity will generally cover debt issued/borrowed by any other entity if that debt is guaranteed by the reference entity, but only if the guarantee satisfies the criteria of a "qualifying guarantee".

Documentation of credit default swaps

The agreement between the parties is contained in a short "confirmation" of the transaction. This is generally subject to a master agreement between the parties in a form produced by the International Swaps and Derivatives Association, Inc. ("ISDA"). The master agreement contains the provisions governing the general relationship between the parties, such as the events of default, representations and warranties, and, importantly, the close-out netting arrangements whereby, on the default of one party, the other can cancel all open contracts and instead calculate one single net amount payable from one party to the other, which amount takes into account all losses and gains on the contracts so as to reduce exposures.

The confirmation incorporates the ISDA credit derivatives definitions, usually in the 2003 version, as amended. As a result, the confirmation only needs to include a number of commercial terms (such as the premium to be paid by the buyer of protection and the period of protection) and make a number of elections as to which parts of the

definitions will apply. In practice, even this latter aspect is simplified by picking a set of elections from a matrix, also published by ISDA. The appropriate set of elections is determined according to the nature of the reference entity. Thus, in the case of sovereigns, the elections depend on whether the reference entity (and hence the transaction type) is an Asian sovereign, an emerging European and Middle Eastern sovereign, a Japanese sovereign, an Australian sovereign, a New Zealand sovereign, a Singaporean sovereign, a Latin American sovereign, a Western European sovereign or a Sukuk sovereign.

The standard form documentation is voluminous and includes not only the confirmation and the master agreement itself, but also various supplements, annexes, templates and protocols. You have to be a real expert doing this every day in order to understand the intricacies of this market. It is hard for commoditisation and standardisation to surmount the extraordinary complexity of these operations.

In March and July 2009, ISDA published two protocols (the so-called "Big Bang" and "Small Bang" protocols). These protocols made significant changes to the documentation and the credit default swap market generally, including the establishment of Determinations Committees and the settlement of credit default swaps by reference to a price determined pursuant to an auction valuation.

Determinations committees

Amongst other things, the Big Bang and Small Bang protocols introduced a Determinations Committee which could make various decisions in connection with the triggering, settlement and some other aspects of credit default swaps. There is a Determinations Committee for each of the five regions of (a) the Americas, (b) Europe, the Middle East and Africa, (c) Japan, (d) Asia ex-Japan, and (e) Australia-New Zealand. Each Determinations Committee is composed of 15 voting members, comprising eight global dealers, two regional dealers and five non-dealers. Each also has non-voting consultative members drawn from dealers and non-dealers. Dealer members are selected by criteria, including the volume of credit default swaps they trade, and buy side participants are chosen at random, in each case annually from institutions that put themselves forward, provided that such institutions meet certain criteria in relation to assets under management and notional exposure to credit default swaps. Relevant Clearing Houses will soon also be able to join the Determinations Committees in an observatory (non-voting) capacity only.

A Determinations Committee can decide such matters as whether a credit event has occurred and its date. Resolutions of a Determinations Committee must be decided either by a majority (more than 50% of those voting) or a super-majority (80% voting), depending on the nature of the determination in question. The determination as to whether a credit event has occurred and its date requires a super-majority. If a Determinations Committee cannot reach the necessary majority the question is referred to an external review panel chosen from regional pool members approved by the relevant Determinations Committee by a majority vote. The external reviewers will generally be independent legal experts rather than market participants. In practice, referral to an external review panel has only actually happened once in any of the Determinations Committees since their inception. This was in the case of the announcement of Cemex S.A.B. de D.V. ("Cemex") that it had entered into a financing agreement possibly triggering a Restructuring Credit Event. Six members of the Determinations Committee voted that a restructuring credit event had occurred, whilst the remaining nine voting members voted that it had not. The question was referred to an external review panel, which determined that a credit event had occurred. While the most immediate effect of the decision of the Cemex External Review Panel was to affirm the relevance of the restructuring credit event to the market, it also proved the ability of the credit derivatives market to govern itself effectively, even in the face of sharp disagreement between market participants on key elements

of the contract. Determinations by a Determinations Committee are binding on all market participants – the vast majority – whose documentation incorporates the 2009 developments.

Theoretically, there could be a challenge in a court to a determination of a Determinations Committee, but the English courts will generally not re-open a decision of a reputable set of experts, unless the decision was not in accordance with the rules or was completely arbitrary and capricious. This has been shown by numerous cases, including cases involving the UK Takeover Panel. A Determinations Committee has to construe the words correctly and cannot take decisions at variance with what was agreed between the parties, just because it suits the market. The market places an extremely high value on predictability, and this desire for certainty and predictability, ie that the parties are held to the contract they articulated, can be expected to be a priority in the case of Determinations Committees. Indeed so far this has proved to be the case. This is therefore not some secret cabal which does what it likes.

One of the important reasons for having a Determinations Committee is that often credit default swaps are in quite long chains on the same terms, eg a seller of protection may in turn buy protection from someone else, like reinsurance, and that somebody else may also buy further protection. It follows that there needs to be a single decision binding on everybody on such matters as to whether a credit event has occurred.

The timetable for decisions is exceptionally rapid. Typically a decision is reached within a working week, and is therefore much faster than would be the case for a decision reached by a court.

Procedure if a credit event occurs

If a credit event does happen in the prescribed period, then the buyer of protection may notify the seller of protection directly with details and publicly available information confirming the occurrence of the credit event. Since the 2009 supplements, if a market participant thinks a credit event has occurred, it can submit such publicly available information to ISDA (as the secretary of the Determinations Committees) and call upon the relevant Determinations Committee to determine whether a credit event has occurred. The latter is by far the more common nowadays.

If a Determinations Committee determines that a credit event has occurred, it notifies the market and this is then binding in respect of transactions incorporating the credit derivatives definitions as supplemented by the 2009 supplements.

Another significant change introduced by the 2009 supplements is a time limit within which a buyer of protection must act on a credit event in order to take the benefit of protection. Somebody must have requested that the Determinations Committee consider whether a credit event has occurred within 60 days of the occurrence of the event in question. If a buyer fails to take action in 60 days and no other market participant has raised the question with the Determinations Committee, it cannot later claim that its protection should be triggered. The object is fungibility, such that each existing contract will perform in exactly the same way irrespective of the date it is entered into. This is important as the market moves towards central clearing of credit default swap transactions.

Settlement following a credit event

If a credit event happens, the seller of protection in the past traditionally physically settled the transaction. The buyer would deliver to the seller some of the agreed range of debt obligations of the reference entity with a face value equal to the size of the transaction against payment of the monetary size of the transaction.

The obligations to be delivered ("deliverable obligations") must typically be selected from a narrower class of obligations than the "obligations" described above. The additional criteria that deliverable obligations must satisfy are intended to protect the protection seller by making sure that they are readily transferable and generally require that deliverable obligations do not contain terms which make repayment unlikely.

For example, deliverable obligations must typically be "not contingent", which means, in summary, that their outstanding principal balance must not be capable of being reduced (other than by payment). Bonds may also have to be "not subordinated", which means that such bonds must not be subordinated in priority of payment to the most senior reference obligation specified in the confirmation, or, if none is specified, any unsubordinated borrowed money obligation of the reference entity. A bond will be subordinated if a holder is not entitled to receive or retain payment during the insolvency of the reference entity at any time that the reference entity is in arrears (or other default) on some senior debt.

Although these characteristics are often specified, in practice, contingent or subordinated bonds issued by sovereigns are very rare.

Auction settlement

The second major innovation introduced by the 2009 supplements (in addition to the Determinations Committees) was in relation to the settlement of credit default swaps.

The problem before the 2009 supplements was that there were, by reason of the increased volumes of credit default swap trading, not always enough deliverable obligations to use in physical settlement without artificially pushing up the price of the reference entity's debt and thus reducing the value of the protection. To counter this, from 2005 auctions were arranged on an ad hoc basis in respect of the major credit events to establish a uniform price for cash settlement following each auction. This form of settlement is called "auction settlement" and was put on a more formal and permanent footing by the 2009 supplements.

Once the auction price has been established, sellers of protection for the bond concerned have to pay the buyers of protection the difference between the original reference price agreed in the contract (typically 100%) and the market price established by the auction. Thus, if in the original contract the reference price of the bonds was 100 % and the auction final price is 30%, the seller of protection must pay the buyer of protection 70% of the notional size of the credit default swap.

Conduct of auctions

In the auctions, dealers offer prices to buy or sell the deliverable obligations, ie those obligations which would previously have been eligible for delivery by the buyer to the seller in physical settlement.

The structure of the auctions is ingenious and serves several related functions.

The auction final price is based on offer prices submitted by the participating dealers (on their own behalf and, if requested, on behalf of their clients) to deliver or take delivery of actual deliverable obligations.

The fact that participants will actually receive, or have to deliver, obligations at the eventual price ensures that the price is reliable. In addition, it effectively replicates physical settlement, thereby allowing a buyer of protection who holds bonds the opportunity to dispose of them and a

seller who, for whatever reason, wants to receive the bonds to do so.

Finally, the auction, combined with the settlement of the credit default swap at the auction final price, eliminates basis risk for a party that has bought protection to hedge its holding of bonds. In the example above, a buyer of protection will receive 70% of the notional value of the contract (100 minus 30) in settlement of the transaction and can also deliver deliverable obligations against payment of the auction final price (in this case, 30%): it will always receive 100% in total.

Because somebody taking delivery of obligations in the auction could receive any deliverable obligation but does not know which it will receive, it will generally bid what it would pay for the least valuable deliverable obligation. The auction price is generally therefore the price of the cheapest deliverable obligation.

What is the legal characterisation of credit default swaps?

These credit derivatives are not in law guarantees or insurance and are therefore not regulated in the same way as guarantees or insurance. The reasons for the characterisation are technical but are nevertheless extremely important, notwithstanding that the various transactions may look similar if you were stationed in the upper stratosphere looking down on planet earth.

The differences between a credit default swap and a guarantee include the following:

– Non-payment is not usually the only triggering event, which it is in the case of a guarantee. Triggering events include, for example, a restructuring of debt.

– The buyer of protection does not necessarily hold the reference obligation, so that the protection is divorced from the protected asset. In the case of a guarantee, the guarantor guarantees specific debt owed to the beneficiary of the guarantee. In the case of credit default swaps, a buyer of protection can, for example, take out protection in respect of a bond of an issuing state even though the actual obligation which the buyer is holding is a bank loan – or even if the buyer does not hold any debt of the reference entity at all.

– The transactions are usually auction-settled so there is no equivalent of subrogation. In the case of a guarantee, once the guarantor has paid then the guarantor normally takes over the debt which it has paid off so that he can claim it from the borrower.

There are also several distinctions differentiating credit default swaps from insurance, including the following:

– There is no requirement for the buyer of protection to hold the obligation on which protection is purchased, in other words there is no requirement to have an "insurable interest". There is no requirement for the buyer of protection to suffer a loss in order to receive a payment from the seller of protection, nor for the payment that the seller of protection makes to equate to such loss.

Section 9.1(b)(i) of the credit derivatives definitions (as amended) spells this out:

"the parties will be obligated to perform, subject to Section 3.1, in accordance with the Settlement Method or, if applicable, in accordance with Section 12.1, Fallback Settlement Method, as applicable, irrespective of the existence or amount of the parties' credit exposure to a Reference Entity, and Buyer need not suffer any loss nor provide evidence of any loss as a result of the occurrence of a Credit Event."

– There is no duty of utmost good faith requiring the disclosure of all material facts by the Buyer to the Seller in credit derivative transactions, unlike in insurance contracts.

How much is involved?

The maintenance of statistics means that there is reasonable transparency on market volumes.

According to ISDA's 2010 market survey, the total outstanding notional amount of all credit default swaps was approximately USD26,263bn. This was significantly down from the 2007 peak at USD62,173bn, due in large part to the industry's "compression" efforts (removing duplications).

Information on standard credit default swaps is recorded in the Depository Trust & Clearing Corporation's repository and is readily accessible on their website. On 6 September 2011, the following figures were shown as the net amounts of standard credit default swap transactions on certain European sovereigns: for France, USD25.6bn; Germany, USD17.6bn; Greece, USD4.2bn; Ireland, USD3.9bn; Italy, USD24.7bn; Spain, USD18.4bn; and the UK, USD12.7bn.

It is worth considering what these figures represent. The net position across the whole market on any given reference entity is of course zero: every credit default swap has a buyer and a seller of protection in equal measures. Rather, each net notional used here is the aggregate of all participants' overall position x, as DTCC sufficiently describes it, "the sum of the net protection bought by net buyers (or equivalently net protection sold by sellers)." For example if A has two credit default swaps, the first selling protection with a notional size of USD10m to X and the second buying protection with a notional size of USD10m to Y then: A's net position is zero, X is a net buyer to the extent of USD10m, Y is a net seller to the extent of USD10m and the net notional across all three trades is USD10m.

Hence the size of the sovereign credit default swap market is a tiny fraction of the total value of the government bonds in issue.

Disclosures of CDS positions

The proposed regulation on short selling and certain aspects of credit default swaps has yet to be finalised (there are currently significant differences between the text proposed by the European Commission, the European Parliament and the European Council) and therefore details of the exact nature of any restrictions and reporting requirements applicable to sovereign credit default swaps is not yet clear. However, it seems likely that when the regulation comes into effect (currently expected to be the beginning of July 2012), among other things, significant positions in uncovered sovereign credit default swaps (in summary, where the buyer of protection does not hold debt instruments of/have actual exposure to the related sovereign debt, or debt instruments of an issuer, the pricing of which has a high correlation with the pricing of debt instruments of the sovereign reference entity) will be required to be disclosed daily to the relevant financial regulator.

The credit events

Altogether six credit events are defined in the credit derivative definitions and the parties can select any one or more of these for their transaction.

The credit events are: Bankruptcy, Failure to Pay, Obligation Acceleration, Obligation Default, Repudiation/Moratorium, and Restructuring. In the sovereign debt markets only three of these are typically used, the others being more suitable for corporations. One of these events which is specified in the contract must happen before the seller of protection is liable to pay the buyer of protection.

The standard sovereign credit events are:

– Failure to pay.

– Repudiation/moratorium.

– Restructuring.

A downgrade in a credit rating by a rating agency is not a credit event.

Other credit events

There are other credit events which are sometimes used in relation to reference entities which are ordinary corporations but not typically in relation to sovereign states. By far the most prevalent of these is "bankruptcy". This includes various insolvency and bankruptcy situations which do not apply to sovereign states because they are not subject to any international bankruptcy laws. In relation to emerging markets, "obligation acceleration" is occasionally a credit event, including in relation to sovereign states. As described above, this is a default by the reference entity that results in obligations in an aggregate amount in excess of an agreed default requirement being accelerated as a result of the occurrence of a default, event of default or other similar condition or event other than a failure to make any required payment. The credit derivatives definitions also include "obligation default" but this is very rarely used and not specified in any of the standard contracts.

Credit events as defaults

Credit events are not themselves events of default in bonds and bank loan agreements between lenders and a sovereign state unless they are duplicated, which they often are, such as failure to pay. However, credit events in credit default swaps are taken as a sign of very serious trouble and it is for this reason that regulators and politicians often wish to avoid the occurrence of a credit event, even though this does not of itself spark off accelerations as against the issuer itself. But the triggering of a credit default swap might affect, for example, the accounting treatment of the debt by indicating that the debt is impaired and has to be written down in the accounts of the financial statements of the holder. This in turn could have knock-on effects for the amount of capital which a bank is required to have under the Basel capital adequacy rules or which an insurance company is required to have under corresponding capital rules for insurance companies.

A credit event which also appears as an event of default in bonds could have consequences under cross-default clauses in the issuer's bonds and loan agreements. A cross-default clause is a creditor equality provision in the events of default which typically provides that a default by the debtor in the payment of principal or interest in respect of borrowed money and guarantees of borrowed money or an acceleration of borrowed money by reason of a default is a warning light which entitles the creditor with the cross default also to accelerate its debt. The reasoning is that, if there is a default towards one creditor, then it is only a matter of time before the issuer defaults towards all creditors. Thus, if a sovereign issuer fails to pay the principal of one bond, then typically other bondholders with cross default clauses can also accelerate their bonds – or rather in practice get a seat at the negotiating table and have legal rights which entitle them to be taken seriously. Effectively, events of default confer votes in favour of creditors.

The main credit events in more detail

We now consider the usual sovereign credit events in more detail.

Failure to pay

"Failure to pay" is a failure by the reference entity to pay principal interest or other amounts.

The technical definition of "failure to pay" is:

"'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 a 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."

The "payment requirement" is generally USD1m or its equivalent in the currency of the obligation so as to exclude trivial amounts. The grace period is as specified in the relevant obligation or, if none is specified, three business days.

The "obligations" are determined as described above. This includes obligations in respect of which the sovereign reference entity has given a guarantee, not just where it is the borrower (in the case of a loan) or an issuer (in the case of a bond).

Changes of law and other exclusions

Section 4.1 of the credit derivatives definitions provides that if an occurrence would otherwise constitute a Credit Event, such occurrence will constitute a Credit Event whether or not it arises directly or indirectly from or is subject to a defence based on any applicable law. Section 4.1 was introduced to deal with moratoria and illegality such as those seen in the Russia crisis where the Russian government was effectively trying to legislate with prior knowledge of the contract to defeat the legitimate objectives of the contracting parties. One specific effect of this is that where, in the case of bonds governed by domestic law, a sovereign changes the law such that it is not obliged to make interest payments on its bonds and then refrains from making payments on that basis, a failure to pay credit event would still occur. This is so notwithstanding that the change in law meant the payments had not become "due" and no event of default had therefore occurred under the bonds. Section 4.1 was relevant in the case of the failure to pay credit event in respect of Bradford & Bingley plc in 2009. In that case, the relevant order specifically provided that payments on bonds would not become due and payable with the effect that, in the absence of Section 4.1, the subsequent non-payment would not have come within the failure to pay definition above which refers to a failure to make payment "when and where due". Irish legislation had a similar effect in relation to the bond obligations of Allied Irish Banks – and when AIB did not pay in June 2011, the Determinations Committee determined that a failure to pay credit event had occurred, reflecting the view of the market generally. In both cases, the Determinations Committee was presumably relying on the provision described here. Although these credit events were in relation to non-sovereign reference entities, there is no reason for a different conclusion to be reached in the sovereign context.

Another example of this might be that, if a sovereign state passes an exchange control preventing payment on its bonds and the exchange control were recognised in foreign courts under, for example, article VIII 2(b) of the IMF articles of agreement or because the bond is governed by local law, then the exchange control would be ignored if, for example, there were a failure to pay.

Section 4.1 sets out two other situations in which a credit event is deemed to occur even though there might otherwise appear to be some defence.

The first is that it is irrelevant that the bond was not properly authorised or was outside the constitutional powers of the issuing sovereign state. The second case is that it is irrelevant that the bond is illegal or invalid.

Section 4.1 applies to all credit events. It reads as follows:

"If an occurrence would otherwise constitute a Credit Event, such occurrence will constitute a Credit Event whether or not such occurrence arises directly or indirectly from, or is subject to a defence based upon: (a) any lack or alleged lack of authority or capacity of a Reference Entity to enter into any Obligation or, as applicable, an Underlying Obligor to enter into any Underlying Obligation, (b) any actual or alleged unenforceability, illegality, impossibility or invalidity with respect to any Obligation or, as applicable, any Underlying Obligation, however described, (c) any applicable law, order, regulation, decree or notice, however described, or the promulgation of, or any change in, the interpretation by any court, tribunal, regulatory authority or similar administrative

or judicial body with competent or apparent jurisdiction of any applicable law, order, regulation, decree or notice, however described, or (d) the imposition of, or any change in, any exchange controls, capital restrictions or any other similar restrictions imposed by any monetary or other authority, however described."

Repudiation/moratorium as a credit event generally

The second usual credit event in relation to sovereign states is "repudiation/moratorium". Broadly, this occurs if the reference entity repudiates one or more relevant obligation(s) or declares a moratorium in respect of one or more relevant obligation(s) in excess of an agreed default requirement (so as to exclude small immaterial amounts).

This on its own is not enough, ie it is not enough that some government official simply makes a wild statement that the bonds concerned are invalid or not binding. There must also be a failure to pay or a restructuring within the definition of those credit events but in each case ignoring any minimum threshold amounts that must otherwise be exceeded for those credit events.

This credit event is usually stipulated only in relation to sovereign reference entities, since corporations do not usually repudiate debt and they usually do not have power to declare a moratorium apart from in a bankruptcy proceeding.

Extension of termination date

Because the repudiation could precede the failure to pay or restructuring by quite some time, there is provision for an extension of the scheduled termination date of the credit default swap, ie although the repudiation or declaration of a moratorium must occur within the period for which the buyer has bought protection, the failure to pay or restructuring may occur in a prescribed subsequent period. This is because the main credit event is, after all, the repudiation or the declaration of a moratorium and the inclusion of failure to pay or restructuring as an additional requirement is intended only to ensure that the repudiation or moratorium is serious. If a potential repudiation/moratorium occurs on or prior to the scheduled termination date, the evaluation date is, if the affected obligations include bonds, the later of 60 days after the potential event and the first payment date (plus any grace period) under any affected bond.

Examples of repudiation

Repudiation of debt is not unknown, eg the Russian repudiation in 1917. A challenge as to the validity of bond debts is also not unknown, eg the recent assertion by Ecuador that its bond debt was not binding. These claims are sometimes made on the ground that the debt was incurred by a government that took power unconstitutionally.

It has been established by case law in both England and the United States, as well as international arbitration, that debts of the state engaged by unconstitutional dictators or other de facto regimes are nevertheless binding on the state concerned. Thus when Tinoco established himself as dictator of Costa Rica, granted concessions to British companies and issued bank notes, the new government after displacement of Tinoco, declared the concessions and bank notes invalid but this was held by an international arbitrator in 1923 to be ineffective. Tinoco was the effective ruler of Costa Rica and therefore his acts were binding on successive governments. It was immaterial that his regime was unconstitutional under Costa Rican law or that his government was not recognised by several countries, including the United Kingdom.

Odious debt

Some commentators claim that odious debts are not binding. Odious debts include regime debts, subjugation debts and war debts. Britain refused to liquidate the war bonds of the South African Boer republics in the early 20th century and the US refused to agree to repatriation

of Spanish national debt on the independence of Cuba in 1898 on the grounds that it had been contracted largely in the interests of Spanish colonisation. But otherwise claims that a debt is invalid because it is odious debt have rarely been successful.

In any event, as mentioned, an event is a credit event notwithstanding the lack of authority or capacity of a reference entity to enter into an obligation or any unenforceability or illegality with respect to the obligation.

Text of repudiation/moratorium credit event

The precise terms of the repudiation/moratorium credit event are set out in Section 4.6 of the credit derivatives definitions as follows:

"'Repudiation/Moratorium' means the occurrence of both of the following events: (i) an authorised officer of a Reference Entity or a Governmental Authority (x) disaffirms, disclaims, repudiates or rejects, in whole or in part, or challenges the validity of, one or more Obligations in an aggregate amount of not less than the Default Requirement or (y) declares or imposes a moratorium, standstill, roll-over or deferral, whether de facto or de jure, with respect to one or more Obligations in an aggregate amount of not less than the Default Requirement and (ii) a Failure to Pay, determined without regard to the Payment Requirement, or a Restructuring, determined without regard to the Default Requirement, with respect to any such Obligation occurs on or prior to the Repudiation/Moratorium Evaluation Date."

In this context, "governmental authority" means any de facto or de jure government or any agency of the government, or any court or administrative or other governmental authority or any entity, whether private or public, charged with the regulation of financial markets, including the central bank.

It is common for insolvent states to declare a moratorium prior to putting forward a proposal for the rescheduling of their debt. This moratorium generally takes the form of an announcement by the government that they will not pay a bank or bond debt for 90 days during which time they will formulate an offer to creditors.

Restructuring as a credit event generally

Restructuring is a crucial credit event and by far the most complicated. The definition is set out in full below. Broadly, the credit event covers five situations:

- A reduction in interest.
- A reduction in principal or premium payable at maturity.
- A deferral of dates for the payment of interest, principal or premium.
- A subordination of the obligation causing a change in the ranking in priority of payment.
- Change in the currency to a currency which is not a permitted currency. A permitted currency includes the currencies of the G7 or an OECD member with a AAA or equivalent rating.

The event must affect one of the Obligations of the reference entity.

In each case, the event must occur in respect of an amount of relevant obligations greater than the "default requirement" specified in the credit default swap confirmation. This is usually fixed at USD 10,000,000.

Without a restructuring credit event, a mere "failure to pay" credit event would not be enough because, by the time it had to make a payment, the sovereign state may have agreed a rescheduling or a write-down of its bonds, thereby preventing amounts from falling due and averting a default. This might effectively rob the buyer of its protection.

Restructuring must bind all holders

The event must bind all holders of the obligation. In other words, it is not enough that, for example, the government agrees to reduce a payment in favour of a single holder.

The reason for this requirement is that there must be a genuine collective default, not just a special unique agreement with one creditor or with a small number of creditors. The essence of the event is that it is analogous to a bankruptcy proceeding, in which case one would expect all or a large number of creditors to be involved.

In practice, it is rare for all the holders of a bond unanimously to agree to a rescheduling, although acceptances can be extremely high, eg more than 97%. The two main methods by which a restructuring can be made binding on all of the holders are either (1) bondholder voting under a collective action clause, if there is one, or, (2) if the bond is governed by the local domestic law of the issuing sovereign state, by a unilateral statute passed by the government of the issuing state.

Collective action clauses are described below, but the crucial point is that they do not usually appear in bonds governed by local law so that, if a rescheduling is to have universal binding effect, the sovereign must either insert collective action clauses in the bonds or else pass a statute universally deferring the bonds. By contrast, if a bond is not governed by local law, the sovereign will not be able to legislate to change its terms so only an existing collective action clause, if any, could achieve this.

In order to constitute a credit event, an event must not be expressly provided for under the original terms of the obligation. For example, where the issuer has an express option in the original bond to reduce the amount payable in certain circumstances, exercise of that right will not generally be a credit event. These options are rare in sovereign bonds.

Multiple holder obligation

There is a provision in section 4.9 of the credit derivatives definitions to the effect that a restructuring credit event will have occurred only if the relevant event was in respect of an obligation with more than three unaffiliated holders and, in the case of loans only, the consent of at least two-thirds of the holders is required. This is to reduce the risk that a protection buyer could hold a narrowly-distributed debt obligation, such as a bank loan, and manipulate or control a modification to trigger its protection.

Financial problems necessary for restructuring credit event

The occurrence of the event must directly or indirectly result from a deterioration in the creditworthiness or financial condition of the reference entity. This means that the credit event does not occur if, say, a sovereign state which is in impeccable financial condition changes its bonds as part of an overall debt liability management exercise intended to reduce the public debt but not to save itself from financial problems.

Exclusions from restructuring credit event

There is an exclusion for administrative, accounting, tax or other technical adjustments in the ordinary course of business.

The fact that a member state of the European Union adopts the euro and hence switches from its domestic currency to the euro is not a restructuring event.

Guaranteed obligations

As for the other credit events, the obligation in respect of which the restructuring occurs may be one for which the sovereign reference entity provides a guarantee as well as its own bonds or loans, provided that any such guarantee satisfies the criteria of a "qualifying guarantee".

Text of restructuring credit event

The precise definition of the restructuring credit event is set out in section 4.7 of the credit derivatives definitions as follows:

(a) "'Restructuring' means that, with respect to one or more Obligations and in relation to an aggregate amount of not less than the Default Requirement, any one or more of the following events occurs in a form that binds all holders of such Obligation, is agreed between the Reference Entity or a Governmental Authority and a sufficient number of holders of such Obligation to bind all holders of the Obligation or is announced (or otherwise decreed) by a Reference Entity or a Governmental Authority in a form that binds all holders of such Obligation, and such event is not expressly provided for under the terms of such Obligation in effect as of the later of (i) the Credit Event Backstop Date and (ii) the date as of which such Obligation is issued or incurred:

(i) a reduction in the rate or amount of interest payable or an amount of scheduled interest accruals;

(ii) a reduction in the amount of principal or premium payable at maturity or at scheduled redemption dates;

(iii) a postponement or other deferral of a date or dates for either (A) the payment or accrual of interest or (B) the payment of principal or premium;

(iv) a change in the ranking in priority of payment of any Obligation, causing the Subordination of such Obligation to any other Obligation; or

(v) any change in the currency or composition of any payment of interest or principal to any currency which is not a Permitted Currency.

(A) "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.

(b) Notwithstanding the provisions of Section 4.7(a), none of the following shall constitute a Restructuring:

(i) the payment in euros of interest or principal in relation to an Obligation denominated in a currency of a Member State of the European Union that adopts or has adopted the single currency in accordance with the Treaty establishing the European Community, as amended by the Treaty on European Union;

(ii) the occurrence of, agreement to or announcement of any of the events described in Section 4.7(a)(i) to (v) due to an administrative adjustment, accounting adjustment or tax adjustment or other technical adjustment occurring in the ordinary course of business; and

(iii) the occurrence of, agreement to or announcement of any of the events described in Section 4.7(a)(i) to (v) in circumstances where such event does not directly or indirectly result from a deterioration in the creditworthiness or financial condition of the Reference Entity.

(c) For purposes of Sections 4.7(a), 4.7(b) and 4.9, the term Obligation shall be deemed to include Underlying Obligations for which the Reference Entity is acting as provider of a Qualifying Affiliate Guarantee or, if All Guarantees is specified as applicable in the related Confirmation, as provider of any Qualifying Guarantee. In the case of a Qualifying Guarantee and an Underlying Obligation, references to the Reference Entity in Section 4.7(a) shall be deemed to refer to the Underlying Obligor and the reference to the Reference Entity in Section 4.7(b) shall continue to refer to the Reference Entity."

Collective action clauses

Something should be said about collective action clauses. The most important of the collective action clauses is a clause in a bond which provides that a specified majority of bondholders can change the terms of the bond in any way they like - even by completely obliterating the bond and the minority are bound. In other words, the majority can bind the minority to a rescheduling proposal. The percentage majorities typically required range from 50% for lesser matters to two-thirds or 75% for important changes, such as reducing principal or interest.

Traditionally, for various reasons, collective action clauses have always appeared in sovereign bonds governed by English law but not in those governed by the laws of New York, German law or Swiss law. The theory behind non-inclusion was that bondholders were more likely to get paid if it was impossible for the issuer to organise them or to bind dissentient minorities to a rescheduling proposal.

Whatever the merits of that view, the fact is that in 2003 the OECD declared that member countries should insert collective action clauses in their bonds and in early 2011 the EU proposed that the bonds of all member states should contain collective action clauses in standardised form.

At the moment, most bonds of eurozone member states which are governed by local law, eg bonds issued by Greece and governed by Greek law, do not contain collective action clauses. Further there are no statutory collective action clauses on the lines of those applying in some countries to corporate bonds, eg in Germany and Switzerland.

Collective action clauses are crucial in relation to the restructuring credit event. This is because a restructuring credit event requires the reduction in principal or interest etc to be binding on all of the holders of the bond. As mentioned, this can be achieved if either (1) there are collective action clauses in the bonds which allow dissident minorities to be bound by a majority resolution in favour of a rescheduling or (2) the sovereign state passes a statute unilaterally rescheduling the bonds, which the state can only do if the bonds are governed by local law.

There is a third alternative. Since it is usually only local law bonds which do not contain collective action clauses, the issuing state theoretically could pass a statute inserting collective action clauses into its local law bonds so as to ensure that hold-out creditors are bound by a resolution. We do not think that the insertion of the collective action clause would constitute a credit event, but its exercise could.

Do voluntary exchanges trigger a restructuring credit event?

The usual method whereby a state reschedules its bond debt is for the state to make an offer to bondholders to exchange their existing bonds for new bonds on rescheduled terms. This has been the procedure adopted in all of the major sovereign state reschedulings since the opening of the international bond market to emerging countries in the 1990s. The main countries concerned have been Argentina, Uruguay, Ecuador, Pakistan and the Ukraine, all from the late 1990s forward. In all of the cases, except Argentina, acceptances were more than 97% The Argentina acceptances were initially around 76% but several years later Argentina made an offer to the remainder.

These voluntary offers typically include a menu of options which bondholders can choose from, eg a discounted 30 year bond with no interest but repayable at par (commonly called a zero), or a shorter term bond with a low rate of interest and repayable after a long grace period. Generally the effect is substantially to reduce the amount which creditors receive. This is known as the "haircut". Thus in the case of Argentina, the value of new bonds was around 30% of the original bonds so that there was a haircut of 70%.

The problem for buyers of protection is that a voluntary exchange would not normally trigger a credit event. The reason is that the restructuring credit event requires changes to the original bond, eg a reduction in principal or interest. An exchange substitutes a new bond, but does not change the terms of the existing bond. In other words, the obligation which the parties have designated is not changed; all that has happened is that a new obligation is issued in its place.

Coercive exchanges

It might be more arguable that a credit event could occur if a case could be made out that the exchange was not actually voluntary as it was mandatorily achieved by, for example, a unilateral statute by the issuer decreeing that old bonds are deemed to be converted into new bonds with reduced principal or interest. The commercial result would arguably be that the original bond was being altered even though in form there was an exchange.

Much would depend on the specific facts.

This form of mandatory exchange should be distinguished from a voluntary exchange offer backed up by some form of economic (or moral or political) coercion. Although offers of voluntary exchanges are often difficult to resist since there is little alternative, it would be hard to make out a case that there was not really an exchange but rather a change to the original terms of the bond.

The reason for the market interest in this concept of coercive exchange, which is not mentioned in the credit derivative definitions, results from arguments advanced by the buyers of protection to justify why they should get paid, even though the terms of the original obligation are not changed.

It is worth noting that under a previous form of the credit derivatives definitions (those published in 1999, which were effectively replaced by the 2003 version), an "obligation exchange" also constituted a credit event. This covered a "mandatory exchange" of obligations, though the question of what was "mandatory" caused uncertainty, as in the New York case of *Eternity Global Master Fund Limited v JP Morgan Chase Bank*.

The politics of a restructuring credit event

The politics of the matter are complicated. First of all, buyers of protection will generally want a credit event to happen. They want to be paid so that the depreciated or rescheduled bonds they hold are topped up to the full amount via payment from the seller of protection.

On the other hand, sellers of protection obviously do not want to have to pay.

On the whole, the sovereign issuers of bonds are initially unlikely to want to spark off credit events because this is likely to be perceived by the market as a default and likely to affect the future credit ratings of the state. Some sovereign states have hostile views on the credit default swap market, which they blame for publicising and exaggerating their financial woes.

The attitude of regulators tends to depend upon who they think are the ultimate beneficiaries of the credit default swap and who ultimately will have to pay. If they think that banks' exposures are reduced by credit default swap protection and if they think that banks are not sellers of protection, then they will favour the crystallising of a credit event. A default by a significant sovereign state could have serious repercussions for the banking system and could in the worst case result in threats to financial stability and another financial crisis. Banks are very vulnerable to contagion effects and the falling of one domino can knock down the others so as to give rise to a systemic crisis. Regulators are sensitive to the systemic consequences of credit default swaps partly by reason of the disasters experienced by the US insurance group AIG in 2008.

If, on the other hand, the regulators think that the sellers of protection are largely banks as well, then their attitude

is likely to be different: they are unlikely to favour the crystallising of a credit event.

The position is complicated by an assessment of how much is likely to be involved. The amount of protection on countries such as Greece, Ireland and Portugal is quite small, when expressed as a percentage of the overall public debt of these countries.

Engineering a restructuring credit event

The other political dimension to be factored in is that the issuing sovereign state will often wish to make sure that, despite its reservations about credit default swaps, any voluntary exchange it makes is accepted by the holders of bonds. If the holders of bonds have credit protection and want a credit event to happen, then they are less likely to accept a restructuring offered by the sovereign state, unless a credit event can be assured.

It would indeed be possible to engineer a credit event. This was in fact achieved in the case of the restructuring of the bonds of the Anglo Irish Bank in Ireland in 2010. The technique is that, when bondholders accept the voluntary exchange, they also agree under what is called an exit consent to amend the terms of the existing bonds by reducing the amounts of principal and interest to a tiny fraction of the full amount, eg 0.1%. or by giving the issuer an option to reduce.

The effect of these exit consents, if they bind all of the holders, is that there is a restructuring event, separate from the voluntary exchange.

If, however, the bonds are governed by local law, as most of them are, then they will usually not contain collective action clauses which allow bondholders to vote to change the terms of the existing bonds by exit consents. As mentioned above, it may be possible for a sovereign to effectively insert collective action clauses into its local law debt by legislative action. In that way the issuer could make it possible to bind all holders and satisfy the definition of a restructuring credit event.

One effect of an Anglo Irish type option, whereby an issuer can redeem any bonds that are not exchanged at a very low price, is that a bondholder would be incentivised to accept the exchange offer to avoid such a low return. In the case of Anglo Irish Bank, in order to accept the exchange offer in relation to several series of bonds in November 2010, holders also had to consent to the inclusion in the old bonds of a call option allowing the issuer to reduce each EUR1,000 of the bonds to EUR0.01. The Determinations Committee determined that a credit event had occurred. The insertion of the call options constituted a reduction in the amount of principal payable for the purposes of the definition of restructuring. To consider the full outstanding principal to be 'payable' unless or until the option was exercised would have been an excessively narrow reading of that word. The issuer was not in practice obliged to pay the full amount as it could always exercise the option. Therefore the much lower amount should be considered to be what was payable after the insertion of the call option. The same analysis should apply to a sovereign issuer if it were to insert call options in similar circumstances, whether by using collective action clauses (as Anglo Irish Bank did) or by a change in law.

There have sometimes been suggestions that the manufacture of a credit event by collusive behaviour with the sovereign debtor may prejudice the occurrence of the credit event on the basis of various insurance policy cases to this effect. This is a complex area: Section 9.1(b)(iii) of the credit derivative definitions should be considered.

The exclusion of voluntary exchange offers

As discussed above, a voluntary exchange would not normally trigger a credit event. The fact that a voluntary exchange is not a credit event is a fact which is well known to the market and is one of the risks participants take into account when they enter into these transactions. In addition, as shown below, it is hard in practice for an issuer to avoid a credit event if there is a restructuring. Some very useful research prepared by J.P. Morgan

shows that this has been largely true in recent major sovereign restructurings: see a paper by J.P. Morgan "Restructuring Credit Events (Part 2): Case Studies in Sovereign Defaults and the Options of Greece", 24 May 2011.

Other implications of voluntary exchange offers

As we have seen, if a sovereign state makes a voluntary exchange offer, then protection may not be 'triggered' because a credit event has not happened within the period of the protection.

However, there are other potential outcomes. In the first place, if there is a voluntary exchange offer, then it is very rare indeed for all of the holders of the bonds to accept the exchange, although it is quite common for acceptances to be over 97%. Almost invariably a tiny minority of holders do not accept. This may be because they are holding out in the hope of a better offer, or this may be because they or their brokers are taking a nap that day or are on a long vacation.

Sovereign issuers who make voluntary offers usually – in the absence of a collective action clause – also make a statement that they will not pay those bondholders who were eligible to accept the offer but did not accept the offer (though it is worth noting that Greece had not given any indication as at July 2011 as to how it proposed to deal with investors who will not accept the exchange offer, if such offer progressed). If they did not say this, then there would be less incentive on bondholders to accept because, if most people did accept, leaving a small rump that did not, then the rump might get paid ahead of the rescheduled bondholders who did accept. So the issuer makes a commitment not to give any bondholders a better deal than the deal on offer in the voluntary exchange. Therefore, in that situation, the fact is that sooner or later the issuer will not pay the rump of holders so that there will be a failure to pay, which is a credit event. In that case, the buyers of protection still get a credit event, even though the voluntary exchange itself is not a credit event.

Deliverable obligations are necessary for settlement

A buyer of protection does not actually have to hold an obligation of the sovereign issuing state or any correlated debt in order to buy protection and indeed there are many buyers of protection who do not hold the debt. They have nothing to protect but enter into the transaction with the view to making a profit.

However, when it comes to settlement there has to be a deliverable obligation. If there is an auction, which there usually is, there must be deliverable obligations in existence which can be valued pursuant to (and bought and sold in) the auction so as to ascertain the market price. No deliverable obligation, no auction.
If there is no auction for some reason (for example, if there are too few trades to warrant it), the credit default swaps will commonly be settled by physical settlement (handing over deliverable obligations in return for money from the seller). Again, if there is no deliverable obligation, there will be no settlement.

Whether a transaction would be unwound on the ground that it was frustrated because there were no deliverable obligations would depend on the circumstances. In most cases, the risk of the absence of a deliverable obligation is a known risk which is part of the initial deal, in which case a claim that the contract had been frustrated would be hard to sustain.

Amendments which disqualify a deliverable obligation

Issues may particularly arise with this in the context of a restructuring credit event as the terms of the bonds may have been amended so as no longer to qualify as deliverable obligations.

If a call option is inserted into the terms of all of the

sovereign's bonds, they may continue to be, technically speaking, deliverable obligations. However, they may be unsatisfactory for buyers of protection. This is because the price is expressed as a percentage of the outstanding principal and such bonds would be considered to have an outstanding principal of the amount of the issuer's call option. For example, if an issuer has inserted a right to call at 20%, the outstanding principal would be considered to be 20% of the face value: if it were likely that the call would be exercised, the current value of a bond with a face value of USD100 would be approximately USD20, ie close to 100% of the outstanding principal. If an auction final price was based on this bond, a buyer of protection would receive only a marginal payment in settlement of its credit default swap, rather than a payment reflecting the full diminution in value caused by the restructuring.

The buyer of protection would also lose out in the more straightforward case where all deliverable obligations are redeemed prior to settlement.

This seems unsatisfactory at first blush, particularly as it is effectively the very thing for which protection is bought (the restructuring event) which thwarts the buyer.

It is possible for a reference entity to arrange the restructuring process in such a way as to avoid denying a buyer its protection, even where all debts are to be restructured. The restructuring of the bonds would be staggered so that the first series to be amended triggers the restructuring credit event, allowing the buyers of protection to exercise their rights. The further series of bonds are not restructured until after completion of the auction and consequent settlement of standard transactions under the auction settlement method and of the sales and purchases made through the auction. This was in fact done in the Anglo Irish Bank credit event in 2010 and the Allied Irish Bank, Bank of Ireland and the Irish Life and Permanent plc credit events in 2011. This method therefore ensures that there are sufficient deliverable obligations to enable an auction to take place.

Currency changes which disqualify a deliverable obligation

It is usually provided that a deliverable obligation must be payable in one of the specified currencies (being the currency or currencies specified as such in the related confirmation or, if no currency is so specified, any of the lawful currencies of Canada, Japan, Switzerland, the United Kingdom and the United States of America and the euro and any successor currency to any of the aforementioned currencies). If there are no obligations denominated in an eligible currency, there can be no auction and no settlement.

One of the issues is whether, if a eurozone country changed its currency by switching from the euro and reissuing its predecessor currency, this would qualify as a successor currency within the definition. For example, if Greece were to switch from the euro to drachma 2, would this be a successor currency to the euro?

There has been an enormous amount of debate about whether a eurozone member could unilaterally withdraw from the eurozone and resurrect its own currency at some specified rate of conversion. The upshot is that they probably could, but that this would be extremely unlikely. Theoretically the whole of the EU or the eurozone could break up and everybody could go back to their former currencies or to some new currency.

The question of whether successor currencies would qualify so as to ensure that there is a deliverable obligation would depend upon whether the euro was still in existence and upon the particular circumstances of this cataclysmic event.

If a restructuring credit event were to be triggered, among other things, by the redenomination of debt into a currency which does not constitute a permitted currency (as defined in the credit derivatives definitions and primarily being the currencies of the G7 countries or any OECD country with an AAA rating), whether such debt is deliverable may also depend on whether it is sovereign

debt or corporate debt (as a result of the definition of "sovereign restructured deliverable obligation").

Subordination as a restructuring credit event

Unlike ordinary corporate bankruptcy law, in the case of sovereign states there is no bankruptcy ladder of priorities laid down in an international statute. Ordinary bankruptcy law normally has a long ladder ranging from super-priority creditors, such as those with collateral or a set-off, through to priority creditors (such as employees and the taxman), through to senior unsecured creditors (such as bondholders), through to subordinated bondholders and down to equity shareholders.

Instead, in the case of states, there is a kind of priority ranking which is based on consensus and agreement and is not laid down in any law.

When a state reschedules its debt, it usually prescribes the classes of debt which it will reschedule. There are generally three groups, namely official or governmental creditors, bank lenders and bondholders. The state is required to agree that it will not give any of these eligible classes of creditor more favourable treatment than the others. Invariably however, the IMF and the other multilateral organisations, such as the World Bank, are stated not to be bound by this comparability requirement. In other words, the sovereign state can and must continue to keep the IMF and the other multilaterals current by paying the amounts owed to them as and when they fall due, notwithstanding that other creditors are rescheduled.

The economic effect is that the IMF might have a priority in substance because, if there is a shortage of assets, the IMF receives payment before the rescheduled creditors and, when the time comes for the rescheduled creditors to be paid, there may not be enough to pay them. In effect therefore, the IMF and the other multinationals are preferred. This is not the same as a bankruptcy priority where a trustee in bankruptcy collects all of the assets and then distributes the proceeds in a prescribed order, but it has a similar economic effect.

The EU has dropped its previous assertion that any EU bail-out funds from the European Financial Stabilisation Mechanism loans would have preferred status over bondholder debt.

So the issue is whether these understandings concerning priority would mean that a credit event within the restructuring head has occurred on the grounds that it is "a change in the ranking in priority of payments of any Obligation causing the Subordination of such Obligation to any other Obligation" which results from a deterioration in the creditworthiness or financial condition of such sovereign state?

The language gives rise to some very fine and nuanced issues of meticulous interpretation. There has to be a change in "the ranking in priority of payments" and this change in ranking has to satisfy the definition of subordination in the credit derivatives definitions. In substance, the definition of subordination requires that there must be (1) "a contractual, trust or similar arrangement" (i.e. some binding obligation but perhaps non-statutory) which must provide (i.e. it has to state this, it seems), that "the holders of the Subordinated Obligation [that is, the holders of the bonds] will not be entitled to receive or retain payments in respect of their claims against the Reference Entity at any time that the Reference Entity is in payment arrears or is otherwise in default under the Senior Obligation that is the IMF loan".

The precise definition in Section 2.18 of the credit derivatives definitions is:

"'Subordination' means, with respect to an obligation (the "Subordinated Obligation" and another obligation of the Reference Entity to which such obligation is being compared (the "Senior Obligation"), a contractual, trust or similar arrangement providing that (i) upon the liquidation, dissolution, reorganisation or winding up of the Reference Entity, claims of the holders of

the Senior Obligation will be satisfied prior to the claims of the holders of the Subordinated Obligation or (ii) the holders of the Subordinated Obligation will not be entitled to receive or retain payments in respect of their claims against the Reference Entity at any time that the Reference Entity is in payment arrears or is otherwise in default under the Senior Obligation. "Subordinated" will be construed accordingly. For purposes of determining whether Subordination exists or whether an obligation is Subordinated with respect to another obligation to which it is being compared, the existence of preferred creditors arising by operation of law or of collateral, credit support or other credit enhancement arrangements shall not be taken into account, except that, notwithstanding the foregoing, priorities arising by operation of law shall be taken into account where the Reference Entity is a Sovereign".

The actual result will depend upon the circumstances – and on the view taken by the relevant Determinations Committee. But it is to be noted firstly that IMF standby agreements may not strictly be legally binding; in which case there would be no legally binding commitment which makes provision for subordination. However, this does not apply to the preferred status of the debt of other multilaterals such as the World Bank. Secondly, if the definition were to be interpreted literally, one is unlikely to find a statement precisely on those terms by the IMF. Thirdly, the IMF priority is not a change in the mandatory ranking of debt but rather an agreement that the IMF debt will be kept current, notwithstanding any rescheduling of bondholder debt. All that is happening is that some classes of creditor insist that their debt is kept current, ie that they will not accept a rescheduling.

The argument is that an insistence by a creditor that its debt is paid when due and payable is not in itself a subordination of other creditors. If it were, then any creditor contracting that its debt must be paid on a particular date would give rise to a violation if other debt creditors were rescheduled or waived their payments. Hence every time one creditor extended the time for payment by agreement, then there would automatically be a subordination and hence a creditor event. So if this were the interpretation, credit events would be happening all the time since all debt contracts require payments to be made on the due date and extensions of time for payment are quite common.

The preferred view is that the IMF priority does not qualify as a change in the "ranking in priority of payment". There is no mandatory provision of law that the IMF will rank ahead, only an agreement between the IMF and one of its member states that the IMF debt will be kept current.

This issue was raised with the EMEA Determinations Committee in March 2011 in the context of the IMF loans to the Republic of Ireland. Their unanimous conclusion was that "a Restructuring Credit Event has not occurred with respect to Republic of Ireland. On the basis that no information is available to confirm that a Restructuring has occurred under Section 4.7(a) of the 2003 Credit Derivatives Definitions as supplemented (the "2003 Definitions") and specifically that no Subordination has occurred within the meaning of Section 2.19 of the 2003 Definitions". Although no further detail is available, this accords with the analysis in this paper.

The second issue on priorities is whether the IMF priority would constitute a violation of typical pari passu clauses which appear in bonds of sovereign states, or at least in bonds governed by foreign law. If they were a violation of the terms of a bond, then the bondholders would normally have rights to accelerate their bonds, which in turn would be likely to spark off a "failure to pay" credit event.

The pari passu clause in a sovereign bond usually provides that the bonds rank at least pari passu, without any preference amongst themselves, with all other outstanding unsecured obligations of the issuer, present and future. It is generally considered that this clause affirms the mandatory ranking of debt where there is competition between creditors, ie the state is unable to pay everyone. It is not an agreement that the debtor will in fact pay its

debts pro rata without discrimination after the debtor is actually insolvent. For there to be a violation, there probably has to be a mandatory statute which gives priority to some bonds and subordinates others.

Hence the mere fact that an issuing state pays off the IMF and keeps the IMF current, but does not keep other creditors current, is considered not to be a violation.

There has been a great deal of litigation about pari passu clauses but there appears to be no fully developed decision of a higher court internationally which rules upon exactly what the pari passu clause means in bonds. The reasoning put forward by market participants as to why the pari passu clause only refers to mandatory ladders of priority, notwithstanding that there is no bankruptcy ladder of priorities for sovereign states (because there is no international bankruptcy law) is that if a state is in financial difficulties, it nevertheless continues to pay its judges, its health service bills, its pensioners, its unemployed, its defence establishment and the milk bill, even though it means that these creditors get paid ahead of other creditors, if subsequently there is a shortfall. It is not considered that the actual making of payments, ie keeping some creditors current while others are unpaid, is a violation.

In other words, the fact of a payment which is discriminatory is not enough: there must be a specific mandatory ranking of debt by a statute or equivalent.

If this were not the case, then all pari passu clauses would have to deal with excluded payments, which most people agree a state should be allowed to pay if it is insolvent. These "most favoured debt clauses" are a typical feature of bank rescheduling agreements for sovereign states and are both long and complicated. The clauses would be far too complex to negotiate in relation to each bond issue. There would have to be specific inclusions, for example, for payments to the IMF and other multilaterals and trade payments, as well as all the other governmental routine payments. Nobody has ever suggested that this is necessary, which must mean that the markets give a narrow interpretation to the meaning of ranking in the pari passu clause.

Impact of sovereign insolvency on banking systems

If a sovereign state becomes insolvent, then usually this leads automatically to the collapse of the domestic banking system, which ceases to be able to borrow on the international market or in the inter-bank market. The insolvency of the state can also impact on banks in other countries which hold bonds of the state.

The result is that state insolvency often also leads to problems with banks, domestically or internationally or both.

This in turn has significant implications for holders of credit default swaps as against banks in the countries concerned. The situation becomes more complicated if the state itself has guaranteed its banks, as in the case of Ireland.

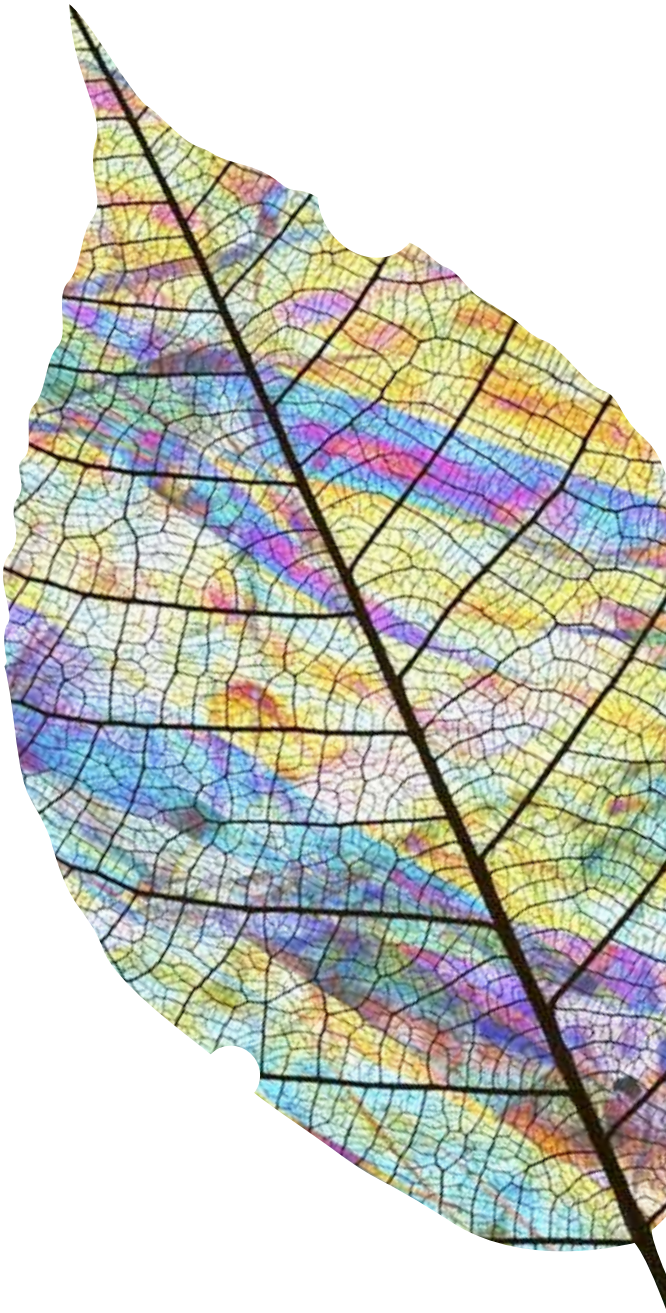
There is currently much discussion in Europe as to whether a strong-arm bank resolution statute for all of Europe should contain bail-in provisions. At present some banks have issued bonds which are automatically convertible into equity if the capital of the issuing bank falls below a certain threshold such as five per cent. These bonds are called contingent convertibles or cocos. There are proposals on foot that regulators should be permitted to convert bonds forcibly and compulsorily if a bank's capital falls to a low level and there is a threat to financial stability. These compulsory conversions are called bail-ins.

As regards credit default swaps with standard terms, in the case of cocos the conversion would not give rise a credit event because the conversion is specifically provided for in the terms of the issue. In the case of a forcible conversion by bail-ins, there would probably be no credit event sparked by an exchange, but there would be if the debt is converted into subordinated debt or equity. So

the occurrence of a credit event may depend on how the bail-in is done – if we ever get to the point of compulsory bail-ins. Other credit events may be crystallised, e.g. non-payment or bankruptcy, although the legislature may attempt to neuter these. There are detailed issues over deliverable obligations if debt is converted into more deeply subordinated debt or into equity.

Conclusions

This paper demonstrates that credit default swaps in the sovereign arena are quite complex instruments. This should cause no surprise because, although credit default swaps are not guarantees and are not insurance, they involve third parties paying somebody else's liability, like both guarantees and insurance. The general law in relation to both guarantees and insurance is, in most jurisdictions, of fantastic intricacy and complication so that actually credit default swaps look much easier in comparison. But one can certainly anticipate at least some complication, and some detail which requires concentrated attention to the rights of the parties. Recently, ISDA has announced that there may be a review of the credit derivatives definitions, which could include a review of the definition of a restructuring credit event if ISDA's members wish and it will be interesting to see what the market reaction is. After all, this is a market where the documentation is highly responsive to what practitioners want and what best suits realities.



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