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Greek Sovereign Debt Q&A (Update)

The following are responses to the most frequently-asked questions that ISDA has received in connection with the application of credit derivatives to a potential restructuring or reprofiling of Greek sovereign debt. The following does not constitute legal advice, and is subject in all respects to any determination that the ISDA EMEA Credit Derivatives Determinations Committee may make in relation to CDS referencing the Hellenic Republic (Greece). ISDA makes no comment on the likelihood of the events described in this Q&A.

UPDATE OCTOBER 27:

The determination of whether the Eurozone deal with regard to Greece is a credit event under CDS documentation will be made by ISDA's EMEA Determinations Committee when the proposal is formally signed, and if a market participant requests a ruling from the DC. Based on what we know it appears from preliminary news reports that the bond restructuring is voluntary and not binding on all bondholders. As such, it does not appear to be likely that the restructuring will trigger payments under existing CDS contracts. In addition, it is important to note that the restructuring proposal is not yet at the stage at which the ISDA Determinations Committee would be likely to accept a request to determine whether a credit event has occurred.

INFORMATION ORIGINALLY POSTED ON JULY 8:

How are Credit Default Swaps documented?

The vast majority of Credit Default Swaps (CDS) are documented using the 2003 ISDA Credit Derivatives Definitions, as supplemented by the July 2009 Supplement. The Definitions can be obtained from ISDA's Bookstore.

What triggers CDS?

The CDS contract contains a number of elections that parties can make (for example, which events from a menu of potential Credit Events will apply, what obligations are relevant for triggering a Credit Event, what kind of obligation will be deliverable if a Credit Event occurs). Of course, parties are free to agree to make whichever elections they wish, but standard elections are generally used for particular transaction types (so, for example, some of the elections for North American corporates, will be different from those for, say, Western European Sovereigns).

A CDS is triggered when a Credit Event occurs. There are three Credit Events that are typically used for Western European Sovereigns (including Greece), they are: Failure to Pay; Repudiation/Moratorium and Restructuring. We will focus on Restructuring for these purposes.

The Restructuring Credit Event is triggered if one of a defined list of events occurs, with respect to a debt obligation such as a bond or a loan, as a result of a decline in creditworthiness or financial condition of the reference entity. The listed events are: reduction in the rate of interest or amount of principal payable (which would include a "haircut"); deferral of payment of interest or principal (which would include an extension of maturity of

an outstanding obligation); subordination of the obligation; and change in the currency of payment to a currency that is not legal tender in a G7 country or a AAA-rated OECD country. The decline in creditworthiness or financial condition requirement is intended to filter out restructurings that occur as a result of improved financial condition.

Are CDS triggered by a declaration by a rating agency that the Reference Entity has been downgraded or is in "default"?
No. There is no link between a rating agency declaration and a CDS Credit Event. It is possible that the same set of facts might give rise to both, but it is also possible that one might occur but not the other.

As noted above, one element of the Restructuring Credit Event is that the event has to occur as a direct or indirect result of a decline in creditworthiness or financial condition of the reference entity. In determining whether that criterion has been met, rating agency actions may -- but need not -- be considered, together with any other relevant information.

What is the difference between "Restructuring", "Modified Restructuring" and "Modified Modified Restructuring"?
The CDS Definitions provide for three different variants of Restructuring: Restructuring (sometimes referred to as "old" Restructuring), Modified Restructuring and Modified Modified Restructuring). The differences relate to what is deliverable following a Restructuring Credit Event. Modified Restructuring and Modified Modified Restructuring contain certain limitations on the maturity of debt that can be delivered in a Restructuring Credit Event when the buyer triggers. These limitations are the reason why there are auctions for different "maturity buckets" following a Restructuring Credit Event. "Old" Restructuring does not apply any special restrictions to deliverable obligations, and is subject to the usual 30- year maturity limit on deliverables, so the same obligations will be deliverable for an Old Restructuring as for any other Credit Event. Old Restructuring applies to Western European Sovereigns.

Does it matter whether the event is "voluntary" or "mandatory"?
The CDS Definitions do not refer to a distinction between voluntary and mandatory events, though it does come up indirectly. An important element of the definition of Restructuring is that the event has to occur in a form that binds all holders of the "restructured" debt. Thus, for example, if bonds contain a Collective Action Clause (CAC) with a 75% threshold for making a change to bond terms, then if 75% or more of the holders vote in favour, that change is binding on all the holders, even those that voted against. That is, the change does not have to be agreed upon by all the holders to trigger a Credit Event, just the relevant majority of them. In that sense, the change is "mandatory" for those who voted against it. We understand that Greece's domestic law debt, which accounts for over 90% of all of its outstanding debt, does not contain CAC clauses.

Would a debt exchange trigger a Credit Event?
A voluntary debt exchange typically would not trigger a Credit Event. A restructuring credit event requires an amendment of terms of outstanding bonds or loans, whereas an exchange means the original bonds are redeemed and replaced with new bonds on the new terms. Economically they may be the same but legally they are different, which could have very different consequences for CDS.

If Greece's debt were restructured in a way that did not trigger a Credit Event,

would this call into question the utility of CDS as a hedging tool?

No. It has always been understood that the Restructuring definition cannot catch all possible events. Restructuring was, in fact, dropped as a Credit Event for North American investment grade names because it was felt to be unnecessary. It was, however, maintained in Europe because European companies tend to restructure their debt where North American companies would reorganise under Chapter 11 (which would trigger the Bankruptcy Credit Event). If a creditor is hedging using CDS, and declines to participate in a voluntary restructuring, then the creditor would still hold its original debt claim and its CDS hedge, which would continue to protect against future non-payment or a mandatory restructuring for the remaining term of the CDS.

What is the process for determining a Credit Event?

All firms entering into CDS transactions using the standard ISDA documentation (described above) have agreed to be bound by the decisions reached through the process for determining a Credit Event set out in the CDS Definitions. This process is fair, transparent and well tested, and was developed working closely with global regulators. Credit Events are determined by one of five regional ISDA Credit Derivatives Determinations Committees (DCs). An event with respect to Greece would be dealt with by the EMEA DC. The composition of the DCs is explained below.

The process begins when a market participant puts a question to the DC for the relevant region. Any market participant (who need not be an ISDA member) with one or more CDS transactions can raise a question. A question is raised by submitting it, along with publicly-available information evidencing the event, using an online form on the ISDA website.

After a question is submitted, it must be accepted by one of the members of the appropriate DC. This step is included in order to filter out frivolous questions. Once a question is accepted, the DC will meet within a defined timeframe to consider it. The DC will weigh the publicly-available evidence and vote on whether a Credit Event has occurred within the terms of the CDS Definitions. It should be noted that the DC simply applies the Definitions to the public facts; it is not empowered to
decide whether, as a matter of policy, a Credit Event should or should not occur in particular circumstances.

As soon as a vote has occurred, the determination is posted on the ISDA website. Each DC member's vote is made public. Requests to the DCs and updates following meetings of the DCs are posted immediately on the ISDA website on the Credit Derivatives page at http://www.isda.org/credit. In order to stay up to date on requests to any of the 5 DCs and the status of the requests the DCs are considering, you can subscribe to our RSS feed, which allows you to receive updates by e-mail or through a news aggregator. To subscribe to our RSS feed click here: http://www.isda.org/dc/rssform.asp

Details on how RSS feeds work are available here: http://www.isda.org/dc/aboutrss.html
Further details of the operation of the DCs are available at www.isda.org/dc/dc_info.asp

Who are the members of the DCs?

Each DC consists of ten voting dealers and five voting non-dealers, plus two consultative (non-voting) dealers and one consultative non-dealer. The dealers are selected annually according to (and only to) their CDS trading volume over the past year and their compliance with certain requirements, notably to participate in CDS auctions, whilst the non-dealers are

selected annually at random from a pool of buyside market participants meeting certain specified size criteria. Non-dealer members' one-year terms are staggered so that they do not all finish their terms at once. A list of the firms that are members of the DCs is available at: http://www.isda.org/dc/committees.html

Would a Credit Event on Greece lead to massive payments by protection sellers?

No. According to the Depository Trust & Clearing Corporation's CDS data warehouse, the total net exposure of market participants who have sold CDS credit protection on Greek sovereign debt is approximately $3.7bn as of 10-21- 2011. This figure is calculated by summing the net exposures of the protection sellers, and so it is impossible for any one firm selling protection to have more than $3.7bn in exposure and, of course, given that there are many net sellers, any one seller's exposure is likely to be far less. Also, firms' net exposures are partially offset by the recovery value of underlying obligations. For example, if the CDS auction showed the recovery value of debt to be (hypothetically) 50%, the maximum aggregate amount payable would, in Greece's case, be 50% of $3.7bn: $1.85bn. Furthermore, statistics indicate that, on average, 70 per cent of derivatives exposure is collateralised and the level of CDS collateralization is likely to be even higher as over 90% of CDS transactions (by numbers of trades) are collateralised. Thus, in this example, of the $1.85bn payable, about $1.5bn has effectively already been paid.

The data regarding CDS exposures on Greek sovereign debt, and for the top 1,000 reference entities, are public. They are available here: www.dtcc.com/products/derivserv/data_table_i.php?tbid=5 (Greece is listed under "Hellenic Republic").

Regulators have access to additional data, including individual firm CDS exposures.

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