ORRICK

DERIVATIVES MONTH IN REVIEW

MAY 2012

Contacts

Nikiforos Mathews
Partner
nmathews@orrick.com
(212) 506-5257

Edward Eisert
Partner
eeisert@orrick.com
(212) 506-3635

William Haft
Partner
whaft@orrick.com
(212) 506-3740

Thomas Mitchell
Partner
tcmitchell@orrick.com
(415) 773-5732

Al Sawyers
Partner
asawyers@orrick.com
(212) 506-5041

Greece Triggers Credit Event and Raises Questions for Sovereign CDS

On March 9th, the ISDA Determinations Committee for Europe unanimously concluded that The Hellenic Republic (Greece) had triggered a restructuring "credit event" under credit default swap ("CDS") contracts in connection with the exchange of its debt with private creditors. The committee's determination was based in large part on the imposition and use by Greece of retroactive "collective action clauses" ("CACs") on bonds governed by Greek law which bound all holders of such debt to the decisions of a supermajority. In accordance with the 2003 ISDA Credit Derivatives Definitions, a restructuring credit event (whether due to a reduction of coupon, extension of maturity or other specified change) is not triggered unless the restructuring "occurs in a form that binds all holders."

When it was first announced in October 2011, the Greek debt exchange appeared to be carefully structured to avoid a credit event by making the exchange with private investors voluntary. However, as Greece's economic situation deteriorated (or became more apparent) in the months that followed, private investors became more reluctant to participate, which precipitated the imposition of the CACs. The final debt exchange deal with private investors, which is intended to help reduce the Greek debt load from 165 percent of GDP in 2011 to below 120 percent by 2020, resulted in a real loss of some 74% on bond holdings.[1] On March 19th, ISDA held an auction for the Greek bonds and established a recovery rate of 21.5%, resulting in net payouts of some €2.89 billion (*i.e.*, 78.5% of the approximately €3.7 billion net notional amount of protection out of some €80 billion in gross CDS notional).

Despite many commentators' concerns, the settlement of CDS contracts in the wake of the determination of a Greek credit event did not lead to broader market turmoil and has been widely viewed as a success.[2] Nevertheless, the CDS market's experience in connection with Greece's credit event, and other developments,

---

[1] On April 25th, the Greek finance ministry announced that 96.9% of debt held by private bondholders (some €199 billion out of a total €205.5 billion) had been exchanged.

[2] Indeed, it remains to be seen whether the potential settlement of CDS contracts for a sovereign for which there are far larger volumes would lead to market panic and present systemic risk. The approximately €3.7 billion net notional amount of CDS contracts on Greece at the time of its credit event is dwarfed by the current net notional amount of CDS contracts on other sovereigns, including approximately €22 billion on France and between €18-20 billion on each of Italy, Germany and Brazil.

have generated substantial apprehension and raised several questions regarding the future of the sovereign CDS market. One of these questions is whether the sovereign CDS product, as it currently exists, can be too easily circumvented. Specifically, many market participants expressed dissatisfaction when it became apparent that the Greek debt exchange, as it was originally proposed, would not trigger a credit event due to its "voluntary" nature, arguing that such a comprehensive restructuring should trigger protection payments under CDS contracts. Although a credit event was eventually triggered, the confusion regarding the circumstances under which a credit event would occur in the case of a sovereign debt restructuring has led to calls to modify the relevant ISDA definitions to deal with similar situations in the future.[3]

Another concern has been voiced regarding the bonds deliverable in the ISDA settlement auction itself. Specifically, auction bidders were primarily able to bid only on the new Greek law governed bonds issued in the Greek debt exchange, because the old bonds (other than international law governed bonds) generally had been retired and no longer existed at the time of the auction. There was concern that the price of these new bonds, which necessarily looked to Greece's risk profile after the extinguishment of debt through the bond exchange, would be higher than the price of the original bonds which, in turn, would lead to a lower CDS recovery rate. Fortunately, and somewhat fortuitously, the price for the new bonds closely approximated the level of loss sustained by private sector investors.

Another concern is the potential impact of the European Union's recent ban on "naked" sovereign CDS, which came into effect on March 25th, but will apply beginning November 1, 2012. The ban, which includes certain exemptions, will be overseen by the European Securities and Markets Authority ("ESMA"). However, the draft guidance published by ESMA[4] regarding the ban raises questions regarding how determinations of violations will be made. For example, it appears that the ban could cover "cross border" situations where a market participant seeks to hedge exposure in a sector of one sovereign (*e.g.*, Italian banks) by purchasing protection against the default of another sovereign (*e.g.*, Cyprus). The existence of the ban itself, and any confusion caused by the breadth of its potential enforcement, may lead some market participants to exit the sovereign CDS market.

[3] On a related note, the future involvement of clearinghouses in making determinations regarding CDS contracts (including whether credit events have occurred) has also become a recent topic of market discussion.

[4] ESMA's draft technical advice on possible Delegated Acts concerning the regulation on short selling and certain aspects of credit default swaps (EC) No XX/2012) (15 Feb 2012).