How would Credit Derivatives deal with a "Grexit"?

Exit from the Labyrinth or an encounter with the Minotaur?

With the Syriza party coming into power at the recent Greek general election on 25 January 2015, the concerns about an Eurozone exit have resurrected. This topic was considered by market participants in 2011-2012, in the context of a Greek sovereign default, and was - many thought - put to bed. However, as Odysseus' long and tortuous journey to Ithaca, recent events have shown that 2012 was not the end of that journey and have thrown up new obstacle and questions. Fears have grown of new pressures within the EU's framework, involving Greek demands for debt-reduction, violation of the EU's deficit rules, risks of bank runs within Greece, threats by the government to default on Greek government bonds and in return, counter-threats by the European Central Bank to stop providing liquidity to Greek banks.

The concerns in 2011

In 2011-2012, the contracts at risk were those (i) governed by the law of a departing country, or (ii) with transaction specific nexus with the legal currency of a departing country, (iii) non-Euro denominated sovereign or public debt obligations of a departing country, and (iv) contracts to be performed in a departing country.

In the field of credit derivatives (Credit Default Swaps "**CDS**"), the concerns involved (i) whether voluntary exchanges will be caught by the Credit Derivatives Definitions, (ii) the interplay of redenomination and the definition of "Permitted Currencies" and (iii) the deliverability of certain restructured obligations.

Changes under the 2014 Credit Derivatives Definitions

The new 2014 Credit Derivatives Definitions made numerous changes to address market issues that arose during the financial crisis, including those surrounding a Euro-zone break-up. The aim of this note is briefly to list the changes relevant to a Euro-exit situation; or where a government intervenes to reduce the burden on the local financial institutions.

Amendments to the Restructuring Credit Event

- The Restructuring Credit Event now expressly applies upon bond exchanges;
- The required write-down of interest /principal for this trigger may be caused by currency redenomination;
- The requirement that a Credit Event results from deterioration of creditworthiness does not apply upon a Euro-exit; but
- Redenomination out of the Euro will <u>not</u> qualify as Restructuring if it is due to Governmental Authority action, there is a freely available market rate for conversion between the two currencies and no write-down of interest /principal occurs.

Governmental Intervention; Bail-in of Financial Entities

If, as an alternative to a Euro-exit, the Greek government decides to expropriate bank debt, or impose mandatory write-down of bank debt, then the new **Governmental Intervention Credit Event** will become relevant. This new trigger:

- Applies to changes in the terms of the relevant debt obligation resulting from the action of a Governmental Authority pursuant to restructuring laws;
- Covers expropriations, changes in beneficial holder, mandatory cancellations, conversions or exchanges; and
- Where Financial Reference Entity Terms apply, the senior and subordinated CDS for that bank will be treated independently for the purposes of Governmental Intervention and Restructuring Credit Event, and also when determining a Successor.

Asset Package Delivery

Where one of the following occurs: (a) Governmental Intervention with respect to a Financial Reference Entity, (b) Restructuring Credit Event with respect to a Financial Reference Entity, or (c) Restructuring with respect to a Sovereign, the new CDS terms will assist with the deliverability of the resulting assets.

The terms on which CDS now trade have been fine-tuned to better allocate the outcomes of a Euro-exit or bail-ins between the buyers and the sellers of protection.

Generally in financial contracts, the provisions that will remain relevant to the allocation of risk in an Euro-exit situation include: (i) governing law and jurisdiction clauses; (ii) any express designation of the currency of account/payment; (iii) the place of payment and any rights to unilaterally alter the place of payment; (iv) MAC clauses; (v) provisions for either continuation or termination of the contracts, such as illegality and change of law provisions; (v) indemnities that may cover losses upon change of currency, and (vi) obligation to assign (or restrictions on assignment) upon events such as illegality.

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