This note provides an overview of the 2003 ISDA Credit Derivatives Definitions (the 2003 Definitions).

THE 2003 DEFINITIONS AND THEIR STRUCTURE

From time to time the International Swaps and Derivatives Association (ISDA) publishes standard definitions for particular derivative products that can be incorporated by reference in a transaction confirmation thereby avoiding the need for detailed and complex definitions to be set out within the confirmation itself. For an overview on the various standard ISDA definitions, see Practice note, ISDA documentation: overview. For more on confirmations, see ISDA documentation: overview: Confirmation.

The 2003 Definitions are the market standard definitions for credit derivative transactions and contain the building blocks for all credit derivative transactions. For an overview of a credit derivative transaction see box, Credit derivatives.

The 2003 Definitions are divided into a table of contents; an introduction and preamble; and 10 articles. Within the 10 articles are 229 definitions, many of which cross-reference each other, and are sometimes modified by other definitions. There are also six exhibits, setting out forms of documents that a party to a transaction may need to use or serve during the term of the transaction.

INTRODUCTION AND PREAMBLE TO THE 2003 DEFINITIONS

The introduction to the 2003 Definitions confirms that:

- The 2003 Definitions are intended for use in credit derivative transactions that are governed either by the 1992 Master Agreement or the 2002 Master Agreement. For more information on the master agreements, see Practice note, ISDA documentation: overview: The master agreement.

- Parties to a credit derivative transaction may adapt or supplement the 2003 Definitions as they wish.

- The 2003 Definitions are freestanding and so therefore, for most transactions, there is no need to incorporate any other ISDA definitions booklets (such as the ISDA 2000 Definitions) into a credit derivative confirmation.

ARTICLE I – GENERAL DEFINITIONS

Article I’s definitions cover four distinct areas:

- First, they cover a transaction’s identity and structure by providing definitions of ‘credit derivative transaction’, ‘confirmation’ and ‘2002 ISDA Master Agreement’.

- Second, they cover a transaction’s landmark dates and term, namely:
  - The date when the parties agree to enter into a transaction.
  - The trade date of the transaction.
  - The term of the transaction.
  - The date when the term will begin.
  - Definitions of a transaction’s relevant business days for matters such as grace periods and settlement dates.

- Third, they cover key determination dates and time periods, namely:
  - The dates as to when a credit event is determined. For more information on credit events, see box, Credit derivatives and Article IV – Credit events.
  - The periods within which notices may be given to settle the derivative transaction if a credit event occurs.
  - The date the transaction will be terminated if a credit event occurs.

- Fourth, they cover the identity and location of the parties to a transaction, including definitions of ‘buyer’, ‘seller’, ‘calculation agent’ and ‘calculation agent city’.

ARTICLE II – GENERAL TERMS RELATING TO CREDIT DERIVATIVE TRANSACTIONS

The key provisions of article II relate to:

- Determining the identity of the reference entity if the original reference entity is succeeded by one or more entities as a result of a merger, amalgamation, transfer of assets, de-merger or other similar event.

- Mechanics of payments.

- The defining of the reference obligations and/or deliverable obligations under a transaction. Article II defines certain obligation categories (for example, it defines “bond”, “borrowed money” and “loan”) and certain obligation characteristics (for example, it defines “Not subordinated”, “Non sovereign lender”, “Not domestic currency” and “Listed”) that assist in simplifying the description of the relevant reference obligation and/or deliverable obligation in a confirmation. For more information on reference obligations and deliverable obligations, see box, Credit derivatives.
Credit derivatives are derivative instruments that derive their price and value from the credit risk inherent in the debt obligations and/or the creditworthiness of a third party (the reference entity). Under the simplest and most common credit derivative contract, one party, the buyer, will purchase protection against the credit risk of a third party reference entity from the other party, the seller. In return for the seller assuming this credit risk, the buyer will periodically pay it a premium. This will usually be a percentage of the credit derivative’s notional amount. The amount of the premium will reflect the credit risk of the particular reference entity, with greater risks reflected in higher premiums.

It is market practice to trade six categories of credit risk only (these categories include the occurrence of certain insolvency events in relation to the reference entity, a default in the payment of principal or interest by the reference entity and so on). Each category is known as a “credit event”, and a specific credit derivative contract will only trade the risk of the pre-agreed credit events. For more on the six categories of credit event, see Article IV – Credit events.

If a credit event occurs the buyer (and often the seller) has the right, but not the obligation, to trigger a credit event. The party triggering the credit event is called the notifying party and the date on which it does so is the event determination date. To trigger the credit event, the notifying party must satisfy the conditions to settlement (including the delivery of a credit event notice, usually a notice of publicly available information, and in the case of a physically settled transaction, a notice of physical settlement).

Credit derivatives can be either cash settled or physically settled. In cash-settled transactions, the calculation agent (usually the seller) selects and determines the market value of the obligation of the reference entity specified at the transaction’s outset (the reference obligation) and will notify the parties of that value. The transaction is then settled an agreed number of days later. The cash settlement amount paid by the seller will usually correspond to the transaction’s notional amount less the market value of the reference obligation determined by the calculation agent.

Where the parties have specified that physical settlement applies, and an event determination date occurs, the buyer will serve a notice of physical settlement. The notice of physical settlement sets out the actual obligations of the reference entity (the deliverable obligations) that the buyer will deliver to the seller on the physical settlement date. The physical settlement date will be either as agreed by the parties or within the longest period customary in the market. On the physical settlement date, the buyer will deliver the deliverable obligations to the seller and the seller will pay an amount equal to the face value of the deliverable obligations.

The above diagrams illustrate a simple cash settled credit default swap credit derivative and a physically settled credit default swap credit derivative.
Under article II:

- Certain obligations that are guaranteed by the reference entity can be reference and/or deliverable obligations. Depending upon the relationship between the reference entity giving the guarantee and the third party whose obligations are being guaranteed, the guaranteed is referred to as a “qualifying guarantee” or a “qualifying affiliate guarantee”.

- A termination event will occur under a transaction if there is a merger of a reference entity with the party who is selling the credit protection under the transaction. This provision may be varied in certain circumstances, for example, where a credit derivative transaction forms part of a credit linked note issued by a special purpose vehicle (for more on credit linked note structures, see Credit derivatives: Funded credit derivatives).

ARTICLE III – CONDITIONS TO SETTLEMENT

Article III sets out the conditions that must be satisfied in order for a party to initiate the settlement of a credit derivative transaction if a credit event occurs. The two settlement methods contemplated by the 2003 Definitions are cash settlement and physical settlement. In both cases there must be delivered a credit event notice and, if required in the confirmation, a notice of publicly available information. In physically settled transactions, a notice of physical settlement must also be delivered.

For more on cash settlement and physical settlement, see box, Credit derivatives.

Credit event notice

A credit event notice describes the credit event that has occurred. The credit event need not be continuing when the credit event notice is delivered: for example, a missed interest payment may trigger a “failure to pay” credit event even if the payment is subsequently made before the credit event notice is delivered. A form of a credit event notice is set out in Exhibit B of the 2003 Definitions.

The party entitled to give the credit event notice is nominated in the confirmation and is referred to in the 2003 Definitions as the “notifying party”. In all cases the notifying party will be the buyer of the credit protection, however, in some cases, it may also include the seller of the credit protection. For example, a seller may wish to trigger a credit event if:

- It had hedged its position by entering into another credit default swap as a buyer and it wishes to trigger that transaction.

- It suspects that the reference entity’s creditworthiness could decline further and therefore wishes to cut its loss.

Article III also provides that:

- A credit event notice cannot be revoked.

- In the case of a “restructuring” credit event, a notifying party is permitted to deliver multiple restructuring credit event notices, each triggering a credit event for only part of the reference entity’s notional amount.

Notice of publicly available information

The confirmation for a transaction may provide that the notifying party has to give independent verification to the other party that a credit event has occurred. This notice is referred to in the 2003 Definitions as a “notice of publicly available information”. A form of the notice is set out in Exhibit B of the 2003 Definitions and can be incorporated in the credit event notice.

Under article III the independent verification must:

- Have been published in a specified number of public sources. Market practice and the fallback position under the 2003 Definitions is two sources. The public sources can be specified in the confirmation or, if not specified, will be those listed in article III. The list includes Bloomberg, the Financial Times, the Wall Street Journal and other leading financial publications. Market practice is to rely on the list.

- Be received from (or published by) the reference entity or a trustee or agent of its obligations. Where the reference entity is a sovereign the information can be received from a sovereign agency. If the buyer of the credit protection is (1) the trustee or agent, (2) the sole information source and (3) a holder of the obligation which has suffered the credit event, the notice of publicly available information must be accompanied by a certificate signed by one of its officials of managing director rank, certifying the occurrence of the credit event.

- Constitute information contained in the reference entity's bankruptcy, insolvency or related proceedings.

- Constitute information contained in any court, tribunal or similar administrative or regulatory body’s document.

Article III recognises that certain information may be difficult to independently verify and accordingly excludes from independent verification certain defined information.

Notice of physical settlement

In a physically settled transaction, the credit protection buyer must deliver a notice of physical settlement within 30 days of the event determination date. The notice is irrevocable, but can be amended as many times as the buyer wishes, prior to the end of the 30-day period.

The notice states that the buyer will physically settle the transaction and contains a detailed description of the deliverable obligations that it intends to deliver. The description of the deliverable obligation will include the outstanding principal balance or the due and payable amount of each deliverable obligation. A form of the notice is set out in Exhibit C of the 2003 Definitions.

ARTICLE IV – CREDIT EVENTS

Article IV sets out the six credit events that can be included in a credit derivative transaction (for more on credit events, see box, Credit derivatives). The selection of credit events for a particular transaction will depend on relevant market standards for the reference entity’s jurisdiction and characterisation. For example,
the market standard for North American insurance reference entities includes only bankruptcy and failure to pay as credit events; whereas the market standard for European emerging market reference entities is bankruptcy, failure to pay, obligation acceleration, repudiation/moratorium and modified/modified restructuring.

The six credit events are extensively defined within article IV. The six events are:

- Bankruptcy. The definition of bankruptcy includes insolvency events such as winding up, administration and receivership. Subject to some minor changes, the definition tracks Section 5(a)(vii) of the 1992 ISDA Master Agreement.
- Failure to pay. This event covers the reference entity failing to make a payment of principal or interest. A minimum threshold amount is normally nominated in the confirmation that must be exceeded before this event is triggered. If no amount is nominated article III deems the threshold amount to be $1 million.
- Obligation acceleration. This event covers a reference entity’s debt obligation being accelerated by reason of an event of default. A minimum threshold amount is normally nominated in the confirmation that must be exceeded before this event is triggered. If no amount is nominated article III deems the threshold amount to be $10 million. If “obligation acceleration” is nominated as a credit event for a reference entity the “obligation default” credit event cannot be nominated in the same transaction.
- Obligation default. This event covers the reference entity defaulting on one of its debt obligations. If “obligation acceleration” is nominated as a credit event for a reference entity the “obligation default” credit event cannot be nominated in the same transaction.
- Repudiation/moratorium. This event covers the reference entity repudiating all or some of its debts or declaring a moratorium over all or some of its debts.
- Restructuring. This event covers the reference entity arranging for some or all of its debts to be restructured causing a material adverse change in their creditworthiness. There are four variations of restructuring each of which are specifically defined in article IV; full restructuring, modified restructuring, modified modified restructuring and no restructuring. The variation selected will depend on the reference entity’s jurisdiction and characterisation.

Article IV confirms that various common law defences (such as a reference entity not having the capacity to enter into an obligation or an obligation being unenforceable or invalid) are excluded when determining whether a credit event has occurred.

ARTICLE V – FIXED AMOUNTS

Article V covers the mechanics of the premium paid by the buyer to compensate the seller for assuming the credit risk.

ARTICLE VI – GENERAL TERMS RELATING TO SETTLEMENT

Article VI is a short article. It is an enabling provision that defines certain settlement terms. The two settlement methods contemplated by the 2003 Definitions are cash settlement and physical settlement. Each is chosen by being specified in a relevant confirmation. If cash settlement is selected (or if it is deemed to apply because physical settlement is impossible or impractical), the provisions of article VII will apply. If physical settlement is selected, the provisions of article VIII will apply.

ARTICLE VII – TERMS RELATING TO CASH SETTLEMENT

Article VII sets out the terms that apply if cash settlement is selected in the relevant confirmation (or if it is deemed to apply because physical settlement is impossible or impractical).

ARTICLE VIII – TERMS RELATING TO PHYSICAL SETTLEMENT

Article VIII sets out the terms that apply if physical settlement is selected in the relevant confirmation.

ARTICLE IX – ADDITIONAL REPRESENTATIONS AND AGREEMENTS OF THE PARTIES

Article IX covers the parties’ additional representations and agreements, as well as delivery fallbacks for physically settled transactions.

Additional representations

Under article IX, the parties represent and agree that:

- They have not made any representation to the other about the reference obligation or any of the reference entity’s or underlying obligor’s related obligations.
- They will perform the transaction irrespective of credit exposure to the reference entity.
- They need not suffer any loss or prove loss if a credit event occurs.
- The transaction will create no rights or obligations for any parties other than the transaction parties.
- The parties, their affiliates and the calculation agent may deal in the reference entity’s or underlying obligor’s obligations, and may also conduct banking and investment business with these parties which might actually cause a credit event to happen.
- There is no obligation to disclose any material information.
- Unless information is otherwise subject to confidentiality requirements, it will not trigger any confidentiality obligation and related losses will be indemnified.
Additional representations and agreements for physical settlement

Article IX provides that if physical settlement applies:

- When the buyer makes a delivery of deliverable obligations, it is deemed to represent that, except in the case of participations, it is transferring full title and that it will indemnify the seller should this prove not to be the case.
- Unless the buyer provides an indemnity to the seller to cover the situation, the buyer is deemed to represent that (except for some minor exclusions) the delivery of the deliverable obligations will not lead to any commitment on the seller to lend additional funds.
- The parties agree to carry out the necessary steps in relation to documentation and obtaining consents for delivery to take place.

Delivery fallbacks for physical settlement

Article IX provides certain fallback procedures if the buyer is unable to deliver the reference obligations detailed in the notice of physical settlement. The primary fallback is for either party to designate an affiliate to deliver or take delivery of the deliverable obligations. There are different fallback provisions for bonds and for loans, each of which begin when a buyer is unable to deliver the deliverable obligation within 5 business days of the physical settlement date.

If due to events beyond the parties’ control it is impossible or illegal for the buyer to deliver, or for the seller to accept, any of the deliverable obligations listed in the notice of physical settlement, then on or before the physical settlement date the buyer must deliver any deliverable obligations for which it is possible to complete the delivery. The seller must then pay the portion of the physical settlement amount corresponding to the amount of deliverable obligations that are delivered in accordance with the current market practice for that deliverable obligation. The relevant party must give the reasons for the impossibility or illegality to the other in writing.

If, following the occurrence of any impossibility or illegality, the amount of deliverable obligations specified in the notice of physical settlement cannot be delivered before the latest permissible physical settlement date, then partial cash settlement terms (as defined by article IX (see Partial cash settlement terms)) will apply to these undeliverable obligations (notwithstanding that cash settlement was not specified in the confirmation).

Partial cash settlement terms

The 2003 Definitions provide for three partial cash settlement provisions. These relate to ‘partial cash settlement of consent required loans’, ‘partial cash settlement of assignable loans’ and ‘partial cash settlement of participations’. Each provision is applicable only if selected in the relevant confirmation (for example, by stating ‘partial cash settlement of consent required loans applicable’).