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NARROWLY TAILORED CREDIT EVENT AMENDMENTS IMPLEMENTED AT LAST

The long awaited amendments to the 2014 ISDA Credit Derivatives Definitions (the "**2014 Definitions**") to address narrowly tailored credit events finally came into effect on 27 January 2020. The amendments apply to credit derivative transactions with a corporate reference entity (but not to transactions with a sovereign reference entity) and have been implemented through the 2019 Narrowly Tailored Credit Event Supplement to the 2014 Definitions (the "**NTCE Supplement**").

Key issues

- The amendments to the 2014 ISDA Credit Derivatives Definitions implemented by the 2019 Narrowly Tailored Credit Event Supplement to address so-called narrowly tailored credit events came into effect on 27 January 2020
- Narrowly tailored credit events are credit events that have been manufactured as the result of an arrangement between a buyer of credit protection and the reference entity under credit derivative transactions it has entered into
- ISDA has also published an updated physical settlement matrix incorporating the 2019 Narrowly Tailored Credit Event Supplement
- The amendments will apply to transactions referencing corporate reference entities only

NARROWLY TAILORED CREDIT EVENTS

There is no definitive definition of a narrowly tailored credit event but broadly speaking it is where a buyer of credit protection enters into an arrangement with the reference entity under credit derivative transactions that it has entered into and such arrangement is tailored to trigger a credit event for the purposes of such transactions whilst minimising the impact on the reference entity itself. They are also commonly referred to as manufactured credit events.

Such arrangements are controversial as their purpose is usually to benefit a buyer of credit protection under a credit derivative transaction at the expense of the seller of credit protection by bringing about a credit event that would not otherwise have occurred.

The recent market focus on narrowly tailored credit events was the result of a number of such credit events and potential credit events that have occurred in recent years. The final and most recent of these unfolded at the end of 2017 and during the first half of 2018 in respect of the US real estate company Hovnanian Enterprises.

Hovnanian had negotiated a refinancing pursuant to which it would exchange some of its short term debt for new long term debt. Pursuant to the terms of this refinancing, a subsidiary of Hovnanian was obliged to purchase some of its outstanding bonds and Hovnanian agreed to miss an interest payment on those bonds. All other bondholders would be paid so only the subsidiary would be affected by this non-payment. Such non-payment was nevertheless expected to constitute a failure to pay credit event for the purposes of the 2014 Definitions.

The refinancing was challenged by certain sellers of protection of credit derivative transactions referencing Hovnanian, who brought a case in the US courts alleging, amongst other things, market manipulation.

Ultimately the case was settled and, as part of the settlement, the covenant pursuant to which Hovnanian had agreed not to make the relevant payment to its subsidiary was waived. As a result, ultimately no credit event materialised.

Nevertheless, the Hovnanian case (in particular) captured the attention of the market and attracted a robust response from regulators, leading to the development of the NTCE Supplement by ISDA to address narrowly tailored credit events.

AMENDMENTS TO THE 2014 DEFINITIONS

The principal amendment to the 2014 Definitions introduced by the NTCE Supplement is in practice fairly simple. The definition of Failure to Pay is amended to provide that if 'Credit Deterioration Requirement' is specified as applicable in the relevant confirmation, then in order to constitute a failure to pay the relevant payment failure must result from or in a deterioration in creditworthiness of the relevant reference entity.

In addition to the amendment itself, a draft guidance note has been published which is intended to assist the ISDA Determinations Committees in deciding in respect of any specific case whether the Credit Deterioration Requirement has been satisfied or not.

Amongst other things, the guidance note lists a number of non-exhaustive indicators that the Credit Deterioration Requirement may or may not have been satisfied, such as that the relevant non-payment did not result in the reference entity's other debt obligations generally being accelerated or related only to debt obligations held by affiliates.

In addition to the amendment to the definition of Failure to Pay, some technical changes have been made to the Outstanding Principal Balance definition, including changes to prevent a reference entity from manufacturing the cheapest to deliver deliverable obligation in a CDS auction by issuing a bond at a substantial discount.

IMPLEMENTATION OF AMENDMENTS

Parties were able to incorporate the NTCE Supplement into the terms of their legacy credit derivative transactions through adherence to the ISDA 2019 NTCE Protocol (which has now closed).

The protocol was widely adhered to, with over 1300 adherents prior to the adherence period closing on 24 January 2020. As a result, existing credit derivative transactions between the majority of market participants are likely to have moved to the new trading terms.

An updated physical settlement matrix was also published on 27 January 2020 in which the NTCE Supplement is specified to be applicable for transactions referencing a corporate reference entity. As a result, the default position moving forwards for new transactions with a corporate reference entity will be for the amended terms to apply.

Nevertheless, there will be some counterparties who have not adhered to the protocol who will therefore need to consider whether and how to incorporate the amendments introduced by the NTCE Supplement into their contracts. In particular, in respect of the credit-linked note market, the protocol will not have applied to issuers' credit-linked note terms and issuers with credit-linked note programmes will need to consider supplementing these programmes to reflect the new standard terms for credit derivative transactions.

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