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**Analysis of Credit Default Swaps: Market, Applications and Legal Issues, di
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ABSTRACT

This paper aims to explore some of the most interesting issues related to credit default swaps' instruments. This particular category of credit derivatives has brought a real revolution within derivatives' industry, either in term of volume of transactions closed or in term of sophistication and importance of market applications. The analysis conducted in this dissertation demonstrates how credit default swaps contributed to the development of the modern financial engineering allowing derivatives users to hedge credit risks in a manner which was merely unforeseeable until few years ago. Those kinds of products are only at the beginning of a long and, for many aspects, unknown process of fascinating evolution. We would argue that the borders of this process cannot be drawn, even by the most estimated credit derivatives experts.

This paper is divided into 5 sections. Firstly, a basic understanding of credit default swaps is provided by illustrating rationales and risks of a credit default swap transaction as well as referring to the underlying market. A brief outline of the latest products' innovation is also contained in the section.

Chapter II illustrates the key terms of a standard credit default swap transaction, paying particular attention to the definition of *credit events*. Even though the matter would deserve a more detailed exposition, an highlight of the major novelties introduced by the relevant ISDA standard documentation has also been included.

Further, we examined the most sophisticated applications of credit default swaps in the area of structured finance, with particular reference to synthetic CDOs and portfolio credit default swaps.

Chapter 4 analyses the issue of the legal qualification of credit default swaps contracts according to Italian legal system including, where appropriate, few references to the English perspective.

Finally, some conclusive remarks complete the research.

CHAPTER 1

Overview of credit default swaps instruments

1. Introduction

Credit Default Swaps (CDSs) represent a new type of financial instruments which have registered a dramatic growth during the past decade¹.

Particularly, CDSs are classified as a specific category of credit derivatives contracts. The origin of credit derivatives' market is not entirely clear although, approximately, it is estimated that the first credit derivative transaction was completed around 1991-1992. Since then, the underlying market began to increase very quickly, especially after the financial crises in Asia and Russia². According to a recent survey, in fact, has been estimated that the global market for credit derivatives reached 1.6 trillion dollars in term of volume of transactions by the end of 2002³.

Although many reasons can be found in order to explain the growth of these instruments, the most important is the huge possibility offered by credit derivatives to manage in an effective way credit risks. In fact, it is not a case that the spread of credit derivatives across the financial market represented a critical change in the manner to manage credit risks out of the traditional economic and legal instruments⁴. An important role towards the creation of a global derivatives market has been played by the International Swaps and Derivatives Association (ISDA), which pay great efforts to promote the use of credit derivatives across the financial markets with the creation of a set of standard documentation for the purpose to minimize the risks arising out of credit derivatives transactions⁵.

Within credit derivatives' industry, credit default swaps are the most utilized instruments⁶. They allow users to manipulate credit risks in a more efficient, economically convenient and effective way than the traditional methods of risk management practise. It is not a mere coincidence, in fact, that CDSs, as all the others credit derivatives instruments, drew the attention of the financial community just immediately after the big crises which, in the 1990s, hit the financial markets across the globe. The mentioned crises, in fact, were caused by specific key factors, *as the rise in interest rates in the local borrowing markets, capital outflow movements from the affected economies which worsened the liquidity crisis, huge foreign exchange losses due*

¹ Gardner, A. (1999), "Credit Derivatives and the Divergence between Economic and Regulatory Capital", Yearbook of International Financial and Economic Law, p. 387.

² Das, S. (2000), Credit Derivatives and Credit Linked Notes, 2nd edition, John Wiley & Sons, USA, p. 883.

³ Those data are drawn from British Bankers Association – Credit Derivatives Survey (2000), see Scott H.S., Wellons, P.A. (2001) International Finance: transactions, policy and regulation, eighth edition, New York Foundation Press, New York, p.1049.

⁴ Gardner, A., op. cit., p. 388-89.

⁵ The International Swaps and Derivatives Association, formerly called International Swaps and Dealers Association has offices in London, Tokyo, New York and Singapore and groups all the major users of derivatives instruments across the financial community, as Investments Banks, Law Firms and Financial Institutions. Its activity consists in creating standard documentation for derivatives users in order to overcome possible disputes arising out from derivatives transactions. ISDA also organizes and promotes periodic meetings and forums to discuss the latest issues of derivatives' transactions. For more information about ISDA's activity and to download the relevant documentation visit the ISDA web site: www.isda.org.

⁶ Credit derivatives are commonly grouped in three different classes: the Total Rate of Return Swaps, the Credit Default Swaps and the Credit Default Notes.

to devaluation process of currencies. Hence, those factors, all together, deteriorated considerably the creditworthiness of sovereign and private entities operating in the affected economies. As a result, their counterparties faced an increased concentration of credit risks across their portfolios and also registered increased credit exposures. Due to this macroeconomic cycle, credit derivatives soon emerged as effective financial tools capable to manage credit risks in order to allow investors, banks and financial institution to continue transacting business with risky counterparties⁷. In other words, credit derivatives allowed many financial players to continue to play in situation of financial distress.

2. **Basic framework of a credit default swap transaction**

This section outlines briefly the basic structure of a plain vanilla (or traditional) credit default swap⁸. In the basic form a CDS is a contingent payment that one party, the protection seller (the party who provides the protection), makes to his CDS counterparty, the protection buyer (the party interested in acquiring credit protection), at the occurrence of a specified credit event, *the credit default event*, regarding an underlying asset (the reference asset), which can be represented by loans, bonds or receivables. The buyer of protection pays periodic fees to the seller, usually expressed as a percentage of the asset's face value calculated in basis point⁹.

Therefore, the basic aim of a CDS transaction is to provide the protection buyer with a *credit insurance* against risks of default on a reference asset.

In order to establish exactly when the obligation of the protection seller arises, a crucial importance has the definition of *credit events* which, in turn, trigger the seller's obligation. When a credit event occurs, the CDS transaction can establish either a *physical settlement*, if the protection seller is required to purchase the defaulted asset at the current value, or a *cash settlement*, whereas the transaction is terminated paying the difference between the original price of the asset and its current value determined after the occurrence of the credit event¹⁰.

3. **Rationales and risks related to credit default swaps**

As mentioned briefly so far, credit default swaps allow users to isolate and manipulate in different possible ways the credit risk on a reference asset. In other words, such a manipulation is achieved by replicating synthetically the asset and isolating each of its elements. Then, the risks underlying the single elements of the asset are considered and traded separately. The result is a minimization of the overall credit risk on the reference asset¹¹. The latter can be considered the highest innovation achieved by the modern financial engineering.

Behind the general hedging activity of risks allowed by CDSs, there is a broad range of applications available to credit default swaps users. For example, CDSs can be used by corporate entities as an effective coverage against the risk of default of their

⁷ Das, S., op. cit., p. 877.

⁸ The definition of plain vanilla (or traditional) CDS is used across credit derivatives' industry to differentiate standard instruments from exotic (or complex) derivatives which are structured to meet specific needs of particular investors. Exotic derivatives usually embed elements of different classes in order to configure *hybrid instruments*. The majority of exotic credit derivatives are embedded in Credit Linked Notes as the BLAST Notes, the DISCO Notes and the CLEAR Notes.

⁹ Tavakoli, J. (1998), *Credit Derivatives*, John Wiley & Sons, Inc., USA, p. 65.

¹⁰ Scott, H.S. - Wellons, P.A., op. cit., p.1049.

¹¹ Das, S., op. cit., p. 3-7.

counterparties in specific transactions. CDSs, in fact, offer a kind of protection which is competitive if compared to the traditional techniques of coverage against credit risks. Particularly, protection achieved via credit default swaps is cheaper than the traditional credit insurance since it does not involve many administrative costs present in other transactions.

Hedging credit risk has become a crucial activity for banks and financial institutions. CDSs allow users not only to reduce credit risk but also to diversify such a risk. Diversification is particularly important when a portfolio is highly exposed to credit risks¹². Credit default swaps, in fact, mitigating credit risk, permit to improve the overall performance of a portfolio transferring some of the risks to other market sectors¹³.

In addition to a general reduction of costs, the synthetic transfer of risks achieved by CDSs brings also the advantage to simplify the procedures necessary to complete the transfer operation. This is particularly important when the reference asset is a loan included in a bank's portfolio. Through a traditional loan assignment transaction, in fact, the bank should inform the underlying obligors of the transaction obtaining their consent in order to complete the deal. Obligors, in turn, could refuse their consent on the basis of confidentiality reasons. Using a credit default swap, instead, the bank can replicate *synthetically* the asset (i.e. without any physical transfer of property) isolating and transferring only the credit risk without transferring the underlying asset. In other words, the asset remains "*physically*" on the bank's balance sheet even though the related credit risk is transferred to the CDS's counterparty. At the completion of the transaction, therefore, bank is relieved from the burden to deal with the underlying obligors, seeking their consent¹⁴. On the other hand, the result achieved "*synthetically*" via a CDS is the same than the result obtained making recourse to a *physical transfer* of the assets. Risky assets are removed from the transferor's balance sheet achieving liquidity and regulatory capital relief.

The use of CDSs also involves tax and accounting incentives. Purchasing default protection via a credit default swap, in fact, can hedge the credit risk without triggering adverse tax or accounting consequences present in a contract of sale. More often, the secondary market for many loans and private placements might not exist at all. Some forms of credit exposure, in fact, such as the exposure of employees to their employers in relation to non-qualified deferred compensation, are simply not legally transferable. Moreover, sometimes the loan agreement prohibits the sale of the loan to third parties. In those cases, credit default swaps can achieve those results not otherwise achievable through the sale of the asset¹⁵.

Credit default swaps can also be employed effectively by investors within a more complex investment strategy. Assuming that an investor owns a high credit-risky asset able to generate high income but requiring high funding costs, credit default swaps represent an opportunity to acquire default protection offsetting the credit risk while

¹² High credit exposures can be the consequence, for example, to particular geographic location where, for example, a portfolio is concentrated in a particular market segment or around to a specific category of clients.

¹³ Scardovi, C. – Pellizon, L. – Iannaccone, M. (1998), "Pianificare il credito e gestirne il rischio con i credit derivatives", No. 1, *Banche e banchieri*, p. 103.

¹⁴ Das, S., op. cit., p. 634.

¹⁵ "Credit (Default) Swaps - extracted from "Credit derivatives: A primer" issued by J.P. Morgan (February 1998)", <http://my.dreamwiz.com/stoneq/products/credit1.htm>, visited 28th July 2003.

retaining the asset which generates the income in the balance sheet. CDSs, therefore, are becoming an important source of investment opportunities and portfolio diversification for banks, insurance companies and other institutional investors¹⁶.

On the other hand, the use of CDSs is not entirely risk-free itself. In fact, an imprudent use of these instruments can involve more risks than advantages. Firstly, it is extremely important to choose the protection seller with the right qualities. A good CDS counterparty is, of course, a high-rated entity not exposed to any risk of default. Moreover, another important requirement to be assessed relates to the linkage between the protection seller and the reference asset. It is highly recommended, in fact, to choose as protection seller an entity which is eventually less rated but completely unrelated to the reference asset¹⁷. Further, before entering into a credit default swap the protection buyer should evaluate the possibility of adverse changes in the value of the reference asset which are not caused by the credit event. This kind of loss, in fact, is not covered by the CDS and is normally retained by the protection buyer. If the reference entity is easily exposed to price fluctuations, then other types of coverage are required in addition to CDS (for example interest rate swaps or currency swaps)¹⁸.

4. **Products evolution**

Credit derivatives market is rapidly evolving towards always more sophisticated products. Following a growing complexity of financial markets, complex structures have been created to hedge different elements of credit risk. We believe that this process is far from arresting itself. Although it is not the main object of this research, it can be useful to give a brief outline of the most important and recent credit derivatives innovated products. The common feature of those innovated instruments is that they represent a sophisticated variation of a basic credit default swap contract. The function, however, remains the same: achieving protection from credit risks.

The main evolved products can be listed as follows:

- **First - to - Default Baskets**

The peculiarity of this credit derivative is that the reference asset is represented by a basket of credits. Therefore, the credit event triggering the obligation of the protection seller is the **first default** of any of the credits included in the basket.

The rationale underlying the use of first-to-default baskets is to diversify and hedge large credit exposures. Hence, it is not a surprise that this instrument is employed particularly with reference to emerging market credits.

- **Credit Exchange Agreements**

A credit exchange agreement constitutes a variation of first-to-default baskets. This product allows the buyer of protection to substitute one credit for another within the reference asset. The important consequence is that the buyer is able to “allocate” effectively the credit protection within the asset according to the credit evolution of the portfolio.

- **Swap Guarantees (or Market Risk Contingent) Credit Default Swaps**

Unlike the structures considered so far, this derivative is employed when the underlying credit exposure is not fixed or known where, for example, an exposure is represented by another derivative as a swap transaction. If that is the case, the credit risk is a *dynamic variable* which cannot be hedged with a traditional credit default swap. If a credit event occurs, therefore, the protection seller will liquidate the buyer an amount calculated on the mark-to-market value of the swap at the time of default.

- **Currency Inconvertibility Agreement**

¹⁶ *Ibid.*

¹⁷ Tavakoli, op. cit., p. 73.

¹⁸ Gardner, A., op. cit., p. 391.

These instruments cover the credit risk of sovereign entity in emerging markets transactions and are especially used by foreign investors in emerging economies. Particularly, the risk covered is the *inconvertibility* of the currency or the *non-transferability* of the currency¹⁹.

CHAPTER 2 Key Terms and documentation

1. Key Terms of credit default swaps

As mentioned in the last chapter, a credit default swap transaction is an agreement where one party, the protection buyer, pays certain periodic fees to his counterparty, the protection seller, in order to be indemnified against the credit risks related to a reference entity²⁰. Behind the general framework of the transaction, each contract may change according to various elements as, for example, the intentions of the parties, the rationale of the credit coverage or some specific features of the underlying reference entity. Even though this is not the appropriate place to treat in details all the variants of a credit default swap agreement, we will try to point out the most crucial terms of a typical CDS transaction.

a. Reference Entity

The reference entity is the underlying obligor of the credit default swap transaction. The default or other related events of the reference entity triggers the payment's obligation of the protection seller under the swap. In other words, the protection buyer, entering into the contract, aims to acquire protection against the credit risk related to the performance of the reference entity. It is interesting to note that the provision concerning the reference entity is exclusive of the credit default swap. Other credit derivatives' transactions as total return swaps and credit spread transactions require a reference asset provision²¹.

b. Reference Asset

The reference asset is the asset (usually a bond or a loan) issued or guaranteed by the reference entity. Particularly important is the initial price of the asset which must be fixed by the parties at the inception of the transaction²².

c. Credit Event

The credit event is the negative event which affects the capacity of the underlying reference entity to fulfil its obligation. According to the term of the swap, the credit event triggers the payment's obligation of the protection seller. Generally, credit event may be represented by a wide range of events well beyond the mere situation of default. This is due to the possible different nature of the credit obligation which might be negotiated by the parties in the contract. Frequently, those events triggering the swap obligation can be classified as follows:

- default of payment on obligations above a fixed amount after the expiration of a specific grace period;
- cross default on other related or unrelated obligations;
- Bankruptcy, winding up or similar insolvency event;
- restructuring events;
- rating downgrade below determined threshold²³.

¹⁹ Das, S., op. cit., p. 39-54.

²⁰ Usually credit default swaps transactions are embedded in more complex financial structures (as, for example, synthetic securitizations) where CDS counterparties are banks, investment companies, public entities and financial institutions.

²¹ Das, A., op. cit., p. 32.

²² *Ibid.*

Besides the events which are generally capable to constitute “credit events”, a distinction must be drawn between private entities and sovereign obligors. The particular nature of sovereign entities, in fact, involves additional considerations in determining those events triggering the credit coverage. Firstly, the “bankruptcy term” is not applicable since from a strict legal point of view public sovereign entities are not subject to bankruptcy proceedings. Secondly, additional credit events should be considered as situations of “debt moratorium” or suspensions of payment, as well as restructuring of obligations where the new conditions are harmful for the creditors.

Within credit default swaps’ transactions, therefore, the term defining credit events is extremely important because it determines when the credit protection must be provided by the protection seller. This is a ground where parties must pay a great attention in order to define carefully and precisely the events triggering the payment’s obligation. The consequence of superficial negotiations could be, in fact, disastrous. Even experts derivatives users as investment banks are not immune from mistakes and misunderstandings²⁴. Particularly, major problems have arisen with reference to restructuring events to the extent that a certain number of US dealers have decided to remove the term “restructuring” from the list of credit events included in swaps agreements. Basically, two set of interests tend to conflict on this ground. On the one hand, bankers and dealers are in favour of quick negotiations based on standard documents as ISDA agreements, in order to achieve an always increased liquidity. On the other hand, counsels tend to protect investors’ interest claiming the adoption of credit derivatives contracts negotiated on individual basis and according to the systems in force in the different jurisdictions²⁵.

d. Key dates

Every credit default swap contains some key dates which are crucial for the parties. These dates are as follows:

- the “trade date”, which is when the terms of the contract are agreed between the parties;
- the “effective date” (usually 3-5 business days after the trade date) when the transaction commences to bind the parties;
- the “termination date” that represents the moment when the contract expires²⁶.

e. Materiality

Although the *materiality requirement* is negotiated as an autonomous term of the swap agreement, it can be considered as a feature of the credit event. This term ensures that the credit event constitutes a real event of default, in order to avoid apparent situations of default which are not qualified to trigger the obligation payment under the swap. The materiality term is determined on minimum changes in either the price of the reference asset (bonds or loans) or in the spread of the bond or loan tied to a reference rate as US\$ Libor or US Treasury bonds. Below this specified threshold, fluctuations cannot be qualified as credit events²⁷.

²³ *Ibid.*

²⁴ By way of example, on March 2001 UBS Warburg sued Deutsche Bank for an unpaid credit default swap obligation. Particularly, UBS had bought credit protection from DB on Armstrong World Industries as reference credit entity. The notional amount of the protection was \$10 million. Armstrong filed for bankruptcy but, in the meantime, he created a holding company making recourse to a reorganization process. Therefore, when UBS triggered the payment’s obligation of Deutsche under the credit default swap, Deutsche refused to pay on the ground that the name of the defaulted party (Armstrong) was different from the name of the new entity generated after the restructuring. See, Morris, J. (2001), “The difficulty of defining a default”, No. 4, *Euromoney*, p. 134.

²⁵ *Ibid.*

²⁶ Das, S., op. cit., p. 33

²⁷ *Ibid.*

d. Publicly available information

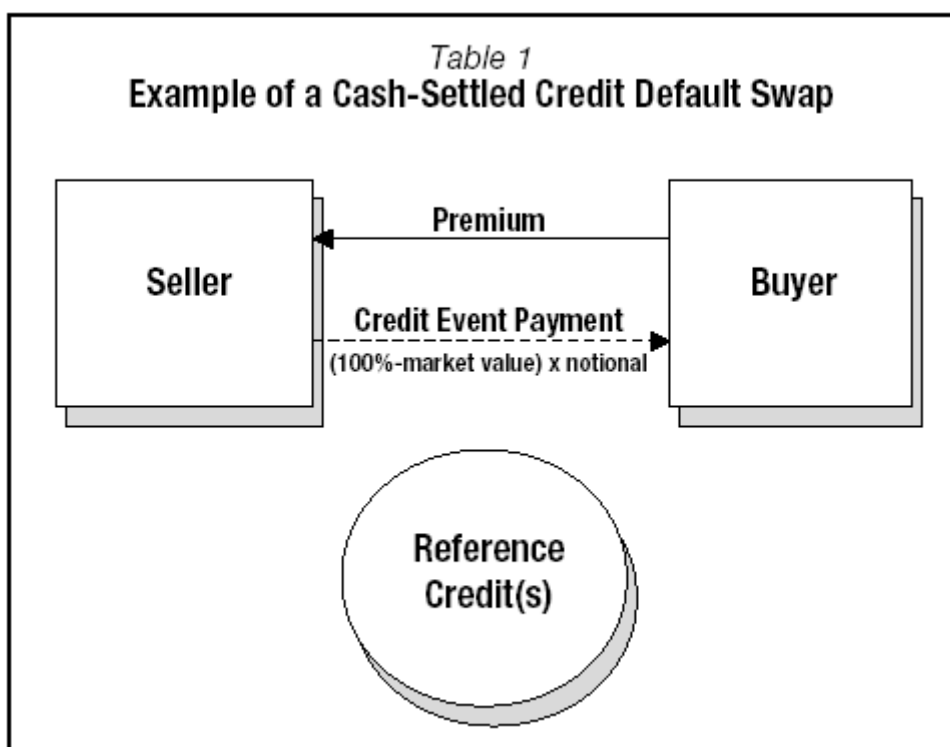
This requirement may be compared to materiality, in light to its function. Also publicly available information, in fact, ensures a certain degree of certainty in the process leading to establish the occurrence of a credit event. On this ground, has been agreed that a credit event is determined usually with reference to two reputable public sources of information as financial periodicals. Other sources linked only to one of the parties are, of course, no valuable in order to trigger a credit event. In order to avoid unforeseen problems, a process of alternative disputes resolutions has been included in the system²⁸.

e. Default Payment

At the occurrence of a credit event, the protection buyer entitles to receive a payment from the protection seller to be compensated for the loss suffered following the credit event. The payment's obligation of the seller can follow two different methods: *cash settlement or physical settlement*. In a cash settlement compensation (see Table 1) the buyer receives an amount which represents a pre-agreed fixed percentage of the notional principal covered by the credit default swap. Another variant of the latter is called "post-default price" and consists in an amount correspondent to the transaction principal multiplied for the change in the reference asset following the credit event.

On the other hand, the physical settlement provides for the payment of the par or initial price of the reference asset in exchange for delivery of the defaulted credit asset.

Market practise has registered the post – default price and physical settlement to be the most popular methods of default settlement. If the recourse to the physical settlement is impeded by legal or regulatory issues, the credit default swap contract usually contains an option for a cash settlement as alternative method of resolution²⁹.



Source: Tolk, J. (2001), "Understanding the risks in credit default swaps", <http://www.mayerbrownrowe.com/cdo/news/MoodysSyntheticCDORisks.pdf>

²⁸ *Ibid.*, p. 34.

²⁹ *Ibid.*, p. 35.

2. Documentation

In the light of the considerations made so far, the importance of the legal documentation has emerged to be particular relevant in credit default swaps and, generally, in all credit derivatives transactions. This is due to the fact that obligations undertaken via credit derivatives, unlike many other derivatives' contracts, are triggered by specific *credit events* rather than fluctuations in currency or interest rates (as, for example, within interest rate and currency swaps). Hence, it is crucial to specify the terms of the events, in order to ensure the protection seller to be aware of the "borders" of its payment's obligation and, on the other hand, to ensure the protection buyer of the exact moment when his right to the payment arises. The credit events as well as all the relevant obligations of the parties entering in credit default swaps are negotiated at the inception of the transaction³⁰.

Market practise related to all derivatives contracts, however, leaves little space to parties' negotiation, especially with reference to the crucial terms of the transaction as the definition of "*credit events*". Parties entering into a credit default swap, in fact, generally make recourse to the standard documentation published by ISDA. The adoption of ISDA standard documents offers the great advantage of reducing considerably the risks eventuality of disputes arising out of derivatives transactions.³¹

The documentation prepared by ISDA allows parties entering into a credit default swap to utilize a standard confirmation letter in order to transact the credit default swap under the umbrella of the ISDA Master Agreement³². As expressly stated in the confirmation letter, the purpose of the letter is to confirm the basic terms of the credit default swaps entered into by the parties on the trade date. The confirmation forms a part of the ISDA Master Agreement and incorporates the Credit Derivatives Definitions³³.

2.1 ISDA Master Agreement

The ISDA Master Agreement is a standard form contract largely used across derivatives' industry by all the relevant market participants to document over the counter (OTC) transactions. The latest version of the ISDA Master Agreement has been released on 2002 and has significantly modified the 1992 version³⁴. The main reasons to revise the former version of the contract, as ISDA has explained, were constituted by a change in the market practise across the industry over the last ten years as well as certain important market events like the Russian Bank moratorium and the Asian crises in 1990s. Although it is not the main subject of this paper, the new version of ISDA Master Agreement contains important changes which is worth mentioning for the consequence which they might exercise also on credit default swaps transactions. As highlighted by ISDA in releasing the new version of the Master Agreement, there four main amendments to the framework of the contract. These amendments can be explained as follows:

a. Close-out amount

³⁰ JP Morgan, op. cit., p. 14.

³¹ At the time being, almost all derivatives' transactions are closed using the ISDA standard documentation.

³² Besides the legal negotiation between the parties, it is worth mentioning that the trading activity in derivatives' business is usually conducted by telephone when the parties agree orally to enter into the transaction and take a note of the economic terms of the negotiation. The intention of the parties to enter into a derivative contract is documented by a Confirmation letter which will represent the basis of the formal agreement which will be closed in a subsequent moment. See Edwards, S. (2002), "Legal principles of derivatives", Vol. 1, *The Journal of Business Law*, p. 4.

³³ A sample form of Confirmation Letter may be found on the ISDA website: www.isda.org.

³⁴ Both the versions of ISDA Master Agreement can be obtained from ISDA website (www.isda.org).

The introduction of the close-out amount clause allows the non-defaulting party to calculate the amount of its losses in case of an early termination of the contract. The calculating party may utilize a number of factors in determine the close-out amount but the result must be “commercially reasonable”. This new method combines both the Market Quotation and Loss methods contained in 1992 version of the ISDA Master Agreement.

b. Force Majeure

The inclusion of force majeure as termination event has been included for the first time in 2002 version and represents the response of the market to the recent unpredictable events which may affect the conduct of business³⁵. This event occurs when one of the parties is prevented from making or receiving payments or deliveries because of force majeure or act of state. In order to trigger the force majeure term, the event must be not overcome by the party who, in any case, has to pay any reasonable effort in order to overcome the event. In addition, a waiting period of eight business days must expire before triggering the force majeure term.

c. Grace period

This section is particularly important for credit default swaps transactions since it might influence the occurrence of the credit event. The 2002 version of the ISDA Master Agreement shorten certain grace periods of the last edition. Particularly, the grace period for a payment default has been fixed in one business days (before it was three business days)³⁶. Bankruptcy events have also been modified. If the bankruptcy proceeding has been commenced by a third party the grace period has been reduced from 30 to 15 business days, whereas the period has even been removed in case the proceeding has been initiated by the swap counterparty³⁷.

c. Set-off clause

The introduction of a set-off clause is also a novelty introduced by the new ISDA Master Agreement³⁸. This clause operates in case of events of default or termination events under section 5(b) (v) of the Agreement and gives the non defaulting party the option to set-off any amount due by the counterparty or outstanding between the parties according to the contract³⁹.

2.2 ISDA Credit Derivatives Definitions

As already mentioned at the beginning of this section, parties negotiating a credit default swap transaction can rely on a set of standard terms, the ISDA Credit Derivatives Definitions, elaborated by ISDA for credit derivative users. If the parties enter into the CDS by means of a confirmation letter including the credit derivatives definition, those terms will apply to the contract unless the parties do not agree otherwise.

³⁵ The Force Majeure termination event is contained in section 5(b) (ii) of 2002 ISDA Master Agreement.

³⁶ See section 5(a)(i) of 2002 ISDA Master Agreement.

³⁷ See section 5(a)(vii) of 2002 ISDA Master Agreement.

³⁸ See section 6(f) of 2002 ISDA Master Agreement.

³⁹ Allen Arthur Robinson, (2003), “2002 ISDA Master Agreement”, <http://www.aar.com.au/pubs/pdf/baf/fobafmar03.pdf>, visited 28th July 2003.

Credit derivatives represent an area of derivatives business interested subject to a rapid and unexpected evolution. Therefore, it is not surprising that ISDA has demonstrated particular attention to this category of products, considered also the evolution in the documentation which brought recently to the issuance of the new 2003 Credit Derivatives Definitions⁴⁰. This process reflects the difficulty to elaborate standard terms for products whose development is difficult to anticipate.

The new 2003 ISDA Credit Derivatives Definitions introduce important changes to the former version published in 1999, in the name of increasing the liquidity of derivatives' market⁴¹. Although the importance of the subject would impose a more appropriate treatment, we will try to highlight briefly the most important changes introduced by the latest version of the Credit Derivatives Definition. The major changes of the 2003 Credit Derivatives Definitions can be summarised as follows:

- **Definition of Obligation**

Even though the definition of "obligation" within a credit default swap is particularly important involving the determination of credit events, the language of the 1999 edition was vague and incomplete. By way of contrast, the 2003 version of the Credit Derivatives Definitions define accurately the "obligation" as an obligation of the reference entity either performed directly or as provider of any Qualifying Guarantee⁴².

- **Subordination**

The subordination is a characteristic of the obligation and replaces the *pari passu* contained in the last version. The subordination requirement is related to the most senior reference obligation or, in case no reference obligation is provided in the contract, to unsubordinated borrowed money of the reference entity.

- **Loan participation**

The "loan participation" option has been definitely removed from the new Definitions. This option was adopted by the 1999 version and consisted in a delivery of loans through *direct or indirect loan participation*, which has proved to expose the protection seller to relevant credit risk brought by possible defaults of the participation seller⁴³.

- **Credit events**

The new Credit Derivatives Definitions contain significant changes to credit events related to sovereign entities. Particularly, the event of repudiation was modified to require that the repudiation comes from an "*authorized officer*" and be subject to an evaluation period. Moreover, the repudiation must arise from a default of payment in order to be considered as credit event⁴⁴.

- **Physical settlement**

The procedure of physical settlement has been considerably modified by the new Definitions. The delivery according to physical settlement must be fulfilled within 30 days from the credit event (as in 1999 version) but it must include a detailed description of the deliverable obligations. Following the relevant market practise, payment and delivery are no longer required to be contemporaneous. Moreover, the valuation time for

⁴⁰ The new 2003 Credit Derivatives Definitions are available on ISDA website (www.isda.org). They are structured in ten articles divided, in turn, in several sections. They also contain six exhibits related to forms of confirmations and notices.

⁴¹ Henderson, S. (2003), "2003 ISDA Credit Derivatives Definitions", No 4, Butterworths Journal of International Banking and Financial Law, p. 138.

⁴² *Ibid.*

⁴³ *Ibid.*, p. 139.

⁴⁴ *Ibid.*, p. 140.

partial cash settlement has been changed to 11:00 am in the principal trading market for the undelivered obligation⁴⁵.

- **Novation provisions**

This provision is introduced by art. 10 of 2003 Credit Derivatives Definitions for the purpose to increase the liquidity in the underlying market allowing the transfer of all or part of a credit derivative contract. The Definitions provide that the transferor, the transferee and the remaining party can enter into a “short form novation confirmation” incorporating a new agreement between the parties⁴⁶. The new agreement determines the new terms of the transaction, eventually leaving into force some of the terms related to the old transaction. The new agreement is usually represented by the 2002 ISDA Master Agreement⁴⁷.

CHAPTER 3 Applications of credit default swaps to structured finance products

1. Overview of market for credit default swaps

The area where credit default swaps have demonstrated all their potential, either in term of volume or in term of transaction’s sophistication, is the structured finance or structured credit market. This particular sector of financial engineering has created a huge market where mainly two broad categories of products are traded: synthetic Collateralized Debt Obligations (CDOs) and portfolio credit default swaps. The marriage between CDSs and the traditional structured finance products has made possible to securitize certain kinds of portfolios that could never have been packaged into the traditional asset-backed securities⁴⁸. This relationship has proved to be explosive, removing the boundaries of the past financial engineering and ensuring credit derivatives’ traders huge profits.

2. Synthetic Collateralized Debt Obligation

The synthetic CDO’s industry is the ground where credit default swaps meet the basic securitization’s technique, with the result to increase the potential to securitize assets and to transfer credit risks. CDO’s market has been established in August 1997 when Swiss Bank Corporation closed the first synthetic deal of the new modern era, called Glacier Finance Ltd. Since then, some big commercial banks as NatWest and UBS began to securitize their loans’ portfolios for the purpose to achieve regulatory capital relief, hedging the strict capital requirement determined by the Basle Accord⁴⁹.

Soon, banks became aware of the huge potential offered by credit default swaps as applied to CDOs’ transactions and realized that they could avoid transferring “*physically*” their loans in order to achieve capital relief. In other words, banks

⁴⁵ *Ibid.*

⁴⁶ A form of the novation confirmation is attached as Exhibit F to the 2003 Credit Derivatives Definitions.

⁴⁷ *Ibid.*, p. 141.

⁴⁸ Peterson, M. (2000), “Master chefs of the credit market”, No. 370, *Euromoney*, p. 54.

⁴⁹ *Ibid.*, p. 60. The synthetic CDO is an evolution of the traditional CDO’s technique, called cash-flow CDO, which employs the transfer of an underlying asset to a Special Purpose Vehicle which, in turn, issues the securities and repays to the originator the issued securities using the cash flows generated by the underlying asset. Generally speaking, a CDO transaction is called Collateralized Loan Obligation (CLO) if the reference asset includes bank loans or Collateralized Bond Obligation if the reference asset is represented by high yield and investment grade bonds.

discovered that applying CDSs to securitizations transactions they could operate *off-balance sheet* with considerable advantages. As a result, today the majority of bank balance sheet's CDOs are being closed synthetically. According to a recent survey, in fact, has been estimated that only in 2000 \$83 billion of credit risks was sold via synthetic CDOs⁵⁰.

The advantages of synthetic CDOs are particularly evident in Balance Sheets transactions (see Table 1, p. 34). Balance Sheet CDOs are those transactions structured with the purpose to achieve regulatory capital relief and must be distinguished by Arbitrage CDOs which, in contrast, are finalized to gain profit by arbitrage activities.

In order to fully understand the application of CDSs to synthetic transactions, we believe it is necessary to give a general overview of a synthetic CDO. Synthetic CDOs may be either fully funded or partially funded. Even though both the CDO's models employ a credit default swap to transfer "synthetically" the credit risk on a reference portfolio, there are significant technical differences between the two structures which is worth mentioning.

- **Fully Funded Synthetic CDOs**

In a fully funded synthetic CDO the originator enters into a credit default swap with the Special Purpose Vehicle (SPV), receiving credit protection and paying the SPV a premium in return of the protection. The SPV, on the other hand, issues notes which are tranching by credit quality and are equivalent to approximately 100% of the value of the reference asset. However, even in fully funded CDOs the originator absorbs a first-loss equity portion which usually amounts to 1.0%-1.5% of the notes, with the result that only losses which exceed the first-loss equity may trigger the SPV's obligation of payment under the CDS. The notes issued by the SPV are allocated on the capital market and are bought by those investors willing to invest in credit-risk securities. The premium paid by the originator under the credit default swap is directed to fund the coupon on the CDO notes subscribed by investors. The proceeds of the notes are used generally to buy collateral for the SPV's obligation and are invested in high-rated securities as government securities, repurchase agreement on government securities and triple A rated Asset-Backed Securities (ABS). At the closing of the transaction, therefore, the investors of the notes receive an interest payment on the notes, equal to the yield on the securities subscribed by the SPV as collateral plus the CDS premium paid by the originator. On the other hand, the investors in CDO's notes fund the credit protection on origination's asset⁵¹.

- **Partially Funded Synthetic CDOs**

In partially funded transactions the risk is transferred in the same way than in fully funded via credit default swaps. The main difference relates to the amount of the notes issued by the SPV to back the credit protection. The notes issued in partially funded CDOs, in fact, represent only the 5%-15% of the reference asset⁵². Therefore, the CDO, reducing the

⁵⁰ *Ibid.*

⁵¹ Goodman, L. (2002), "Synthetic CDO: an introduction", Vol. 9, No. 3, The Journal of Derivatives, p. 64-65.

⁵² The first partially funded CDO was called Broad Index Secured Trust Offering (BISTRO transaction) and was implemented by J.P. Morgan Bank in December 1997. In Bistrot structure an originator acquired credit protection from J.P. Morgan via a credit default swap on a portfolio of corporate credits. JP Morgan, in turn, bought protection from a SPV (BISTRO SPV) through another credit default swap. Both the protection buyers (the first originator and JP Morgan) retained a first loss-equity of 1.50% on the reference portfolio. See JP Morgan (1999), The JP Morgan Guide to Credit Derivatives, JP Morgan Risk Publication, UK, p. 62.

value of the issuance, is able to achieve the same favourable capital hedge than in fully funded models but at a lower cost. Moreover, in partially funded CDOs the originator retains a first-loss equity tranche (exactly in fully funded) and the SPV usually invests the notes' proceeds in high-rated securities to be retained as collateral against the payment's obligation under the CDS. Of course, the smaller the amount of the notes issued the smaller the collateral retained by the SPV. The reason allowing CDO to issue only a small percentage of notes is that the unfunded portion of CDO is always a pool of asset very highly rated (generally the creditworthiness of the asset is better than a triple A rated entity) with a low probability of default. However, sometimes CDOs transactions can also provide the unfunded portfolio with credit coverage through a credit default swap which is called *super senior credit default swap*. On the other hand, the funded part of CDO is protected by a junior credit default swap. The difference between the two credit default swaps is that the super senior CDS compensate only those losses above the amount covered by the junior CDS⁵³.

The credit default swaps in both fully funded and partially funded CDOs can be done directly between the originator and the SPV within a two-parties transaction or, alternatively, with the intermediation of a bank located in an OECD Member State. The presence of an OECD bank does not change the function of transferring credit risk from the originator to the SPV, since the bank enters into a first CDS with the originator who, in turn, purchases protection from the bank and, further, the bank in turn purchases protection from the SPV entering into a second credit default swap. The basic difference between the two models is expressed by the risk capital treatment for the originator. In the two parties CDS, the risk weight depends from the credit quality of the SPV's investment. Hence, the regulatory capital to be held by originator could reach 8% of the asset invested with a risk weight of 100%. On the other hand, structuring the risk-transferring through an OECD bank will bring the advantage to limit the capital charge on the swap to 20%⁵⁴.

The use of credit default swaps in CDO's industry has also modified the attitude of investment banks in managing credit risks. Banks, in fact, not only are able to manipulate synthetically their portfolios using CDSs but, moreover, they are intentionally building high-risk portfolios in order to gain higher yield, buying later credit protection on those portfolios⁵⁵.

As mentioned above credit default swaps, introducing the synthetic structure in securitization industry, has made possible the application of this technique to a greater variety of assets. For example, the latest innovation in this business area is the CDO of aircraft loans. In May 2000, Merrill Lynch as arranger and Banca Commerciale Italiana (BCI) in quality of originator jointly structured the synthetic CDO of \$1 billion asset of aircraft loans. The program was called "*Leonardo Synthetic*". The transaction was made possible just making recourse to a credit default swap, which allowed the originator to keep on its balance sheet the portfolio of loans while continuing to service the loans. Merrill Lynch acquired credit protection buying three different tranches of credit default swaps: senior, junior and mezzanine swaps. This system permitted the arranger to hedge further the credit risk took by BCI. Due to the particular nature of the portfolio (aircraft loans) as well as to the variety and dimension of the asset, the physical transfer of the loans via a traditional securitization technique would never have been possible⁵⁶. The

⁵³ *Ibid.*, p. 67.

⁵⁴ *Ibid.*, p. 65.

⁵⁵ Peterson, M., op. cit., p. 60.

⁵⁶ *Ibid.*, p. 62.

major obstacle to a normal securitization was, in fact, the great number of the underlying obligors which should have been notified of the transaction and required to give their consent. This would have involved too high costs to the extent to impede the securitization.

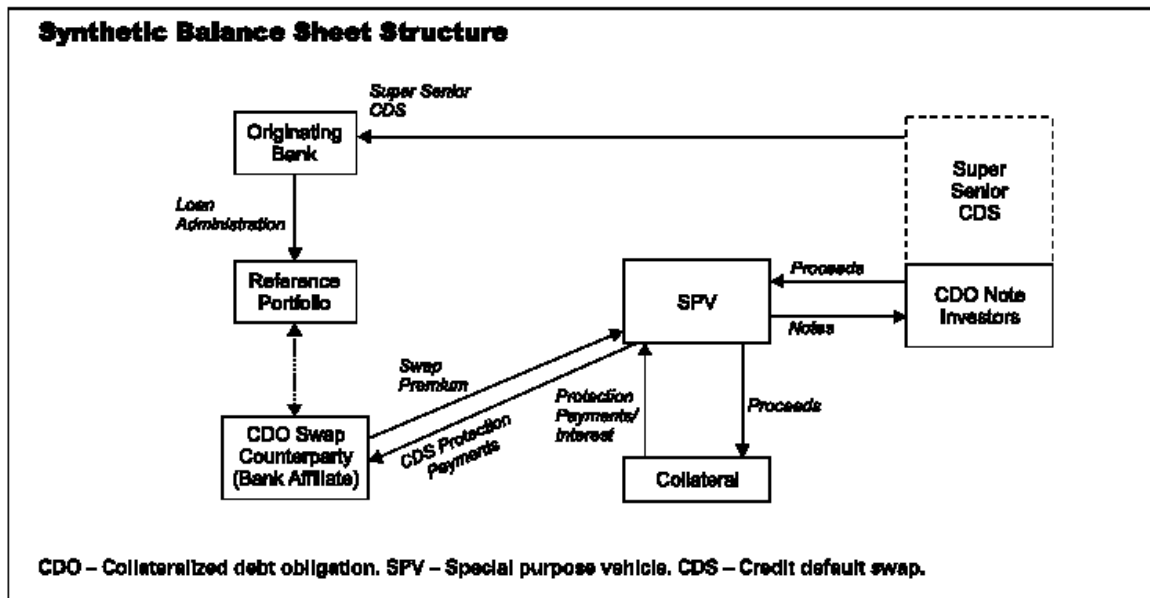


Table 1: scheme of a synthetic CDO. Source: Fitch, “Synthetic CDOs: a growing market for credit derivatives”, <http://www.mayerbrownrowe.com/cdo/news/wsyn0206.pdf>, visited 2nd August.

3. Portfolio credit default swaps

Portfolio credit default swaps represent another important and growing area of credit products employing CDSs to transfer synthetically the credit risk on a reference portfolio. The basic framework of this category of products is similar to a CDO. As shown in table 2, the basic difference is that in CDS portfolio the credit risk is transferred only on a small and defined percentage of the whole portfolio. Usually the percentage of the portfolio whose risk is transferred includes 20-25 underlying obligors, even though a smaller number can be included in the portfolio, as 10-15 obligors. In the light of these features, a portfolio credit default swaps represents a highly customized solution for those protection buyers who desire to diversify their portfolio’s credit risk in order to balance too concentrated exposures⁵⁷.

⁵⁷ Fitch, “Synthetic CDOs: a growing market for credit derivatives”, <http://www.mayerbrownrowe.com/cdo/news/wsyn0206.pdf>, visited 2nd August;

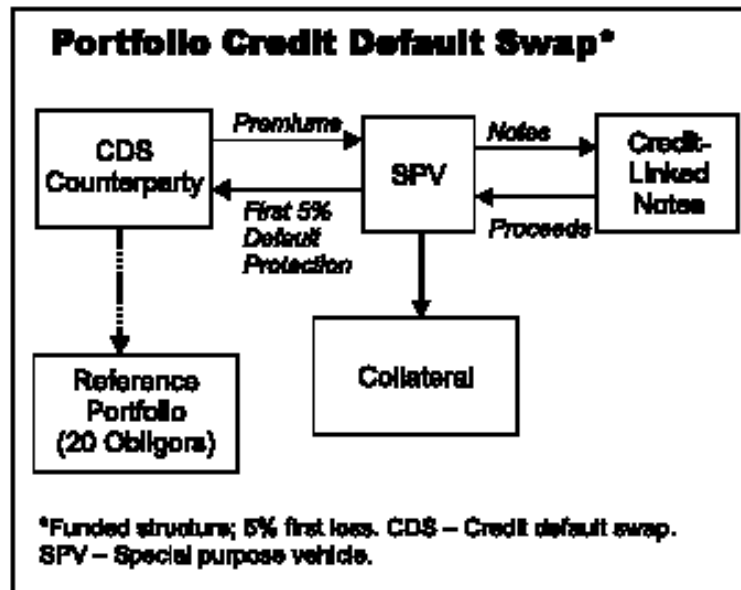


Table 2: sample of portfolio credit default swaps. Source: Fitch, “Synthetic CDOs: a growing market for credit derivatives”, <http://www.mayerbrownrowe.com/cdo/news/wsyn0206.pdf>, visited 2nd August.

4. Who takes the risk of CDSs?

The risk takers in structured credit market are those entities who retain exposure to credit risk entering into credit default swaps agreements with those buyers who seek protection. In the recent years, insurance companies have become the leaders of what is also known as “*financial guaranty business*”.

The reason is simple. Insurance and reinsurance companies, in fact, can utilize their economic models to allocate effectively various tranches of credit risk in synthetic form. The diversification of credit risk which those companies are able to achieve allows them to hedge the burden of the regulatory capital requirements on their portfolios.

Basically, protection sellers can be grouped in three big categories.

The most important are monolines insurers specialized only in credit business. They provide protection only on highly rated tranches of risk in order to maintain their high rating (generally triple AAA ratings).

Another category is represented by multilines insurers which recently have entered into the credit business, without achieving a great success yet. Investors, in fact, fear that those companies, applying the same procedures of traditional insurance policies, are not able to pay promptly the amount of the protection in the eventuality a credit event occurs. The rating companies, as Standard & Poor’s, recently tried to deal with those concerns introducing a new scale of rating for insurance companies operating in credit business’ area, assessing not only the ability to pay but also the commitment to pay quickly.

The last group consists in small less-rated companies willing to take the riskiest exposures in order to gain higher profits⁵⁸.

5. Is synthetic an advantage for investors?

We have examined the structure of a credit default swap transaction from the perspective either of protection buyers or sellers of protection. But CDS are made possible because there are investors who take risks in such instruments. From the investors’ perspective, synthetic products do not differ greatly from traditional structures in the sense that

⁵⁸ *Ibid.*, p. 66

investors, in both the transactions retain a risky exposure to an underlying asset (the reference asset). The basic question is, therefore, whether synthetics are more convenient than cash structures. The two techniques differ basically in the degree of exposure taken by investors to the credit of the reference entity. Hence, if compared with traditional structures, it can be argued that synthetic models are more able to mitigate credit risks. If, for example, the swap requires a bank to make payments in advance and the transaction terminates because of a failure of the bank to meet its obligation, the investors do not suffer any loss as a consequence of an early termination of the swap provided that a certain amount of collateral has been provided to cover the loss⁵⁹.

CHAPTER 4 Classification of credit default swaps under Italian law

1. Introduction

Following the new trend of the modern financial engineering, also the Italian market has shown a considerable interest in synthetic securitization built on credit default swap's mechanism, even though synthetic structures in Italy are still far from the volume of UK market. Nevertheless, the potential for this new type of securitization, including CDOs, CLOs and CBOs, is huge also in Italy. Italian securitization's market, in fact, has become the second biggest market in Europe after UK, since the introduction of law no. 130 in 1999 regulating expressly the securitization's technique. Hence, it is not a surprise that also in Italy much attention is being paid to the considerable advantages offered by the synthetic transfer of risk via credit default swaps⁶⁰. Particularly, we would argue that it is reasonable to estimate a dramatic growth of synthetic transactions within Italian market in the next few years, also considered the new capital adequacy requirements established by the Basel Committee. Almost all Italian securitization transactions to date, in fact, have been motivated by needs of originators to achieve liquidity by selling pools of non performing loans. Therefore, it is fair to assume that in the next future originators will utilize securitization with the different purpose to hedge their balance sheets exposure. On that ground, synthetic model will offer many advantages, especially with reference to tax benefits as well as simplicity and reduction of costs.

This section examines the crucial issue of the legal qualification of credit default swap's contracts under Italian law.

⁵⁹ Das, S., op. cit., p. 667.

⁶⁰ Andrioli S.-Dezzani L. (2002), "Synthetic Securitization: a growing funding technique", International Financial Law Review Supplement – Structured Finance Yearbook 2002, p.83.

2. Qualification of CDS contracts

The introduction of credit default swaps agreements within Italian legal system animated a great debate across scholars' members, lawyers and judges about the compatibility of the purpose realized by those contracts, and generally by all swap transactions, with the general principles of contracts contained in the Italian civil code. The rationale of the debate was the attempt to classify CDS as "typical contracts" within the categories regulated by the Italian civil code, in order to apply to them the discipline of the related specific class of contracts.

Alternatively, failing the attempt to include credit default swaps in typical contracts' categories, they must be classified as "atypical contracts" which are admitted by Italian law only if it is demonstrated that they pursue legal purposes worth to be protected by the law. Article no. 1322 of Italian civil code, in fact, expressly confers parties the power to enter into any type of contract provided the presence of the mentioned requirements.

The core of the debate can be related, in general, to all swap transactions. The main obstacle to include swaps into one of the categories regulated by Italian civil code is the argument for which swaps are similar to "bets" and are entered into by the parties for a speculative purpose. According to this legal point of view swaps cannot be considered as "contracts" and, therefore, parties are not bound by the obligations arising out of the contracts. According to article no. 1933 of Italian Civil Code, in fact, gaming contract are not enforceable under Italian law, even if the gaming is legal⁶¹.

On the one hand, those who support the illegality of swaps transactions explain that swaps can be considered similar to bets because in a "bet agreement", parties undertake to pay an amount of money as a result of a *challenge*. In such a contest the winner gains an economic value which is transferred by the loser counterparty. That transfer of money, therefore, is achieved out of the typical "channels" provided for transferring moveable or immoveable properties under Italian law. Since there is no legal rationale for the transfer, the flow of money occurs against the principles of contract law with the consequence to affect the whole transaction closed by the parties⁶².

On the other hand, according to the view of the majority, swap agreements are legal and are subjects to the discipline regulating all the contracts existent under Italian law. Hence, swaps are seen as financial instruments which realize a double cash flow between two parties, based either on the fluctuation of specific values (interest or currency swaps) or on the occurring of specific events (credit default swaps). In addition, in favour of the validity of credit default swaps according to Italian law, has been argued that those agreements achieve an economic coverage against credit risk similarly to certain types of guarantee regulated by the Italian civil code. Consequently, the objection of the "speculative purpose" is not applicable to credit default swaps, since they realize purposes which are protected under Italian law⁶³.

⁶¹ Agostinelli, R. (1997), "Le operazioni di swap e la struttura contrattuale sottostante", Vol. I, *Banca, Borsa e Titoli di Credito*, p. 128.

⁶² *Ibid.* This is also the outcome of the evolution reached by the modern jurisprudence. Following the elaboration of the scholar's thought, even the most reluctant judges came to the conclusion in favour of the validity of swaps contracts. Particularly, in two important decisions taken by the Court of Turin (see Tribunale di Torino (Italy), Fallimento Mediogest S.p.A. v. Sacchi, 10 April 1998, in *I Contratti*, (1999), No. 1, p. 45) and the Court of Milan (see Tribunale di Milano (Italy), Fioroni v. Credito Italiano, 20 February 1997, in *Banca, Borsa e Titoli di Credito*, (2000), Vol. II, 82-98) the Italian judges ruled for the enforceability of swaps' agreements.

⁶³ According to fundamental principles of Italian law, in fact, individuals have to right to acquire protection against credit risks, making recourse to the most suitable instruments.

Moreover, Italian law contains important disposition on swaps transactions, which support the view considering swaps as legal contracts.

Particularly, article no. 23 of law no. 1 of 1991 (so called “*Legge SIM*”)⁶⁴ rules that the National Commission on Italian Companies and Stock Exchange (CONSOB) can authorise the trading of financial derivatives, as interest and currency swaps, in regulated markets. Accordingly, those contracts are completely enforceable and are not exposed to the objection provided by art. 1933 of Italian Civil Code. In addition, the enforceability of the obligations arising out from swap agreements is also confirmed either in the articles 1- section I- or article 32, -section c- of CONSOB decision no. 8850 dated 9 December 1994⁶⁵.

3. **Classification of credit default swaps into existent legal categories**

The effort to compare credit default swaps to other types of contracts present in the Italian legal system is particularly important in order to establish whether CDSs can be considered either “typical” or “atypical” transactions. The consequence of this interpretative operation, as already mentioned, is crucial, involving the applicability to CDSs of the rules governing many aspects of typical contracts.

Many attempts have been accomplished by legal operators in order to draw the borders between credit default swaps and similar contracts.

Firstly, credit default swaps has been compared to a contract of personal guarantee called “*fideiussione*” which, *prima facie*, can appear similar to CDSs⁶⁶. Trough this contract, in fact, a guarantor undertakes to guarantee the performance of an obligation due by a third party (the guaranteed party). Therefore, the guarantee is triggered only as a result of a default on the main obligation. Moreover, from a strict legal point of view, the object of the guarantee and the object of the obligation guaranteed are the same to the extent that the nullity of the main obligation involves the nullity of the whole transaction. On the other hand, in credit default swaps the undertaking of the protection seller is totally independent from the obligation of the reference entity, with the result that the obligation of payment of the protection seller may be triggered independently from any default of the reference entity. This is due to the fact that many credit events, technically, cannot be considered properly events of default⁶⁷.

Credit default swaps have also been distinguished from contracts of insurance. The difference is subtle but substantial even if the basic purpose of those who buy credit protection via credit default swaps is to achieve an insurance against a risk (the credit risk). The main difference attains to the interest of the party entering into the two agreements. On the one hand, contracts of insurance are void if, at the closing of the contract, the insured party does not hold any interest to the claim for the damages suffered against the object of the insurance.

By way of contrast, protection buyers can enter into credit default swaps even if they do not hold any interest in the transferring of risks but only, for example, with the purpose to

⁶⁴ SIM are a specific category of companies, called *Societa' di Intermediazione Mobiliare*, which are incorporated under Italian law and have the purpose to trade in derivatives and other financial values.

⁶⁵ Agostinelli, R., op. cit., p. 130.

⁶⁶ This contract is regulated by art. 1936 of Italian Civil Code.

⁶⁷ Caputo Nasseti, F. (1998), I contratti derivati di credito, Giuffre' Editore, Milano, p. 21.

speculate on the swap in order to gain profits. This is possible because CDSs isolate the credit risk from the underlying obligation, transferring only such that risk⁶⁸.

Accordingly, within insurance contracts any modification in the degree of risk may influence the amount of the premium paid to insurance company (even involving the termination of the insurance if the risk increases to the extent that it is not convenient anymore for the insurance company to hold the risk) whereas the obligation of protection seller is totally independent from the underlying risk itself⁶⁹.

We have already mentioned the basic difference between swaps and gaming contracts. Particularly, unlike all the other derivatives transactions, credit default swaps present more than one element of differentiation from “bets agreements”. The purpose motivating the parties to enter into a bet, in fact, is the desire either to join the contest or “to challenge the luckiness”. Accordingly, the perspective to gain a profit from winning the bet is secondary to the satisfaction of winning the game defeating the opponent. Moreover, the result of the bet is usually dependent from future and uncertain events.

In contrast, credit events triggering payments’ obligation under CDSs are always determined precisely and in details, in order to avoid possible disputes. The determination of credit event is, in fact, one of most important clause contained in CDSs negotiated by the parties. The legal rationale of the credit default swap is the transfer of risk realized with the perspective of the parties to achieve an economic advantage. Therefore, the speculative purpose eventually motivating the protection seller to enter into the contract is not sufficient to qualify CDSs as bets. As a result, credit default swaps are not exposed to the provision contained in article no 1933 of Italian civil code⁷⁰. The same conclusion has been reached in common law jurisdictions. Particularly, in England many courts’ decision have argued that in order to qualify a contract as gaming both the parties must enter the transaction with the intention to wager⁷¹.

Moving further, credit default swaps presents some similarities with a particular type of sale, known in the Italian contract law as “*emptio spei*”. By means of this contract the buyer pays an amount of money against the “either the forecast or the hope” that a specific good will come into existence in the future. If that is case, the buyer will acquire the property of the good. This contract can be compared with a type of option, since the party aims to ensure the property of something which does not exist when the contract is stipulated but that could exist in the future. According to the Italian law, this option has an economic value representing the object of the contract. Credit default swaps are partly similar to *emptio spei* agreements, because the protection buyer pays certain fees to the

⁶⁸ The issue is so important that has been addressed also in the English jurisdiction, where credit derivatives have reached a high degree of development, mainly with reference to the legal qualifications and treatment of these instruments. Particularly, ISDA has commissioned a legal opinion to Robin Potts, released on May 1997 (available on ISDA website to ISDA’s members), and the issue has also been addressed by the Financial Law Panel (an English body whose task is to identify and clarify uncertain areas in the law regulating financial markets). Moreover, the matter was debated in the context of the most important swap litigation in England, *Hazel v. Hammersmith and Fulham* (see [1991] 1 All ER 545). The importance of the discussion relates to all derivatives transaction and involves considerations attaining also criminal responsibility, since the UK Insurance Companies Act of 1982 punishes as a crime the conduct of insurance business without an appropriate license. The result of the debate has been the same than in the Italian jurisdiction: besides the similarities between credit default swaps and insurance contracts attaining the ends of achieving economic coverage, there are significant legal differences between the two instruments. See Das, S., op. cit., p. 673.

⁶⁹ *Ibid.*, p.22-23.

⁷⁰ *Ibid.*, p. 24-25.

⁷¹ Das, S., op. cit. p. 680.

protection seller in order to be indemnified against the credit risk on the reference entity (which could also never occur). The main difference between the two transactions is that CDSs do not transfer any title of property but, simply, they transfer a risk⁷².

In the light of the analysis conducted so far, has clearly emerged that credit default swaps cannot be classified into any category of typical contracts regulated by Italian civil code, even though they present similarities with more than one typical contract. The obvious conclusion is that they represent atypical contracts with peculiar features. As already mentioned, according to Italian law, atypical contracts are void and immune from the exception under art. 1933 of civil code provided that they realize purposes qualified as legal and worth to be protected. If we consider the main function of credit default swaps, that is transferring a risk against payment of a premium, it can be argued that credit default swaps ultimately promote risk management activities so contributing to reduce the costs of credit risk across financial markets. Italian law considers this aim perfectly legal. Therefore, according to art.1323 of Italian civil code, CDSs are regulated by those provisions suitable, in general, to all the categories of contracts. These rules contain the core principles of the law of contracts under Italian legal system.

Besides the general principles of contract law, credit default swaps are also regulated by those specific rules compatible with the peculiar nature of the transaction. Particularly, CDSs are kinds of contracts which expose both the parties to the risk of performing their own obligation without receiving in exchange the counterparty's obligation: for example, the risk for the protection buyer to pay the fees of the swap without receiving any payment by the seller (because no credit event occurs). Those types of contracts are called "*contratti aleatori*". The main consequence of this characteristic of credit default swap under Italian law is that they are exempt from the application of certain rules contained in the law of contract. Particularly, they are subject to the provision of art. no. 1469 of civil code. The article excludes certain *contratti aleatori*, as credit default swaps, by the early termination clause triggered when the obligation of one of the party becomes too expensive. The increased burden is, in fact, a consequence of the risk brought by the contract, of which parties are perfectly aware entering into the agreement⁷³.

To conclude the analysis of the legal qualification of credit default swaps within Italian legal system, it is worth to point out another important feature of CDSs.

Particularly, CDSs belong to the category of contracts denominated "*ab intuitu personae*" because the parties of the transaction, entering into the contract, choose a specific counterparty as their unique counterparty. In other words, they choose the counterparty in light of personal and economic features, like rating and creditworthiness. The main consequence of this aspect is that credit default swaps cannot be transferred without an express consent⁷⁴.

⁷² *Ibid.*, p. 26.

⁷³ According to art. No. 1467 of civil code, in fact, one of the fundamental principles of contract law under Italian system is that the parties have the right to trigger the early termination of the contract if the obligations become too expensive due to external and unpredictable events.

⁷⁴ Caputo Nasseti, F., op. cit., p. 33-35.

CHAPTER 5

Conclusion

Within the complex world of derivatives instruments, credit derivatives are those which have recently experienced a dramatic growth reaching levels which were unforeseeable just until few years ago. Particularly, credit default swaps represents an industry which have attracted the attention of many credit derivatives users. That is not a mere coincidence, especially if we consider the particular time that the financial community is living.

Already forgotten the golden era when easy profits on the financial markets was the rule, market players are now facing frequent situations of financial distress where businesses and profits can collapse shortly without previous notices. To make the situation even worst, world is fighting obscure forces which are hidden just in those infrastructures built on developments of financial exchange.

Is the situation pictured so far too catastrophic? We do not believe it is. Human nature is, for definition, oriented to surviving and financial business is not an exception, since it represents one of the highest expressions of the human development.

Although the real reasons for the boom of credit derivatives are still not well known, we believe that an important explanation of this success must be found in the capacity of the financial world to overcome situation of financial distress. Particularly, credit default swaps well demonstrate this theorem.

Improving the credit risk management, they represent a valid tool to hedge financial crisis. Expression of the most sophisticated financial engineering, they have permitted in some way to continue transactions with risky counterparties which were close to the default, impeding in this way the termination of many businesses. It is not completely wrong to argue that, at macroeconomic level, CDSs have contributed to avoid or to worsen situation of systemic crises. The other side of the story is a new industry linked to the spread of credit default swaps, where new players and already established entities found profitable to sell credit protection.

Following the wave of ensuring always better risk management practise, we expect a progressive increase in the use of credit default swaps as well as a dramatic evolution in term of new sophisticated products. Many, in fact, are the signals towards this direction.

The great interest around credit default swaps is also demonstrated by the relevant activity of ISDA in credit derivatives business. As early of this year, for example, ISDA released a new set of Credit Derivatives Definitions, showing a precise interest in promoting the spread of the standard documentation in order to increase the liquidity of the market and reduce the disputes in this area which might refrain potential users from entering into CDS transactions. However, not everything is gold. Often, quick transactions in the name of liquidity mean harmful traps for investors and end users. On this ground, crucial is the work of lawyers who are called to offer always more sophisticated legal answers to this apparently confused evolution.

The evolution of credit derivatives products appears to be a process without an end. The possibility offered by combining CDSs and CDOs techniques is only an example of what is possible using these instruments. Today banks are placing real bets selling the risks via credit default swaps without owning the underlying reference assets. They rely to purchase later the portfolios in the secondary market at a lower price, gaining on the spread of the transaction. Not only. They are also intentionally assembling high risk portfolios with concentrated credit exposure in order to ensure high-yield on the secondary market. In fact, they are confident to hedge the underlying credit risk using credit default swaps.

To conclude this paper, we believe that quoting few significant words pronounced by a credit derivatives banker in an interview to a well known financial periodical, could give, better of many explanations, an idea of the level of uncertainty surrounding credit derivatives, even among those who every day deal with the instruments. The uncertainty relates not only to the future development of this market but, moreover, to the actual potential applications of credit derivatives products.

“..... we are only scratching the surface of what is possible with credit derivatives”⁷⁵.

TABLE OF ABBREVIATIONS

- **ABS** = Asset – Backed Security
- **BIS** = Bank for International Settlement
- **BISTRO** = Broad Index Secured Trust Offering
- **BLAST (Notes)** = Bank Loan Asset-Backed Secured Trust
- **CBO** = Collateralized Bond Obligation
- **CDO** = Collateralized Debt Obligation
- **CDS** = Credit Default Swap
- **CLEAR (Notes)** = Credit – Linked Enhanced Asset Return
- **CLO** = Collateralized Loan Obligation
- **CONSOB** = Commissione Nazionale sulle Società e la Borsa
- **DISCO (Notes)** = Default Immunised Secured Credit Obligation
- **ISDA** = International Swaps and Derivatives Associations
- **OECD** = Organization for Economic Co-operation and Development
- **OTC** = Over The Counter
- **SIM** = Società di Intermediazione Mobiliare
- **SPV** = Special Purpose Vehicle

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⁷⁵ See Peterson, M., op. cit., p. 57.

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