# Credit event

Credit event refers to any credit-related event that triggers a contingent payment in a credit default swap. Credit events are determined by negotiation between the parties at the outset of a credit default swap and concern the obligation of a reference entity underlying the contract. Among the common events usually included, the 6 industry standard as defined in the 1999 ISDA credit derivatives definitions (and completed by the 2001 supplement) play a special role: bankruptcy, obligation acceleration, obligation default, failure to pay, repudiation/moratorium, restructuring. Note that the range of credit events in a default swap may include some but not all these credit events. An important practical consequence of the definition of credit events is that the range of credit events in a default swap may be wider than simple default, when a debtor fails to pay interest or principal in due time. Typical example is the one of a company that declares bankruptcy or restructures some of its debt.

Let us review successively the 6 important standard credit events as defined in the 1999's ISDA Credit Derivatives Definitions:

1. Bankruptcy

Bankruptcy in the 1999 definitions follows the wording of the section 5(a)(vii) of the ISDA Master Agreement. Its encompasses a large variety of events associated with bankruptcy or insolvency proceedings under English law and New York law, as well as analogous events under other insolvency laws.

Note also that the ISDA scope of bankruptcy is wider than insolvency-related events used by rating agencies. For instance, certain actions taken by the reference entity, like a board meeting or a shareholders meeting to consider the filing of a liquidation petition, may be considered to be an act of bankruptcy. In comparison, it would not be the case for a rating agency in the context of credit assessment. Thus, the inclusion of this credit event when contracting default swaps would provide credit protection against such circumstances, while in contrast, a guarantee would be useless against insolvency-related events ahead of an actual failure to pay.

2. Obligation Acceleration

Obligation acceleration concerns the situation, excluding a failure to pay, where the relevant obligation becomes due and payable before its normal expiration date. It is mostly the result of a default by the reference entity. One of the important requirements concerns the payable sum. The credit event occurs only if the relevant sum being accelerated is above a minimum threshold, defined in the contract.

It is important to understand the difference between the obligation default and the obligation acceleration concept. Obligation acceleration is only a part of obligation default. Therefore, if in a credit derivative transaction, obligation default is already specified as a credit event, obligation acceleration will only be relevant if the default requirement is lower than the one of obligation default.

3. Obligation Default

Obligation default concerns the situation, excluding a failure to pay, where the relevant obligation becomes capable of being declared due and payable as a result of a default by the reference entity before the due time. As for the obligation acceleration, the relevant sum being defaulted must exceed a minimum threshold.

4. Failure to Pay

Failure to pay refers to a failure of the reference entity to make any payments under one or more obligations at due time. Failure to pay provisions usually takes into account any contractual or institutional grace period before the credit event is triggered. The failure to pay is one of the most important risk for protection buyer under a credit derivative product and is almost always included in credit default swap transaction.

5. Repudiation/Moratorium

Repudiation/moratorium refers to situations where the reference or a governmental authority disaffirms, disclaims or otherwise challenges the validity of the relevant obligation. Usually, like for obligation acceleration or default, a default requirement threshold is specified.

6. Restructuring

Restructuring concerns situations where the terms of the relevant obligation are modified and become less favourable to the obligation holders. Typical examples are a reduction in the principal amount, a decrease of interest payable under the obligation, a postponement of payment, a change in ranking in priority of payment or any other composition of payment. A default threshold amount may be specified. The wording of this definition aims at identifying specific events that are typical elements of a restructuring of indebtedness. However, a restructuring event would not to occur in circumstances where the relevant event does not result in a deterioration of the creditworthiness or financial condition of the reference entity.

Entry category: credit risk management

Scope: ISDA Master agreements.

Related articles: credit derivatives, default (incidents of), default risk.

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**The views and opinions expressed herein are the ones of the authors' and do not necessarily reflect those of Goldman Sachs or Morgan Stanley.**

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