MACFARLANES

IMPLEMENTATION OF THE NEW 2014 ISDA CREDIT DERIVATIVE DEFINITIONS

DERIVATIVES AND TRADING

SUMMARY

What is happening?
The legal terms for the trading of credit default swaps are being overhauled with the issue of the 2014 ISDA Credit Derivative Definitions (the New Definitions). The New Definitions incorporate a number of changes to the current terms commonly used for credit derivatives: the 2003 ISDA Credit Derivative Definitions (the Old Definitions) as modified by the 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement Supplement (Big Bang Protocol) and the 2009 ISDA Credit Derivatives Determinations Committee, Auction Settlement and Restructuring CDS Protocol (Small Bang Protocol).

Why?
The New Definitions aim to simplify and consolidate the Old Definitions, Big Bang and Small Bang Protocols and update the definitions based on the lessons learned by market participants in recent years.

When will this apply?
The New Definitions, published on 21 February 2014, are to be implemented with effect from 22 September 2014. As part of the implementation process, ISDA[1] has published a protocol which opened on 21 August 2014 for users to adhere to and thereby incorporate the New Definitions into their existing credit derivatives with effect from 22 September 2014 (the Protocol). The operation of the Protocol allows parties to multilaterally change the terms of their existing trades and to ensure consistency between those trades and trades entered into under the New Definitions from 22 September onwards. We set out the process to adhere to the Protocol at the end of this note.

BACKGROUND – WHAT IS DRIVING THESE CHANGES

To give context for changes made by the New Definitions, in the following section we highlight a few key events that have led to the changes:

The Greek default – Concerns with sovereign debt
In 2012 Greece passed legislation to impose a mandatory exchange of obligations on holders of Greek law government bonds. The exchange of bonds was effective the day after the law changed. A CDS credit event was declared at the time the exchange was imposed, but an auction to determine the CDS settlement level was unable to be held before the bonds had been exchanged, meaning the auction could not be run using the pre-exchange bonds.

Fortunately for buyers of credit protection, the auction was able to use as a reference long-dated bonds that had been issued on exchange, which by coincidence had a value close to the level at which the pre-exchange bonds had been trading. In other words, only through good fortune was an economically appropriate settlement value for CDS determined in the CDS auction.

Beyond the clear problems created by an exchange occurring before the auction could be run, a number of other concerns were observed in the circumstances of the Greek restructuring:

- A sovereign might convert obligations that were deliverable under a CDS into those that were not, so making the CDS ineffective.
- Bondholders that were overhedged with CDS protection might agree to unfavourable restructuring terms in order to increase the value of their CDS.
- The consequences of a sovereign redenominating euro-denominated debt were not catered for adequately.

Expropriation of subordinated debt of SNS Reaal
In 2012 the Dutch government nationalised SNS Reaal, expropriating its shares and subordinated debt with no compensation, but leaving senior debt and covered bonds untouched. The expropriation of the junior debt did not neatly fit into any of the defined credit events – the bonds had been cancelled, so there was no failure to pay or restructuring, and SNS Reaal was not bankrupt.

The Credit Derivative Determination Committee[2] managed to find an interpretation that a Restructuring had occurred, but then faced a further problem – there were no subordinated bonds on which to run an auction. After the Dutch government refused requests to release some expropriated bonds in order for an auction to be run, an auction was run on the senior bonds instead, generating an unsatisfactorily low CDS payout for any subordinated bondholder that had been relying on a CDS hedge.

Restructuring of Spanish regional bank debt
Banco Financiero y de Ahorra (BFA) and its subsidiary Bankia S.A (Bankia) consolidated the debts of several regional savings banks in Spain. There was a restructuring of the debt between BFA to Bankia that resulted in most of the subordinated debt being held by BFA, while the senior debt and a small portion of the subordinated debt was transferred from BFA to Bankia. The subordinated debt held by Bankia expired soon thereafter.

[1] The International Swaps and Derivatives Association, Inc.

[2] A committee of ten sell-side and five buy-side firms that, among other things, have the power to make determinations with regard the terms of credit derivatives that are binding on market participants. There are five such committees, covering different regions.

For CDS written on the original regional banks, the "Successor" was Bankia, meaning that the CDS were triggered only on a default by Bankia despite the majority of subordinated debt having remained with BFA. If a credit event on Bankia later occurred there would be no pool of available subordinated debt to appropriately determine the pay-out under a CDS.

ANALYSIS – WHAT ARE THE CHANGES

We highlight below some key changes brought in by the New Definitions.

The Finance Reference Entity Terms

With regard to entities that are not sovereigns, a number of the most significant changes within the New Definitions apply only to entities to which the new concept of "Finance Reference Entity Terms" apply. ISDA has stated that these are likely to apply to some European and Asian financial firms, but not to financial firms in other regions, including North and South America and emerging Europe. Although the new "Physical Settlement Matrix" that will specify the terms on which entities will typically trade CDS after 22 September 2014 is not yet published, it is expected that the entities to which the Finance Reference Entity Terms apply are those that are on the "Excluded Reference Entity List" that accompanies the Protocol (as later discussed in this note).

New governmental intervention credit event

In response to the expropriation in SNS Reaal, a separate credit event addressing government bail-ins has been introduced in the New Definitions. For entities to which the Finance Reference Entity Terms apply, the "Governmental Intervention Credit Event" occurs if, irrespective of whether the event is expressly provided for under the terms of the obligation, action is taken or an announcement is made by a Governmental Authority regarding the reference obligations under a CDS that is a binding action and results in:

- reduction or postponement of principal or interest;
- further subordination;
- expropriation, transfer or another event that changes the beneficial holder; or
- cancellation, conversion or exchange.

The Governmental Intervention Credit Event does not require any deterioration in the creditworthiness of the Reference Entity in order to be triggered.

Senior/subordinated obligations split for Finance Reference Entities

Recent experience with European financial firms has led to an appreciation that the consequences for holders of junior and senior obligations could be sharply different due to government intervention. To reflect the fact that junior and senior obligations may involve distinct risks, under the New Definitions parties can determine whether the protection bought on financial firms is on their senior debt or junior debt, with significant consequences when trading on Reference Entities to which the Finance Reference Entity Terms apply.

If parties wish to trade on subordinated debt, they should either agree a subordinated obligation and specify that obligation as a Reference Obligation or if they wish to trade using Standard Reference Obligations (see below) they will have to elect for junior debt as the "Seniority Level" in Confirmations. If the parties want to trade on a senior obligation they can either agree a senior obligation as a reference obligation, or more conveniently simply apply the Standard Reference Obligation (as noted below) and elect for a senior Seniority Level, or if no Seniority Level is elected the senior Standard Reference Obligation applies.

For CDS to which the Financial Reference Entity Terms apply, if a Restructuring or Governmental Intervention occurs only on junior debt, no credit event occurs on CDS traded with a Reference Obligation of senior debt, but a credit event would occur on a CDS traded with a Reference Obligation of junior debt. However, if a Failure to Pay (or Obligation Default if applicable under the Physical Settlement Matrix) were to occur on junior obligations, a credit event would still occur on a CDS traded on senior debt.

Further, where senior debt and subordinated debt are transferred to different successor entities, CDS on senior debt will track the transferred senior debt and CDS on subordinated debt will track the transferred subordinated debt.

Asset package delivery

If a deliverable obligation is exchanged for another obligation before an auction can be held as part of a Restructuring or Governmental Intervention Credit Event (where an entity is trading on Financial Reference Entity Terms or Sovereign entity to which the Asset Package Delivery Term applies), the auction will be held on the proceeds that result from a deliverable obligation that has been exchanged.

For an entity to which the Financial Reference Entity Terms apply, the Asset Package Delivery is determined based on any prior Deliverable Obligation that could have been delivered into an auction if the auction had been held before the exchange.

If a Sovereign entity to which the Asset Package Delivery Term applies (which from 22 September 2014 will typically be sovereigns in Western Europe, and those of Japan, Australia and New Zealand) exchanges its obligations, then based on published criteria set out in the Determinations Committee Rules, ISDA will publish details of a "Package Observable Bond". The Package Observable Bond consists of the exchange proceeds of a bond that pre-exchange was deliverable into the CDS. The CDS settlement auction will then be run on the Package Observable Bond. Only the proceeds of a widely-held bond may form a Package Observable Bond, reducing the risk that bondholders with significantly overhedged CDS protection agree to a poor restructuring on a small issue of bonds. The Asset Package Delivery terms apply even if there are no deliverable obligations following a Restructuring or Governmental Intervention, meaning that the CDS would pay out the entire notional amount.

Standard reference obligation

To increase uniformity and replace the existing practice of parties needing to agree and match a Reference Obligation, the New Definitions introduce a Standard Reference Obligation (SRO) concept. If parties specify that the SRO applies, a standard reference bond will be incorporated by reference. The SRO will be determined by ISDA according to a set of rules, and published on ISDA's website. Parties can opt out of the SRO by specifying a Non-Standard Reference Obligation on a CDS.

Amendment to successor terms

If more than 25 per cent of the "relevant obligations" of a Reference Entity is transferred to a new entity, the notional amount of existing CDS are split equally between each party that retains or acquires more than 25 per cent of the relevant debt of the original Reference Entity. For CDS to which the Financial Reference Entity Terms apply, the "relevant obligations" mean the senior bonds if the CDS is on senior debt and the subordinated bonds if the CDS is on subordinated debt.

A "Universal Successor" concept has been added, which provides that if the obligations of an entity all pass to another entity, the CDS track the new entity, without a need for notification to be made to the ISDA Credit Derivatives Determinations Committee within a 90 day look-back period as is required under the Old Definitions.

If multiple transfers of debt take place as part of a specific, pre-determined transfer plan, the transfers are aggregated for purposes of calculating applicable debt transfer percentage, known as a "Steps Plan".

The New Definitions add the concept of a Sovereign Successor Event, which occurs if there is an annexation, secession or unification of a Sovereign and there is a transfer of debt obligations between the entities. This allows for CDS referencing a sovereign to be realigned with the proportion of any debt transfer that occurs, in the same way as for a corporate successor.

Redenomination

Under the Old Definitions a Restructuring could occur on redenomination into a currency that was not either one of the G-7 countries or an OECD country with a AAA credit rating, which potentially allowed Germany, France and Italy among other countries to redenominate obligations from the euro into a newly created national currency. Under the New Definitions a redenomination from any currency may trigger a Restructuring if the redenomination is the result of a weakening of creditworthiness and is not into the euro or the currencies of the US, Japan, the UK, Switzerland or Canada.

The New Definitions then specifically provide for a redenomination from the euro by providing that a conversion of an obligation from the euro (to a currency other than that of the US, Japan, the UK, Switzerland or Canada) will avoid triggering a restructuring event only if there exists a "freely available market rate of conversion" from the euro into the other currency and the conversion goes through at that market rate with no haircut. This implies that if a country in the eurozone were to create a successor currency, that currency must be allowed to settle to a tradable level before obligations can be converted from the euro without triggering a Restructuring.

Moreover, ordinarily the event that gives rise to a Restructuring must result from a weakening of creditworthiness of the Reference Entity. However, any legislation that causes the debt of a corporate to redenominate from the euro might not be the result of the weakening of the creditworthiness of that corporate. Accordingly the New Definitions do not create a requirement that the redenomination from the euro result from a weakening of creditworthiness in order to trigger a Restructuring Credit Event.

OTHER CHANGES OF NOTE

- **Qualifying Guarantee**: the New Definitions expand the scope of guarantees that can constitute Obligations and Deliverable Obligations of a Reference Entity on a CDS.
- **No Frustration**: additional provisions clarifying that a credit derivative transaction will not be frustrated solely because either the Reference Entity, or obligations, deliverable obligations or reference obligations, do not exist on, or cease to exist following, a trade date.
- **Amendments to Auction Delivery Process**: the New Definitions simplify the operation of the auction process introduced by the Big and Small Bang Protocols. A number of changes have been made to allow a greater range of deliverable obligations to deliver to auction compared to the regime under the Small and Big Bang Protocols.
- **Subordinated European Insurance Reference Entities**: parties can choose to apply this term to mean that if a European insurance entity issues subordinated debt that has an extendable maturity to comply with solvency requirements that debt continues to be treated as meeting the Maximum Maturity Deliverable Obligation Characteristic.

Clarifications were also made to the definition of Publicly Available Information, Bankruptcy Event, and Deliverable Obligation Characteristics. Payment timings regarding a Failure to Pay Credit Event and Grace Period expiration timings were also clarified.

IMPLEMENTATION – WHAT DO I NEED TO DO?

Adherence to the 2014 ISDA Credit Derivatives Definitions Protocol

A link to the Protocol can be found here. ISDA has published a Q&A in respect of the adherence process here, and a Q&A on the Protocol itself here. The Protocol opened on the 21 August 2014 for adherence and remains open until 12 September 2014 (although this might be extended). The Protocol will come into effect on 22 September 2014.

The primary effect of the Protocol is that for all transactions between adhering parties that are "Covered Transactions" and for which the Reference Entity is not on the list of excluded Reference Entities, those terms of the New Definitions that do not require specific new elections will apply (so, significantly, the Finance Reference Entity Terms and the Asset Package Delivery terms will not apply).

The following are Covered Transactions: Covered Index Transactions (CDX Transactions (Tranched and Untranched) governed by CDX Documentation and credit derivative transactions that reference iTraxx® (Tranched and Untranched) governed by iTraxx® Documentation) , Covered Swaption Transactions (credit derivative transactions on either a single name swaption or a portfolio swaption that is not an excluded transaction) and Covered Non-Swaption Transactions (credit derivative transactions that are single name CDS, constant maturity swap, principal only. Interest only, first to default, an Nth to default, recovery lock, fixed recovery, preferred CDS, reference obligation deliverable transaction or a bespoke portfolio transaction).

Adherence to the Protocol does not apply the New Definitions to any transactions that are not Covered Transactions, including (but not limited to) Loan Only, US Municipal Type transactions, transactions on Excluded Reference Entities and CDSs on ABS Transactions.

Importantly, the excluded Reference Entities for which the Protocol has no effect are:

- all entities that are expected to trade from 22 September with the new Finance Reference Entity terms applying; and
- all Sovereigns that are expected to trade from 22 September with the Asset Delivery terms applying.

The list of excluded Reference Entities is available here.

This means that even if parties adhere to the Protocol, the Old Definitions will continue to apply to existing trades on those Reference Entities that are subject to the most significant changes to the normal terms of trading after September 22 2014.

Index trades are affected as if the indexes were baskets on the components of the index. So the components that adherence would bring under the New Definitions if subject to an individual trade will move to the New Definitions, and the components that would remain under the Old Definitions if subject to an individual trade will remain on the Old Definitions. This potentially will result in as many as three forms of index: existing trades for which no adherence was made and so with components only on the Old Definitions, post-22 September trades with components only on the New Definitions, and existing trades that for which adherence was made that are split between the Old Definitions and the New Definitions.

It is an all or nothing choice in applying the protocol to the entire group of trades between adhering parties. Despite this, parties that adhere to the Protocol can agree bilaterally to exclude specific trades from the Protocol.

On future trades, the Protocol allows for parties that have adhered to the Protocol to opt out of using the New Definitions by specifying in their electronic Confirmations that the "Updated 2003 Definitions" (meaning the Old Definitions as updated by the Big Bang Protocol and Small Bang Protocol) apply.

Implications of entering into the Protocol

While it is difficult to predict how quickly it will occur, it is likely that the bulk of liquidity in trading will move to trading under the New Definitions. It is possible that, compared to trading under the New Definitions, a price differential will be created when trading under the Old Definitions due to the lack of liquidity, which could make closing out trades that remain under the Old Definitions more expensive. In view of this, a benefit of entering into the protocol (to the extent that a party's counterparties also enter into the protocol) may be that existing trades are documented under the terms that are the most liquid and therefore cheapest to trade.

A concern in adhering would arise if only a proportion of a party's counterparties adhere. Suppose a party has put on a CDS in 2012 with a counterparty and in 2013 closed out the market risk of the first CDS by trading the equal and opposite CDS with a different counterparty. The first counterparty adheres to the Protocol but the second counterparty does not. If those CDSs have not subsequently been terminated, then by adhering a party could create a degree of basis risk between two CDSs that previously had legal terms that were fully offsetting. ISDA has sought to minimise this risk by creating a pre-condition for the effectiveness of the Protocol that, in effect, first eight Eligible Global Dealers on the Global Dealer Trading Volume List (as defined in the rules applicable to the Credit Derivatives Determinations Committees) must adhere to the Protocol before it is effective. As at the date of this note insufficient dealers have currently adhered, so a question remains whether the Protocol will come into effect.

In view of the numerous effects of entering into the Protocol parties will need to evaluate for themselves whether it is beneficial to change the terms of existing trades by entering into the protocol.

Implementation Date for the New Definitions

On 22 September 2014 the following will come into effect:

- Trading is able to commence on the New Definitions for Corporate, Sovereign and Financial Entities and new series of indices containing those entity types.
- Trading is able to commence on the new transactions types for Financial Entities where applicable.
- Standard Reference Obligations will become available.

Parties will still be able to trade based on the Old Definitions (and a party that wants to close out an existing trade may prefer to do so rather than have basis risk by using a trade on the new Definitions to close out a trade on the Old Definitions).

Anticipated documentation

ISDA intends to publish the following documents by 22 September 2014:

- Revised Credit Derivatives Physical Settlement Matrix and Confirmation
- Revised ISDA Disclosure Annex for Credit Derivative Transactions
- 2014 CoCo Supplement to the 2014 ISDA Credit Derivatives Definitions
- Standard Reference Obligation List

In addition, Markit will be publishing the following:

- Revised iTraxx and CDX Standard Terms Supplements and Confirmations

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