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ISDA 2014 CDS definitions: a robust framework

A new set of ISDA definitions should make the CDS market function more effectively.

— CDS ready to tackle government bail-ins of banks
— Greek default experience incentivised better sovereign credit event mechanism
— Markit has responded to the challenge set by the new rules

Legal boundaries that are clear and well-defined are an essential part of all financial markets. Credit derivatives are no different; indeed, legally binding rules arguably play a greater role in credit than most asset classes due to its relative complexity.

Hence the introduction of a new set of ISDA definitions is no trivial matter. ISDA's 2003 rules have governed how credit swaps operate for over the last ten years, but on October 6th 2014 (see section below for timetable) they will be superseded by definitions that should improve the functioning of the CDS market.

So, what exactly is changing? The ISDA 2014 definitions are an entirely new set of rules (as opposed to supplements), so there are numerous elements that are different. But the main impact is on financials and sovereigns.

Financial Reference Entities

The CDS market generally functions efficiently, but where there are problems they often arise in financials. The 2014 definitions aim to address these issues in three ways:

1. Governmental Intervention

The aftermath of the financial crisis and the policy response by various governments, particularly in Europe, exposed flaws in the 2003 CDS definitions. Numerous banks found themselves undercapitalised and some were unable to source funds from the private sector. This left them in the hands of the state, and this is where the ISDA rules were found wanting.

This was most apparent in the case of SNS Bank. The Dutch bank was nationalised and its shares and subordinated bonds were expropriated by the government as part of an enforced bail-in. Expropriation is not an everyday occurrence, and it wasn't explicitly covered in the 2003 definitions. A restructuring credit event was eventually declared by the ISDA Determinations Committee, but not after a period of legal hand-wringing. There was clearly a reduction in principal; the subordinated bondholders received zero compensation from the government, but the Multiple Holder Obligation wasn't met.

The problems highlighted by SNS have been tackled with the introduction of a new credit event: Governmental Intervention. This is similar to a restructuring credit event, but the trigger has to be the result of an action by a government or a governmental authority. The Multiple Holder Obligation doesn't apply, nor does the reference entity have to experience deterioration in creditworthiness.

Expropriation is explicitly included as a condition, as well as several other amendments that aren't included under a restructuring credit event.

Governmental Intervention also allows for bond language that contemplates the possibility of principal write downs or other negative changes to terms. This is crucial in Europe, where the EU Bank and Recovery Resolution Directive, due to come into force in January 2016, will make bail-ins part of the banking landscape.

2. Asset Package Delivery

SNS Bank showed that the triggering mechanism in a restructuring credit event could fail when applied to bank bail-ins. But it also showed that there were serious issues around deliverability. As mentioned above, the value of SNS subordinated bonds after the expropriation was zero. However, because of the expropriation, there were no subordinated bonds to deliver into the credit event auction. The only available option was to use senior bonds to determine the final auction price, which didn't reflect economic reality as the senior debt had relatively high recovery rates.

If the 2014 definitions had been in place, the SNS expropriation would almost certainly have triggered a Governmental Intervention credit event. This would in turn allow an Asset Package Delivery, another key part of the new CDS documentation. Under the Asset Package Delivery provision, bonds that are designated Prior Deliverable Obligations (existing bonds that were deliverable before the bail-in) will be deliverable into an auction after the bail-in, whatever form they take after the amendments.

In the case of SNS, this means that the subordinated bonds, now worthless, would be used to determine the final auction price. So, the holder of subordinated CDS protection would have received 100% instead of the misrepresentative lower figure that was set by the senior bonds.

3. Splitting senior and subordinated

It was understandable why the expropriation of SNS subordinated debt resulted in a restructuring credit event, even if the legality was somewhat ambiguous. But it was less clear why both subordinated and senior CDS were triggered. The latter didn't suffer any negative impact from the government's actions; if anything, the senior debt's creditworthiness was strengthened. But under 2003 definitions, a restructuring credit event on subordinated CDS also triggers senior CDS.

This will change for CDS using 2014 definitions. If a Governmental Intervention or Restructuring credit event occurs on subordinated debt but not senior debt, only the subordinated CDS will trigger. This makes sense and would have made the CDS market function more effectively not just in the case of SNS, but also several other bank restructurings in recent years.

The default of SNS Bank undoubtedly prompted many of the amendments to the ISDA 2014 definitions. But a more recent example of a bank bail-in highlighted how the documentation around succession events, as well as credit events, needed improving.

Banco Espirito Santo (BES), Portugal's largest bank, found itself undercapitalised due to losses at its parent company. The government split BES into a "good" bank (called Novo Banco) and a "bad" bank, (the existing BES) with the senior debt residing at the good bank and the subordinated debt at the bad bank.

ISDA ruled on August 8th that a succession event had taken place on BES, meaning that all the CDS will be transferred to Novo Banco. In the case of a financial entity, this entails both senior and subordinated CDS. This means that the latter will be "orphaned," and there will be no deliverables on Novo Banco subordinated CDS as all the subordinated bonds will remain obligations of BES.

Source: Markit

BES's subordinated spreads tightened dramatically when it became clear that the CDS was orphaned, a reaction that contrasted with the cash market, which accurately reflected the worsening in creditworthiness of the subordinated debt.

Under the 2014 definitions, the result would have been quite different. The possibility of a good bank/bad bank split has been taken into account, so subordinated CDS will follow subordinated debt and senior CDS will follow senior debt. In the example of BES, subordinated CDS would reference BES and senior CDS would reference Novo Banco, which makes far more sense.

Sovereigns

The Asset Package Delivery provision in the 2014 definitions should make credit events on financial reference entities more efficient. But it will also make sovereign credit events more reflective of economic reality. We only have to recall the default of Greece back in March 2012 to see why change was needed. The Greek government enforced a mandatory exchange of domestic law bonds for new bonds (with a large haircut), GDP warrants and notes issued by the European Financial Stability Facility (EFSF). The binding nature of the exchange consequently triggered a restructuring credit event.

However, this hotchpotch of assets posed a problem for the credit event auction. Under 2003 documentation, only the new bonds were deliverable; the GDP warrants and EFSF bonds were not acceptable. Thus the auction settled off the price of the new bonds, which didn't represent the true loss suffered by holders of the original bonds. Fortunately, the 21.5 final auction price was similar to where the old bonds were trading, so the result wasn't wildly inaccurate. But the flaw in the deliverability rules was all too apparent.

If the 2014 definitions had been in effect, then Asset Package Delivery would have been applied. As long as the restructured bond is deemed a Package Observable Bond (a list of securities published by ISDA), all of the

assets post restructuring will be deliverable. So in the case of Greece, the new bonds, GDP warrants and EFSF bonds would all have been deliverable. CDS would have paid out 100 minus the value of the total package, and a more accurate final auction price would have been determined.

Other changes have also been introduced that affect sovereigns. The possibility of a country leaving the eurozone has been taken into account, though the risk has diminished since the ECB made its commitment to the inviolability of the euro in 2012. The rules around sovereign succession have also been updated to align with the language on corporate CDS. Countries don't split apart very often, though Scotland's referendum on independence and Spain's fragile federation show that it is not impossible.

The protocol, industry challenges and Markit's response

So we have seen that the new definitions have a significant impact on financials and sovereigns. A consequence of this is that there will be an economic difference between trades on 2003 and 2014 contracts. Thus financials and sovereigns will be excluded from the ISDA protocol that will amend trades on all other entities to the 2014 definitions. A handful of corporates are also excluded, and emerging markets will have a mixed approach to the protocol. Full details can be found on the ISDA website.

The existence of the protocol creates considerable operational challenges for the industry. Markit has responded to this through changes to its pricing, reference data and processing services.

CDS and index pricing

Contributors to Markit's CDS pricing service will be able to submit curves for the 2003 as well as 2014 definitions for entities that are excluded from the protocol. There may well be a basis between the two curves; some analysts have predicted that subordinated bank CDS trading on 2014 definitions may be as much as 50% wider than 2003 curves. CDS using 2014 documentation will be worth more to the protection buyer as it has the benefit of the extra credit event (Governmental Intervention), hence the probable wider spreads.

Markit will separate the two curves (2003 and 2014) through the DocClause (restructuring field). 2003 curves will be marked under the existing DocClauses (CR, MM, MR, XR), while 2014 curves will be designated using four new DocClauses (CR14, MM14, MR14, XR14).

All reference entities that are included in the ISDA protocol will be priced using the new DocClauses.

Names excluded from the protocol (list can be found here) are expected to start trading on 2014 definitions from September 22nd, which was the original launch date. This will be fully supported by Markit. Protocol names are due to start trading under the new definitions on October 6th.

The dichotomy is a result of the protocol effective date being extended to October 6th,

which allows the industry to make all the necessary operational changes and minimise basis risk between new trades and legacy transactions.

The introduction of ISDA 2014 definitions will also affect the construction of Markit indices, such as the CDX and iTraxx families. The vast majority of the indices will now roll on October 6th, to coincide with the protocol effective date. Please check the Markit website for full details.

RED/SRO

The concept of Standard Reference Obligation comes into effect in September 2014. The concept is to standardise contracts across cleared and bilateral contracts and introduce further clarification on the deliverability of an obligation in a default situation. The main drivers of the creation of SRO was the emergence of clearing houses using their own preferred obligations and also for participants in the CDS market be able to clearly identify the correct obligations with clarification as to their deliverability on event of a default.

The SRO will see Markit appointed SRO administrator by ISDA where we will support the industry with our unique CDS reference data. Markit will manage the SRO process and produce unique identifiers (SRO RED9) to denote the entity and seniority as CDS is traded on. These SRO codes will be linked back to existing Markit RED 6 and RED 9 identifiers. Markit will continue to identify and manage relationships between entities and obligations for Credit default swaps. All trades where SRO status has been designated by the ISDA determinations committee will utilise these new codes, thus ensuring Markit's premier positioning as supplier of reference data to the CDS market. The roll out of SRO will be a gradual process and at Go-live the expected focus will be upon Western European Financials.

MarkitSERV

The introduction of the 2014 definitions is the largest change to processing and legal confirmation since the Big and Small Bang protocols were introduced. With MarkitSERV legally confirming approximately 98% of all credit derivatives transactions electronically and offering many additional services to its clients much change has needed to be made.

The 2014 definitions do not apply to transactions automatically from September 20th; this must be incorporated into the confirmation or other trading documents. Post September 20th clients will be able to differentiate between transactions on both 2003 and 2014 definitions and reflect that value within the legal confirmation.

With the introduction of new Matrix types to the ISDA Credit Derivatives Physical Settlement Matrix (the "Matrix") to relate to the new credit event triggered by a government initiated bail in (e.g. European Financial Corporate), MarkitSERV platforms are introducing new values to allow clients to trade and confirm referencing these new terms. Additionally various amendments to the Operating Procedures that govern the platform are being made to be in line with the revised definitions and additional supplements.

MarkitSERV will play a vital role in amending historic live transactions to the new 2014 definitions for participants who have adhered to the ISDA Protocol. Working in conjunction with the DTCC TIW, MarkitSERV will process a legally binding amendment to applicable transactions.

Impact on the market

The CDS market aims to provide efficient tools for hedging and taking credit positions. In general, it does this very well. But there were shortcomings in the documentation, as shown by the SNS and Greek credit events. The introduction of the 2014 definitions should rectify most of these problems, though the myriad of way that companies and countries can restructure their debt makes a perfect solution impossible.

Financial CDS, in particular, should benefit from the changes. Liquidity in the subordinated market has been constrained by the uncertainty around credit events. The new, modern CDS contract should see more participants enter the market. CDS is now ready to tackle events in the troubled post-crisis era.

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