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New Credit Default Swap Terms to Be Implemented in September 2014

Posted by Yaron Nili, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Saturday August 9, 2014

Editor's Note: The following post comes to us from Isabel K.R. Dische and Leigh R. Fraser, partners at Ropes & Gray LLP, and is based on a Ropes & Gray publication by Ms. Dische, Ms. Fraser, and Molly Moore.

Earlier this year, the International Swaps and Derivatives Association Inc. (ISDA) published the 2014 Credit Derivatives Definitions (the 2014 Definitions). The 2014 Definitions introduce a new government bail-in Credit Event trigger for credit default swap (CDS) contracts on financial Reference Entities in non-U.S. jurisdictions and also modify the typical terms of sovereign CDS contracts in light of the Greek debt crisis, by allowing a buyer of protection to deliver upon settlement the assets into which the Reference Obligation has converted even if such assets are not otherwise deliverable. Further, they create a concept of a Standard Reference Obligation, which means that most CDS contracts on a given Reference Entity would have the same Reference Obligation, thereby increasing the fungibility of such CDS contracts.

Much like the predecessor 2003 ISDA Credit Derivative Definitions (the 2003 Definitions), which they are intended to supersede, the 2014 Definitions provide the basic legal framework for certain credit derivative transactions and, among other things, provide standard provisions that may not otherwise be specified by parties in a confirmation. As with other product-specific definitions, parties may elect to modify or supplement the standard terms set forth within the 2014 Definitions.

It is anticipated that market participants will begin to use the 2014 Definitions with the September 2014 credit default index swap roll date (i.e., September 22, 2014). The 2014 Definitions will apply to new trades only if so elected by the parties (e.g., by incorporating their terms into a trade confirm). Additionally, ISDA is working on a draft protocol (anticipated to be released in August and to be open until a date in September that is on or near the roll date) that parties can use to elect to have the 2014 Definitions apply to existing trades, although certain existing transactions such as sovereign CDS and CDS on European financial entities are expected to be excluded

from the protocol given the substantial impact the changes could have on such trades' terms and value.

Market participants who trade in CDS contracts will want to understand and assess the 2014 Definitions in advance of the anticipated September 2014 implementation date and determine whether they are comfortable with the new terms or will want to amend any provisions for their CDS trades.

Key Changes Implemented With the 2014 Definitions

New CDS Credit Event Triggered by Government Bail-In of Financial Reference Entities. The 2014 Definitions add a new Credit Event (Governmental Intervention) for CDS transactions on financial Reference Entities (e.g., banks) in non-U.S. jurisdictions. Under the 2003 Definitions, there was some uncertainty whether certain actions taken by a government in a bail-in (for example, the expropriation and extinguishment of the assets of an entity) would trigger a Credit Event (such as Restructuring), and therefore trigger settlement of the CDS contract. Under the 2014 Definitions, a Governmental Intervention Credit Event is triggered if, as a result of action taken or an announcement made by a governmental authority pursuant to a restructuring and resolution law or regulation (such as the EU Bank Recovery and Resolution Directive), certain binding changes are made to the relevant Obligations of the Reference Entity, such as a reduction in the rate or amount of interest, principal or premium, postponement or deferral of payment dates, change in the ranking or priority of payments, expropriation, transfer or other event that mandatorily changes the beneficial owner of the Obligation, or a mandatory cancellation, conversion or exchange. Upon the occurrence of such an event, the CDS contract would be settled based on the outstanding principal amount of the bailed-in debt prior to the bail-in.

The Governmental Intervention Credit Event will not be triggered if the bail-in is of debt that is subordinated to the Reference Obligation (in other words, the bail-in of subordinated debt will not trigger a Credit Event with respect to CDS contracts on the senior debt).

Asset Package Delivery. With respect to transactions on sovereign Reference Entities and transactions on financial entities in non-U.S. jurisdictions, the 2014 Definitions add the ability to settle a trade by delivering assets into which an Obligation that was previously a deliverable obligation has been converted in the event of a Government Intervention (with respect to financial entities) or a Restructuring (with respect to financial entities or sovereigns). These changes are intended to address concerns raised in situations like the Greek debt crisis, where some of the assets issued by the government in exchange for the old bonds were not deliverable obligations.

With respect to sovereigns, only the assets into which a Package Observable Bond of the applicable sovereign has been converted may be delivered. The Package Observable Bonds are intended to be benchmark obligations of the relevant sovereign and will be published on ISDA's website. The rationale for limiting this provision to Package Observable Bonds is to ensure that only widely held bonds of a particular sovereign can be delivered, to reduce the risk of holders of a small issuance of a sovereign bond agreeing to unfavorable terms in a restructuring because they have purchased CDS protection.

Standard Reference Obligation. The 2014 Definitions introduce the concept of a Standard Reference Obligation for more frequently traded Reference Entities. As a result, there will generally no longer be any need to specify a Reference Obligation for these CDS contracts. The rationale for this change is to increase the fungibility and liquidity of CDS contracts. ISDA will publish a list of the Standard Reference Obligations for each relevant Reference Entity and Seniority Level. Note that parties can generally opt out of a Standard Reference Obligation by specifying a different Non-Standard Reference Obligation in the confirmation for a particular transaction.

Successor Provisions. The 2014 Definitions made a number of changes to the provisions dealing with transfers of debt to successor Reference Entities. For example, in determining the Successor for CDS related to a financial Reference Entity, the Successor for CDS on the senior debt and the Successor for the CDS on the subordinated debt will be analyzed separately, so if the senior debt is transferred to one entity and the subordinated debt is transferred to a different entity, there could be different Successors for the senior debt and the subordinated debt.

Also, the 2014 Definitions introduce the concept of a Universal Successor. Under the 2003 Definitions, a Successor can only be determined if a notification is made to the ISDA Credit Derivatives Determinations Committee or the counterparty to the CDS contract within 90 days of the Succession Event. This provision can lead to the risk of CDS buyers losing protection when Succession Events are not noticed. Under the new Universal Successor provision, there is no 90-day "look back" period if one entity assumes all of the obligations (including at least one Relevant Obligation) of the Reference Entity, and the Reference Entity has either ceased to exist or is in the process of being dissolved.

For non-sovereign Reference Entities, the 2014 Definitions remove the need for a Succession Event (such as a merger or transfer of assets or liabilities) distinct from the transfer of a sufficient threshold of debt obligations to determine a Successor, and instead introduce a concept of a Steps Plan, which aggregates debt transfers pursuant to a pre-determined transfer plan over a

period of time to determine whether a sufficient proportion of a Reference Entity's debt has been transferred so that a Successor should be determined.

Qualifying Guarantees. The 2014 Definitions expand the scope of guarantees that will be Obligations and Deliverable Obligations of a given Reference Entity, in particular by providing that the inclusion of a release provision in connection with the transfer of a guarantee and all (or substantially all) of the assets and liabilities of a guarantor on the same (or substantially the same) terms or including a cap on the guarantor's liability will not cause the guarantee to fail to be a Qualifying Guarantee. Additionally, the 2014 Definitions clarify that guarantees provided by a statute or regulation may be Qualifying Guarantees.

Other Changes. In addition to the changes noted above, the 2014 Definitions make a number of other changes, including, in particular, provisions for determining the Successor to a sovereign entity and some changes to the Restructuring provisions. The provisions added to the 2003 ISDA Credit Derivatives Definitions by the 2009 "big bang" and "small bang" supplements, which provided for auction settlement for many CDS contracts, are also incorporated into the 2014 Definitions.