Kramer Levin

ISDA Implements Changes to the Credit Derivatives Definitions

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In a continuing effort to address the advent of narrowly tailored credit events (NTCEs) in the CDS market, ISDA is now preparing for the implementation of the changes designed to deter market participants from running these strategies.

After receiving feedback from market participants, ISDA has now finalized the proposal and has released the final changes that will be made to the Credit Derivatives Definitions (Updated Definitions). The Updated Definitions subject any Failure to Pay credit event determination to a creditworthiness deterioration requirement, which will be determined based on a number of factors specified in a related guidance note. In addition, certain changes were made to the definition of Outstanding Principal Balance to deal with pre-bankruptcy OID issues. The OID-related changes prevent market participants from taking advantage of debt issued with an original discount that would not be taken into account under the current definitions and could potentially artificially impact settlement amounts under the CDS contract.

You will find an analysis of the Updated Definitions and their implications for market participants here.

Implementation Timeline and Process

The primary information contained in the most recent ISDA updates centers on the implementation process for the Updated Definitions. As with any significant market changes, ISDA will be issuing a protocol (Protocol). On July 26, 2019, ISDA confirmed that the Protocol will be released on Sept. 16, 2019, and will be open for adherence through Oct. 14, 2019 (this has been extended through Oct. 28, 2019). A pre-adherence period opened on Aug. 26, 2019, and will run through Sept. 13, 2019. The pre-adherence period is intended to allow key market participants to adhere to the Protocol by the time it is published on the ISDA website on Sept. 16, 2019, ensuring that the Protocol is published already with the backing of significant market participants. The pre-adherence page can be found here. The Updated Definitions will then become effective on Jan. 13, 2020.

Market participants should be prepared for their swap dealers to begin actively reaching out in the coming weeks. Dealers are likely to release summaries of the Updated Definitions as well as notices encouraging adherence when the Protocol is released. In addition, given the relatively short timelines, market participants should begin conducting the analysis that will be needed to obtain internal approvals to adhere to the Protocol.

Scope

The Updated Definitions are intended to impact both new and existing trades. The Protocol will update the terms of legacy trades, whereas the Physical Settlement Matrix will be updated to include the Updated Definitions for all trades entered into after the Updated Definitions become effective. With respect to legacy trades, the Protocol does not provide market participants with the ability to cherry-pick which trades are impacted. This means that market participants will need to consider the advantages and disadvantages of the Updated Definitions for their CDS book as a whole.

Approach to Adherence

For many market participants, adherence to the Protocol will be a relatively natural step. For example, those market participants without a significant net buy position across their CDS book may see little downside in adhering to the Protocol. This is because for all the downside that adherence presents for credit protection buyers, there is a corresponding upside for credit protection sellers. In addition, market participants buying protection on investment-grade Reference Entities may also see little to no issue with the Updated Definitions, given the remote possibility that an unconventional strategy would be run at an investment-grade entity.[1]

However, for some market participants, adherence to the Protocol should be considered far more carefully. Market participants with a significant net buy position across their CDS book should consider the ramifications of the Updated Definitions. In most instances, the Updated Definitions limit the circumstances under which CDS contracts will be triggered and makes the determination process more subjective and less predictable. Naturally, this is somewhat unappetizing for market participants primarily buying protection. That said, the proliferation (albeit in only a handful of cases) of NTCEs and other market forces has already depressed volume in the high-yield single-name CDS market. It may well be that for many net protection buyers, further reducing the liquidity of their positions (and thus limiting exit options) by retaining a contract not including the Updated Definitions might not be viable.

CDS protection buyers will therefore need to weigh the relevant advantages and disadvantages of limiting the value of their CDS protection versus following the market and ensuring liquidity. Given the relative difficulty of modeling the value implications of future DC determinations or the implications of trading in a pool with more limited liquidity as a result of non-adherence, this analysis may well be complex and not without risk.

Also, market participants electing to retain existing contracts without the Updated Definitions may need to take certain steps on trading/matching platforms to preserve their legacy trades. Market participants considering this approach should therefore begin the process of holistically understanding both the economic impact and the mechanics of grandfathering legacy trades before the Updated Definitions become effective.

Cleared Trades

One additional wrinkle in the adherence process is the approach being taken with respect to cleared trades (both single-name and index). For cleared trades, parties will not be required to adhere to the Protocol; instead, the clearinghouses will update their rule books to reflect the Updated Definitions. Naturally, this reduces the workload for market participants with only cleared CDS who are agnostic to or in favor of the Updated Definitions. For market participants wishing to avoid their legacy trades being subject to the Updated Definitions, however, this adds further complication. Such a party would likely have to terminate existing cleared trades and replicate those trades with a bilateral uncleared trade with a dealer. Market participants adopting this approach may very well face pricing issues and possible lack of dealer appetite to enter into such trades, among other things.

For market participants interested in learning more about the Updated Definitions and discussing prevailing issues in the CDS market more generally, Kramer Levin will be hosting a CDS Symposium – Unpacking Market Developments, once the Protocol is open. To receive updates regarding this event, please click here.

[1] This compares with a decline for high-yield CDS, which are more susceptible to NTCE strategies, over a similar period.

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