



KRAMER LEVIN

**New 2014 ISDA CREDIT DERIVATIVES
DEFINITIONS**

Overview, Implementation and Impact

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Table of Content

- ▣ Main Substantive Changes
- ▣ Standard Reference Obligation
- ▣ Implementation and Protocol Issues
- ▣ Index CDS
- ▣ Impact on Market and Liquidity Issues
- ▣ CDS and Impact on Out-of-court Restructurings

New Definitions – Main Substantive Changes

☐ Credit Events

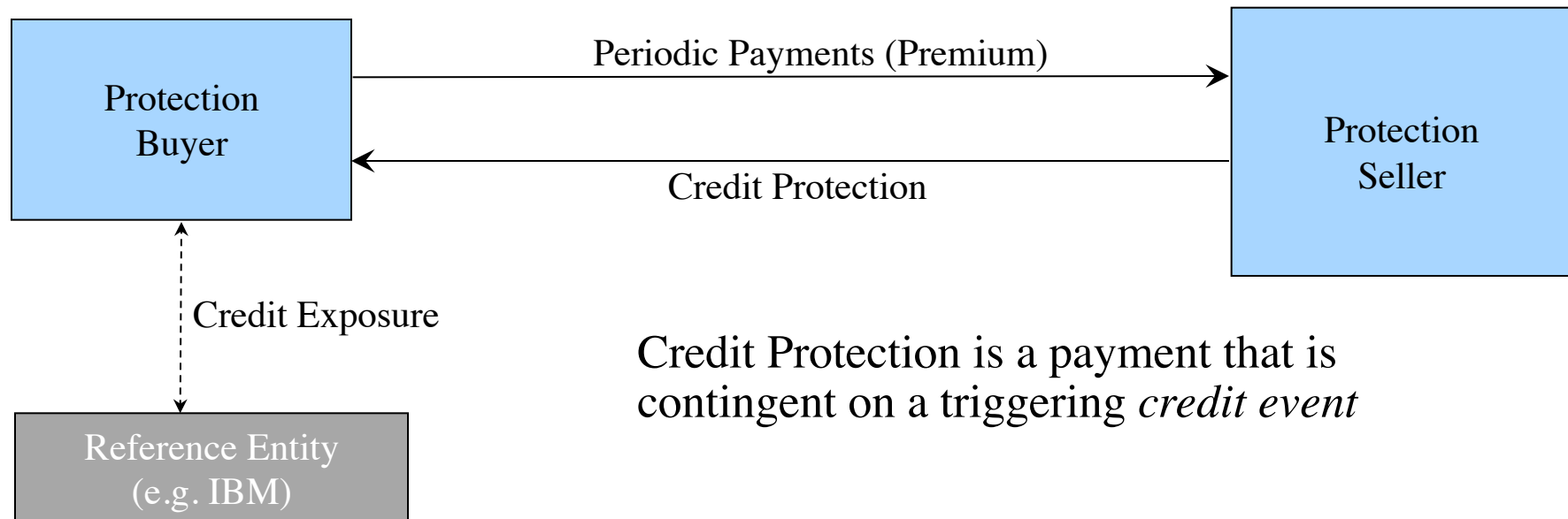
- Financial Entities terms
 - New Governmental Intervention Credit Event
 - Split between Senior and Subordinated CDS
- Asset Package Delivery
- Restructuring

☐ Successors

☐ Guarantees

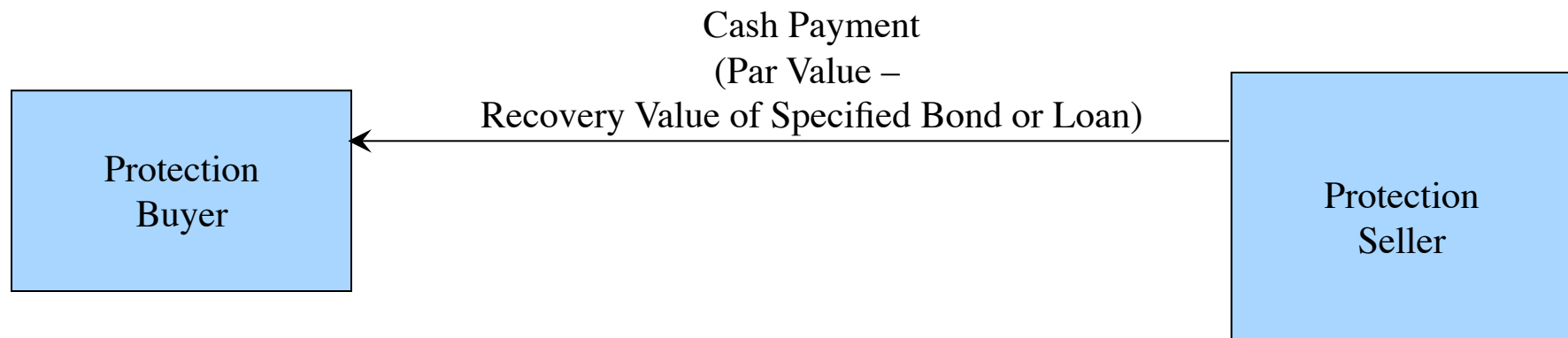
☐ Other noteworthy changes

Plain Vanilla Single Name Credit Default Swap



- ▣ Hedge/investment trades
- ▣ Liquidity

Cash (Auction) Settlement



Example:

Notional Amount	=	\$10 million
Initial Price	=	100%
Final (Recovery) Price	=	60%

Payment by Protection Seller = \$10 million x 40% = \$4 million

Financial Reference Entities Terms

- New Governmental Intervention Credit Event
 - Action taken or announcement made by a Governmental Authority regarding Obligations of not less than Default Requirement (\$10 million)
 - Pursuant to a restructuring and resolution law or regulation (or similar law)
 - In a form which is binding
 - Irrespective of whether such event is expressly provided for under the terms of such Obligation
 - Resulting in...

Financial Reference Entities Terms (2)

- ▣ ...resulting in:
 - Reduction or postponement of principal or interest or further subordination
 - Expropriation, transfer or other event which mandatorily changes the beneficial holder of the Obligation
 - Mandatory cancellation, conversion or exchange
- ▣ Banco Espirito Santo

Financial Reference Entities Terms (3)

■ Subordinated/Senior CDS Split

- Only applies in connection with Restructuring and Governmental Intervention
- Avoid a situation where Senior CDS is triggered by a credit event affecting junior debt
- Also applies to determination of successor Reference Entities

■ Senior Contract

- Trigger (senior only, sub for FTP or Bankruptcy)
- Deliverables (senior only)
- Successors (only look at senior)

■ Subordinated Contract

- Trigger (sub only)
- Deliverables (sub or senior)
- Successors (only look at sub, unless no junior debt outstanding (in which case senior debt))

Asset Package Delivery

- Context: lack of Deliverable Obligations (orphan CDS)
- Asset Package resulting from specific deliverable obligation will used/valued to settle CDS
- Applies to:
 - Financial Reference Entities upon Governmental Intervention or Restructuring Credit Events
 - Sovereign Reference Entities upon Restructuring Credit Event
- Moral Hazard Issues
- Delivering and valuing Asset Package
- New responsibilities for Determination Committee
- Untested approach

Restructuring

- Euro exit
 - Eurozone exit will not trigger Restructuring if there exists a “freely available market rate of conversion” and there is no write-down of interest, principal or premium (determined by reference to the rate of conversion at the time) (haircut)
 - Not necessary to show change in currency caused by deterioration in creditworthiness to trigger a Restructuring based on a Euro exit
- Bond exchange: clarification that Restructuring may occur as a result of a bond exchange (terms of new/old bond will be compared) – must still be an involuntary event
- Simplification of settlement (number of auctions/buckets, range of deliverable obligations, automatic trigger for Old R)

Successors

■ Corporate CDS

- Universal Successor (orphan CDS risk)
- Elimination of Succession Event requirement
- Steps Plan (series of debt transfers)
- Joint successors

■ Sovereign Successions

- No Universal Successor
- Sovereign Succession Event required
- Percentages of Relevant Obligations used to identify corporate Successors now also apply to Sovereigns

Successor Determination

<u>Successor Determination</u>		
<i>% of Relevant Obligations at Reference Entity ("RE") Moving to Successor Entity ("S")</i>	<i>Impact on CDS</i>	<i>Notes</i>
S1 >= 75%	S1 is Sole Successor	
75% > S1 > 25% RE <= 25%	S1 is Sole Successor	
75% > S1 > 25%, 75% > S2 > 25%, RE <= 25%	S1 and S2 Equal Successors	Can apply to 2 or more successors
S1 > 25%, S2 > 25%, RE > 25%	S1, S2 and RE Equal Successors	
All Successors <= 25%, RE still exists	No Successor, RE and CDS unchanged	
All Successors <= 25%, RE ceases to exist	Largest Successor (of Relevant Obligations) is Sole Successor	Tie breaker is % of all obligations (not only Relevant Obligations)
Seller of Protection consolidates with RE	Buyer of protection may choose to unwind the trade (at mark to market)	Section 2.31 of Credit Derivatives Definitions

Guarantees

- Under 2003 Definitions: technical definition resulting in guarantees failing to qualify despite market expectation
 - Guarantee could not be released other than by payment
 - “*All amounts* due under an obligation” had to be covered (no cap)
- Under 2014 Definitions:
 - Permitted Transfers and Fixed Caps no longer disqualify guarantees
 - Bankruptcy and non-payment events causing release provisions to “switch off” are assumed to be non-curable
 - Qualifying Guarantees no longer need to be accelerated in order to be delivered
 - Statutory and regulatory guarantees are expressly included

Standard Reference Obligation (“SRO”) Issues

- Role and deliverability of Reference Obligation
- Current lack of uniformity and related issues
- SRO (and seniority level) will be identified on SRO List
 - If SRO removed from list, there will be no Reference Obligation until a new one is identified (prior SRO still used for subordination analysis)
- Senior/subordinated selection
 - Based on seniority level of Reference Obligation, but fallback to senior (if no RO is specified)
- Parties may still trade with a specific Non-Standard Reference Obligation
- SRO Rules (yet to be published) will govern how an SRO is chosen/replaced. DC Rules will be amended.

Implementation – New Transactions

- Implementation Date is September 22, 2014 (roll date for standard iTraxx and CDX transactions)
- No automatic application: new 2014 Definitions must be incorporated in trading documentation
- Financial Entities
 - Updated ISDA Matrix will contain the new “financial” transaction types applying Governmental Intervention and Asset Package Delivery
 - Available for Western Europe and Asia
 - Result: new financial provisions will apply to new transactions in certain regions where the parties agree
- Sovereigns
 - ISDA published supplement will disapply Asset Package Delivery for certain regions

Implementation – Existing Transactions

■ 2014 ISDA Credit Derivatives Definitions Protocol

■ Timing

- Adherence Period Open until Friday, September 12
- Implementation Date: September 22
- Gap week needed for counterparties to operationally reconcile their portfolios
- List of Adhering Parties on ISDA Website

■ Structure

- Ability of adherents to revoke adherence
- Protocol Effectiveness Condition (7 of 8 Global Dealers are adhering parties)
- Modeled after Big Bang Protocol

Implementation – Existing Transactions (2)

- Scope of covered trades
 - Includes CDX, iTraxx, single name, bespoke portfolios, swaptions, Nth to default, recovery lock
 - Excludes Munis, LCDS, CDS on ABS, *party specified excluded transactions*, swaps to hedge CLNs
 - Novations (expected to only be covered if novation occurs on or prior to Implementation Date)
- One-year “catch-up” period
- Exclusion of certain Reference Entities (e.g. Euro Financials, Sovereigns and certain Corporates)
- Result: new financial provisions and new Sovereign Asset Package Delivery provisions will not apply to any existing transactions

SRO Transition and Clearing

▣ SRO Transition – Result:

- If existing trade does not specify Ref Ob, SRO applies
- If existing trade contains a Ref Ob, Ref Ob is preserved until it is retired, then SRO applies
 - However, if Ref Ob coincidentally happens to be the SRO, then SRO applies

▣ Interaction with Clearing



Markit Indices

Markit delivers a broad suite of independent, fixed income indices, as well as index solutions to support the development of custom indices.

- 10 years experience in index design, administration, calculation and distribution
- End to end index solutions provider
- Products and services across the entire value chain
- Supporting custom index development as well as outsourced index operations

markit

14,000+ indices

500+ customers

50+ data sources

150+ ETFs

\$75bn AUM in ETFs

Markit Credit Indices

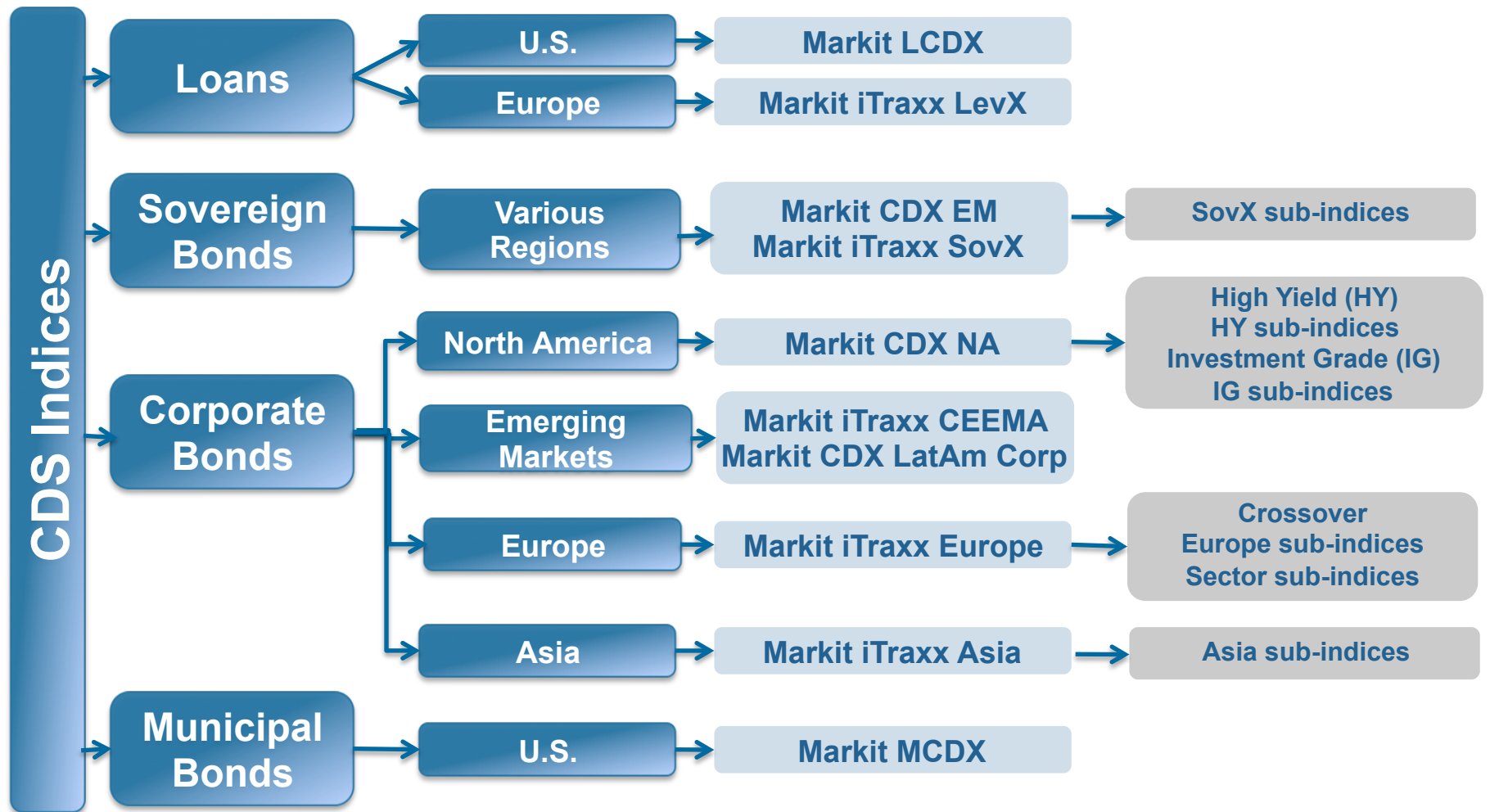
- Markit credit indices are some of the most liquid instruments in the credit derivative market.
- The indices are tradable products that allow investors to establish long or short credit risk positions in specific credit markets or segments.
- Each credit index is a separate, standard credit default swap contract consisting of a basket of single-name credit default swaps.
- Besides being widely traded, the indices are referenced in various research pieces, news items, etc.

Live Positions in the DTCC Trade Information Warehouse:

Product Type	Gross Notional (USD)
Total for all credit products	18,290,469,671,187
Total for CDS credit products	9,710,648,261,526
Total for Credit Indices Products	7,711,496,979,915
Total for CDT Credit Products	868,324,429,746

*Source: DTCC TIW Section 1, Table 1. As of August 29, 2014.

Credit Indices Overview



Markit Credit Indices - Impact of 2014 Definitions



The launch of the 2014 Credit Definitions will impact single-name trades in different ways:

- Most legacy corporate contracts will automatically move to the new definitions through a protocol
- Certain legacy financial (Asia, Europe) and sovereign contracts will not automatically move to the new definitions

This discrepancy will be reflected in Markit indices as well, since the index baskets follow single-name conventions. For example:

Index	Non-Protocol Names	Protocol Names	Basket Type
CDX IG 23 and above	N/A	2014 Definitions	2014 Definitions
CDX IG 22 and below	N/A	2014 Definitions	2014 Definitions
iTraxx Europe 22 and above	2014 Definitions	2014 Definitions	2014 Definitions
iTraxx Europe 21 and below	Old Definitions	2014 Definitions	Mixed

Impact of 2014 Definitions

Index Documentation Updates

- Publication of new trading and legal documents, such as Standard Terms Supplements and Confirmations
- Incorporation of changes such as the Standard Reference Obligations into index processes and methodologies

General Information Updates

- Markit RED will maintain and publish the official SRO (Standard Reference Obligation) list as the appointed SRO Administrator
- For reference entities that were excluded from the protocol, Markit will provide pricing for contracts under both 2003 and 2014 definitions

Impact on Market

▣ Trading Standards

- Corporates: 2014 Definitions, except for Excluded Entities
- Financials: 2014 for Included Entities, for Excluded Entities: 2003 without GI, 2014 with GI
- Sovereigns: 2014 for Included Entities, for Excluded Entities: 2003 without AP, 2014 with AP

▣ Bifurcated markets

▣ Liquidity issues

▣ Broader impact on market

CDS and Impact on Out-of-court Restructurings

- ❑ Empty Creditor Issues
- ❑ Potential Conflicts among Debtholders
- ❑ Disclosure Issues

New 2014 ISDA Credit Derivatives Definitions

QUESTIONS?

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