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# Proposed CDS Revamp

## ISDA proposes changes to the CDS Documentation

European Credit Derivatives Strategy

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- ISDA has recently proposed a number of updates to the existing CDS documentation. These updates represent a general upgrade to the CDS contract in order to make it more robust. Recent events, including the more active role of governments in private debt markets, have highlighted the need for CDS documentation to be updated to deal with the changing world.
- The proposed changes will be the most significant update to the CDS documentation since the Big and Small Bang in 2009. The proposals centre on four areas:
    a) Proposal to allow package delivery for Sovereign CDS transactions.
    b) Proposal to amend the definition of Qualifying Guarantees.
    c) Proposal to amend Successor provisions.
    d) Proposal to have single Standard Reference Obligation for all CDS contracts.
- Given the changing nature of Corporate and Financial debt instruments, we expect to see further proposed changes to the current Definitions, particularly with respect to Financial CDS and upcoming EU bail-in regime.

The primary markets that the current proposals are likely to impact are the Sovereign and European Corporate CDS markets. Exactly how the new proposals are implemented – through a market wide protocol, or as a change to future trading standards – is still to be decided. We expect this to become clearer in the coming months once market participant have reviewed the documentation.

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## Proposal 1: Package Delivery for Sovereign CDS

Recent events in the Sovereign bond market have raised investor concerns about the possibility that there will be a lack of deliverable obligations following a CDS Credit Event. This has been driven by a recognition that the balance of power often resides with the sovereign when it is restructuring its debt. This is particularly true for domestic law bonds, especially in Europe where the majority of bonds are issued in a domestic currency and under domestic law.

An example of when there could be a lack of deliverables would be where a sovereign restructures an obligation by converting the initial obligation into an exchanged package of equity or GBP warrants. While doing so would constitute a CDS Restructuring Credit Event, the exchange package would not be a deliverable obligation into the CDS auction. In order to address this concern, the proposals suggest that certain exchanged packages remain deliverable.

Allowing package delivery of the exchanged package however could introduce the risk of adverse incentives and moral hazard. An investor may accept an uneconomic package in order to receive a higher payout from their CDS contracts.

In order to address this, ISDA has proposed a number of checks to ensure that only large packages, taken up by a majority of investors are eligible for delivery.

This proposal will only be applied to Sovereign CDS.

**Proposal**

ISDA will publish a list of "Package Observable Bonds" (POBs) based on size, liquidity, maturity and governing law. The proposals suggest that there could be one domestic and one international law bond in each of the following silos – a) 1-3 years, b) 3-12 years, c) 12-30 years – based on a set of rules that determine the largest and most frequently traded bond in each silo. An initial POB will remain as such unless, prior to the Credit Event, it no longer meets the deliverability criteria, is called/matures, or is reduced below a threshold. New bonds would be added when a particular bucket is empty.

If a Credit Event occurs (Restructuring or other Credit Event) and a POB has been restructured into a package, then that package, in its entirety, will be deliverable into the auction. For example if a POB with a notional of $100m is written down by 50% and the remaining portion converted into 50 shares, then the 50 shares could be delivered against $100m of CDS. If there is more than one package on offer, then the one that has the highest subscribers will be chosen. All obligations meeting the deliverability criteria remain deliverable as long as they were issued prior to the Credit Event.

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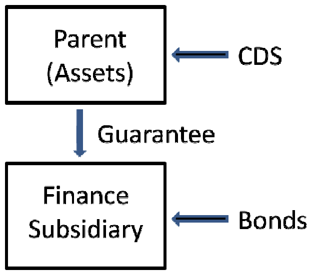
## Proposal 2: Amend "Qualifying Guarantee" Definition

**Typical European Structure**




Once a CDS Credit Event occurs, not all obligations of an issuer are deliverable into the CDS contract. In order to deliver a guaranteed obligation, the guarantee needs to be a "Qualifying Guarantee". The proposals seek to further clarify which type of guarantees work and which do not. This is of particular relevance for European corporates, where CDS are often based at a parent company, but the bonds are issued out of a guaranteed subsidiary. Many of the guarantees that are currently not acceptable for CDS are acceptable in the cash bond market and the proposals aim to more closely align CDS guarantees to also accept those that are acceptable in the cash bond market.

The current Definitions state:

***Section 2.23. Qualifying Guarantee****. "Qualifying Guarantee" means an arrangement evidenced by a written instrument pursuant to which a Reference Entity irrevocably agrees (by guarantee of payment or equivalent legal arrangement) to pay all amounts due under an obligation (the "Underlying Obligation") for which another party is the obligor (the "Underlying Obligor") and that is not at the time of the Credit Event Subordinated to any unsubordinated Borrowed Money obligation of the Underlying Obligor (with references in the definition of Subordination to the Reference Entity deemed to refer to the Underlying Obligor). Qualifying Guarantees shall exclude any arrangement (i) structured as a surety bond, financial guarantee insurance policy, letter of credit or equivalent legal arrangement or (ii) pursuant to the terms of which the payment obligations of the Reference Entity can be discharged, reduced, assigned or otherwise altered as a result of the occurrence or non-occurrence of an event or circumstance (other than payment). The benefit of a Qualifying Guarantee must be capable of being Delivered together with the Delivery of the Underlying Obligation.*

The new proposals aim to clarify that:

a) A release provision that allows for a guarantee to be released upon transfer or sale of assets does not make the guarantee non-qualifying, provided the release provision has not yet been used. Additionally if a guarantee has not been released upon an event of default, it is assumed that the default will not be cured and the guarantee will remain qualifying as it is assumed that the release provisions remain suspended.

b) A guarantee is only required to cover the principal due.

c) Only payment needs to be guaranteed, not collection of payments.

d) Statutory guarantees even if not evidenced by writing are eligible.

e) The test of a guarantee is at the same time as the test of deliverability.

These changes should make it less likely that a guarantee would fail the test of being a Qualifying Guarantee. As we mentioned earlier, most of these types of guarantees are acceptable in the cash bond market and the proposal aim to more closely align CDS with bonds.

## Proposal 3: Amend Successor Provision

Successor provisions allow CDS to move to a new entity in the case where there has been a merger, transfer of debt or other such event. Event surrounding UnityMedia highlighted the need to update the Successor provisions. Following corporate activity, UnityMedia moved debt to a new company which it then renamed UnityMedia and dissolved the old UnityMedia. Since the market missed the transfer at the time and only noticed once the 90 day look-back window had passed, contracts entered into prior to the transfer remained on the old dissolved company.

Among other things, the proposals introduce the concept of a Universal Successor which, in addition to the current Successor rules, would allow a successor to be identified even if the 90 day look-back window had expired in the case that the previous reference entity moved debt and then ceased to exist.

Essentially there are three cases when CDS originally refers to Company A:

1) Company A moves all debt to Company B and remains in existence
    a. If caught within the 90 day window, CDS moves to B.
    b. Not caught within the 90 day window, CDS remains on A.
2) Company A moves all debt to Company B and ceases to exist.
    a. If caught within the 90 day window, CDS moves to B.
    b. Not caught within the 90 day window, (NEW PROPOSAL) CDS moves to B.
3) Company A dissolves without moving debt.
    a. CDS remains on Company A.

The new proposals cover case 2b, in which previously the CDS would have remained referencing A, but now moves to B.

The amended Successor provisions also allow for transfers of debt that take place over a period of time to be considered together rather than just a single transfer event.

## Standard Reference Obligation for all CDS contracts

Under the current Definitions, the Reference Obligation for a particular Reference Entity is not standardised; different CDS contracts on the same Reference Entity could have differing Reference Obligations. For example a trade done in year 1 may have a different reference obligation to trade done in year 2 if the Reference Obligation for an entity has changed over that period. This lack of standardisation can cause problems for netting and clearing of CDS transactions.

The proposal is to have a single Standard Reference Obligation which will apply to all CDS contracts irrespective of when they were entered into.

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