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DISCUSSING THE TRENDS

Q&A with Carlos Alvarez, Loren Finegold and Yvette Valdez

The New 2014 ISDA Credit Derivatives Definitions

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The revision of the 2003 International Swaps and Derivatives Association (ISDA) Credit Derivatives Definitions is likely the biggest overhaul of the definitions in more than a decade. The new 2014 ISDA Credit Derivatives Definitions are slated to become effective on September 22, 2014.

UPDATE: Please note that since publication of this interview ISDA extended the original Protocol implementation date (September 22, 2014) to October 6, 214 and updated the original implementation date for the new 2014 ISDA Credit Derivatives Definitions (September 22, 2014) to October 6, 2014 as well. The extension is intended to enable both market participants and infrastructure providers to make the necessary operational changes and to allow for a smooth transition to trading on the new definitions with minimal impact on the CDS market.

"This overhaul needed to reflect lessons-learned from past experiences (in particular the European sovereign debt crisis) and consider the effect of the Dodd-Frank Wall Street Reform and Consumer Protection Act and related bail-in legislation resulting from the 2008 financial crisis on the credit default swaps (CDS) market," said New York-based Latham & Watkins partner Carlos Alvarez. "And it needed to reflect a model of standardization to properly allow for clearing and auction settlements. With the exception of interest rate swaps, CDS are the only swaps currently subject to mandatory clearing in the United States under Dodd-Frank — so standardization is a very important element."

Alvarez is a member of Latham's Derivatives, Structured Finance & Securitization and Banking Practices and is head of the Derivatives Practice Group for credit derivatives. Loren Finegold is a partner in the firm's Derivatives and Structured Finance & Securitization Practices. Yvette Valdez is an associate and a member of the firm's Derivatives Practice.

In this interview, Alvarez, Finegold and Valdez address the important changes taking effect with the new 2014 ISDA Credit Derivatives Definitions, including bail-in/financial terms for CDS on certain financial reference entities, sovereign CDS asset package delivery for CDS on sovereigns, introduction of standard reference obligations, new successor provisions, currency redenomination provisions and the expansion of guarantees that can be hedged with CDS.

What are some of the key features of the new bail-in/financial terms?

Alvarez: The new definitions introduce a new credit event that may be triggered by a government initiated bail-in. Specifically, a new credit event would be triggered within the meaning of the definition of Governmental Intervention upon the announcement or taking of action by a governmental authority through a restructuring, law or regulation that causes a reduction or postponement of principal or interest or further subordination of the reference obligation, expropriation, transfer or other event that mandatorily changes the beneficial holder of the reference obligation, or a mandatory cancellation, conversion or exchange of the reference obligation.

Additionally, the new definitions establish "asset package delivery" provisions, which establish provisions for the delivery of proceeds of bailed-in debt or restructured reference obligations where, from experience, the market has suffered from a lack of deliverable obligations. The asset package delivery provisions are triggered upon the occurrence of an "Asset Package Credit Event" or APCE.

An APCE is defined as a Governmental Intervention in respect of a financial reference entity, a restructuring credit event in respect of the reference obligation of a financial reference entity where such restructuring does not constitute a Governmental Intervention or a restructuring credit event in respect of a sovereign reference entity. Under an APCE, the deliverable obligation has been broadened to include reference obligations that would have been deliverable had an auction taken place prior to the occurrence of an APCE. In the case of a sovereign, the asset package to be delivered is determined by reference to delivery of "Package Observable Bonds" rather than prior deliverable obligations. The list of Package Observable Bonds for a particular sovereign will be selected in accordance with

criteria to be set out in the Credit Derivatives Determinations Committee Rules and published on the ISDA website.

One of the concerns the asset package delivery provisions seek to address is risk of moral hazard from debt holders. For instance there is concern that bondholders with credit protection in a restructuring have a different risk profile than bondholders without the protection and therefore are more likely to agree to a "poor" deal in a restructuring. The new asset package provisions should result in a wider diversity of the bondholders and reduce the moral hazard risk.

Parties must elect for the asset package delivery provisions to apply in the trade confirmation in order to benefit from such provisions.

Can you explain how the concept of the new "Standard Reference Obligation" will work?

Finegold: The new definitions introduce "Standard Reference Obligations" across all market-standard CDS contracts on the same reference entity and seniority level. The intent of the standardization of frequently traded reference obligations is to reduce basis risk and increase liquidity in the market. The Standard Reference Obligations for a contract will be published in a list and made available on the ISDA website. Parties must elect for Standard Reference Obligation to apply in the confirmation and the specification therein of the seniority level of such obligation. Parties will still be able to trade with a specific non-Standard Reference Obligation by specifying "Standard Reference Obligation" as not applicable.

Why are the changes to the successor provisions and currency redenomination provisions important?

Valdez: The industry has learned some important lessons from recent events. First, with respect to successor provisions, we learned that successors are not always evident and do not always occur as a result of a merger or other corporate event. For example, Unitymedia GmbH underwent a universal succession and the existing entity was dissolved. The new entity changed its name to Unitymedia. As a result, it was well past the 90-day look-back period before the market realized that a succession event had occurred. The new definitions carve-out an exception for universal successors from the 90-day look-back and put in place a back-stop date of January 1, 2014.

The new definitions have also replaced the requirement for a corporate succession event with the concept of a "Steps Plan." The Steps Plan aggregates a series of transfers that take place as part of a pre-determined transfer plan when determining whether or not sufficient debt has been transferred to trigger a successor determination. A corporate event such as a merger or acquisition is no longer necessary.

With respect to currency redenomination, the new definitions address, in particular, what the effect is in the CDS market upon the exit of a country from the European Union resulting in it no longer recognizing the euro as the national currency. Anticipating the possibility of a future euro exit, the market deemed it important to address the instances when a euro exit would be trigger a restructuring credit event. In short, a euro exit will trigger a restructuring credit event unless it occurs at a freely available market rate, with no need to show the currency change was caused by a deterioration in the creditworthiness of the reference entity.

Can you speak to the new provisions regarding guarantees and modifications to Mod R and Mod Mod R?

Finegold: The new definitions broaden the definition of "Qualifying Guarantee" so that guarantees that only guarantee principal and interest, and not all amounts under the relevant obligation, include certain release provisions (e.g., upon transfer of the guarantee) or incorporate a fixed cap, may now be Qualifying Guarantees.

Modified Restructuring (Mod R) and Modified Modified Restructured (Mod Mod R) are complex provisions. The new definitions help simplify the auction process and remove some of the complexity in working with these provisions. One of the key changes is the removal of the enabling obligation, which sought to address concerns about windfalls to buyers under the auction settlement for restructuring terms. Ultimately the enabling obligation proved to be too complicated for the purpose and has been removed. Additional changes to Mod Mod R have been made, including a reduction in the maximum number of auctions that will be run for a Mod Mod R and provisions relating to which auction a restructured bond or loan is delivered.

What are some of the key issues that the buy-side should be aware of?

Valdez: ISDA has published and opened the adherence period for an ISDA Protocol (Protocol) that will enable market participants to apply the new definitions to certain existing transactions. The adherence period is open until September 12, 2014. By adhering, market participants agree to amend qualifying credit derivative transactions within the scope of

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the Protocol to incorporate the 2014 definitions into the documentation for their transactions. The Protocol will cover CDX, iTraxx, Swaptions (single name and portfolio) and Non-Swaption Transactions (single name, fixed recover, recovery lock, bespoke portfolio transactions). The Protocol will exclude certain Financial Reference Entities, sovereigns and corporates listed by name. The Protocol also will not incorporate asset package delivery provisions or Governmental Intervention from the new definitions and as a result, legacy transactions that are amended under the Protocol will not benefit from these provisions. These provisions will only be applicable after the new definitions become effective on September 22, 2014. Firms should identify existing transactions — and transactions that are to be entered into between now and September 2014 — that are or are not to be subjected to the Protocol.

We expect there to be a bifurcated market from September 2014 onwards with CDS transactions on both the 2003 definitions and CDS transactions on the 2014 Definitions referencing the same reference entity, with obvious basis risk implications if parties have an outstanding transaction on the 2013 definitions, which is hedged by a transaction on the new 2014 definitions.

While the purpose of the new definitions is to expand the availability of deliverable obligations, there may be deliverable obligations under new transactions that will not satisfy the requirements for deliverable obligations under old transactions. This is particularly likely to be the case following a Mod R or a Mod Mod R credit event as a result of the removal of the enabling obligation requirement in the 2014 definitions.

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