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Alert

ISDA Publishes Supplement to 2003 Credit Derivatives Definitions and 'Big Bang' Protocol

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The International Swaps and Derivatives Association Inc. ("ISDA") has published the 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement Supplement (the "Supplement") to the 2003 ISDA Credit Derivatives Definitions (the "Definitions") and the related 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement CDS Protocol (the "Protocol"). According a March 12, 2009, ISDA press release, the Supplement and the Protocol (also known as the "Big Bang Protocol") represent a "major milestone" for the "efficient, liquid and transparent" operation of the credit default swap ("CDS") market.

ISDA intends that the terms of the Supplement be incorporated into all future "market standard" CDS transactions. Additionally, parties may use the Protocol to integrate the terms of the Supplement into their existing CDS transactions. The Protocol is open for adherence through April 7, 2009. There is no charge for adherence to the Protocol and a party need not be a member of ISDA to adhere. As with past ISDA protocols, a party adheres to the Protocol by sending an adherence letter (available from ISDA's website) to ISDA. If both counterparties to a CDS transaction adhere to the Protocol, the transaction becomes a "Protocol Covered Transaction" and automatically incorporates the terms of the Supplement. Certain CDS transactions—notably, loan only transactions, CDS on municipal bonds, CDS on asset-backed securities, mortgage-backed securities and collateralized debt obligations, and any other CDS transaction that the parties elect as an "excluded transaction"—are not Protocol Covered Transactions and are not modified by the Protocol. Neither party to a Protocol Covered Transaction may unilaterally revoke its adherence with respect to such transaction once it has adhered to the Protocol.

The Supplement implements five main concepts: (i) a committee of rotating ISDA members (the "Determinations Committee") for each region that will determine the occurrence and details of each credit event and succession event, (ii) a 60-day "Backstop Date" for the determination of credit events and a 90-day "Backstop Date" for the determination of succession events, (iii) the "hardwiring" of an auction settlement method based on ISDA's recent CDS auction protocols, (iv) changes to the determination of the currency exchange rate for physical settlement, and (v) a new method to accelerate the physical settlement process for loans.

Determinations Committee

There will be one Determinations Committee for each of the five major regions: (i) the Americas, (ii) EMEA (Europe, the Middle East, and Africa), (iii) Australia and New Zealand, (iv) Asia excluding Japan, and (v) Japan. Each Determinations Committee will comprise eight global dealers, two regional dealers from the applicable region, and five buy-side members. The members of each Determinations Committee will rotate periodically and as needed, pursuant to a system set forth in the Determinations Committee rules.

To be eligible for membership on a Determinations Committee, a party must be a member of ISDA and must adhere to the Protocol. For dealer members, each must have participated in ISDA's CDS auction protocols and preference will be given initially to those with the largest notional trade volumes as compiled by DTCC. For buy-side members, each must have at least $1 billion in assets under management and meet certain criteria relating to its notional of CDS outstanding and traded within the previous twelve months. Also, the group of buy-side members will contain at least one “registered investment company manager” and at least one “private investment company manager.” Buy-side firms interested in serving on an initial Determinations Committee should contact ISDA prior to March 31, 2009—the date on which ISDA commences its initial review of potential committee members.

The role of the Determinations Committee will be to determine the occurrence and details of each credit event and succession event, including, as applicable, (i) whether the event has occurred, (ii) the date on which the event was triggered, (iii) for credit events, the obligations that constitute deliverable obligations, and (iv) for succession events, the obligations that constitute substitute reference obligations. These determinations, as made by the Determinations Committee, will bind all adhering counterparties. The Determinations Committee will also decide whether to hold an auction to settle the related CDS transactions and will control the terms of and participation in such auction. Determinations by the Determinations Committee of credit events and succession events must be agreed upon by an 80% supermajority of committee members; otherwise, it is subject to external review by a panel of experts similar to an arbitration.

Credit and Succession Event Backstop Dates

Under the terms of the Supplement, in order to determine that a credit event or succession event has occurred, the Determinations Committee must receive notice of the proposed credit event within 60 days of its alleged occurrence (or within 90 days for a succession event). This concept is intended to increase the fungibility of CDS trades.

Under the current Definitions, the protection seller in a CDS trade is liable for credit events and succession events that occur at any point during the trade, from its effective date through its termination date. Thus, two opposite CDS trades (with the same reference obligation and the same termination date) that would otherwise offset each other may still create basis risk if one had an earlier effective date than the other (i.e., the protection seller under the earlier trade may be liable for a credit event that would not be triggered, and for which it would not be entitled to recover, under the later trade).

With “Backstop Dates” in place for credit events and succession events, however, the effective date of a trade is no longer based on its trade date. Rather, for purposes of triggering credit events and succession events, the effective date (the “Backstop Date”) of a CDS trade will always be 60 or 90 days (as applicable) prior to the date on which the Determinations Committee receives notice of the proposed event. Any alleged events occurring prior to the Backstop Date are “stale” and cannot trigger liability by the protection seller. This eliminates the basis risk described above since every trade—whether traded two weeks ago, two months ago, or two years ago—has the same effective date: 60 or 90 days in the past (as applicable). Note that protection sellers will now be liable for credit events and succession events occurring prior to the trade date.

The Backstop Date provisions will take effect (i) on the trade date for non-index CDS trades traded on or after April 8, 2009, and (ii) on June 20, 2009, for pre-existing non-index CDS trades and all index CDS trades.

Auction Settlement Method

The Supplement adds auction settlement as a settlement method under all CDS transactions, and ISDA intends auction settlement to be the market standard for CDS trades going forward. By adhering to the Protocol, parties automatically elect auction settlement as the settlement method for most preexisting trades (with the former settlement method becoming the fallback settlement method). Certain types of CDS trades (e.g., reference obligation only trades) will not be subject to the automatic election of auction settlement under the Protocol. Parties also may agree bilaterally to exclude other specific trades if they so desire.

The auction methodology and mechanics are based on those used in ISDA’s CDS auction protocols. During an auction, dealers submit bids and offers on behalf of themselves and their clients to the auction administrators who calculate the final price for the affected reference obligation. Once the administrators determine the final price, counterparties cash settle their trades using the final price rather than physically settling them. If the auction fails to determine a final price (or if the Determinations Committee decides not to hold an auction), trades will default to their fallback settlement method.

The Supplement also amends the method by which the currency rate conversion is calculated when the protection buyer delivers a deliverable obligation that is denominated in a currency other than the settlement currency. Under the current Definitions, a protection buyer can take advantage of fluctuations in currency exchange rates by amending its notice of physical settlement even if it does not change the deliverable obligations thereunder. The Supplement addresses this by locking in the currency rate for each deliverable obligation when the initial notice of physical settlement is delivered, and determining the currency rate for each updated deliverable obligation based on the one that it replaced.

Finally, the Supplement allows parties to voluntarily "compress" the physical settlement process for loans. If a loan must be delivered several times during physical settlement before reaching its final holder, the Supplement gives the protection buyer that first transfers the loan the option, subject to necessary consents, to skip the intermediate parties and deliver the loan directly to the ultimate protection seller. The intermediate parties then settle their respective back-to-back trades through cash settlement.

The provisions in the Supplement regarding the Determinations Committee and auction settlement will take effect on April 8, 2009 (following the conclusion of the adherence period for the Protocol).

Changes to the CDS Market

ISDA had considered including, but ultimately declined to include, the following economic changes in the Supplement: (i) standard quarterly payment dates, (ii) full first coupon with no stub, (iii) 100 and 500 basis points fixed coupons for CDS trades on investment grade and high-yield bonds, respectively, and (iv) no restructuring for North American corporate CDS trades. Instead, these terms will be incorporated into the Standard North American Corporate ("SNAC") trade type on DTCC and through the ISDA settlement matrix. Parties may still enter into North American corporate CDS trades on other economic terms, but they will not be able to use the SNAC trade type to confirm them.

All parties should note that, with respect to any renegotiation of a financial instrument, consideration should be given to the possible tax consequences of such renegotiation, particularly in instances where the renegotiated instrument has unrealized appreciation.

If you would like to know more about the terms of the Supplement or the effects of the Protocol, please contact:

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