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Implementing ISDA's Credit Derivatives Definition Changes

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In a continuing effort to address the advent of narrowly tailored credit events, or NTCEs, in the credit default swap market, the International Swaps and Derivatives Association 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 released the final changes that will be made to the credit derivatives definitions.

This article addresses how those changes will be implemented, and certain issues market participants should take into account in deciding to adopt the changes.

Background

Over the past few years, a number of issuers in financial distress and their investors have used refinancing and restructuring strategies that capitalize on CDS contracts written on the issuer, as reference entity, to achieve a better economic outcome. These strategies take various forms, but the ones that attracted market attention, NTCEs, involve the triggering of the CDS contract via a failure-to-pay credit event.

The ensuing monetization of the CDS contracts for the benefit of CDS protection buyers can enable those CDS protection buyers to extend financing to the reference entity on more favorable terms. At the same time, the relatively low failure-to-pay threshold in the standard CDS contract of $1 million often enables CDS contracts to be triggered without hitting cross-default thresholds across the reference entity's capital structure. Failure-to-pay credit events of this type are unconventional because they result from voluntary, rather than unavoidable, payment defaults.

These NTCEs have emerged as one of the most controversial opportunistic CDS strategies in recent years. In the cases of Codere SA, iHeartCommunications Inc., and Hovnanian Enterprises Inc., voluntary payment failures were criticized as artificial defaults not reflecting the spirit of the credit derivatives definitions. In addition, the case of Hovnanian also resulted in a widely publicized market manipulation claim and criticism from regulators.

Following the Hovnanian litigation and subsequent interest in the CDS market from regulators, the ISDA Credit Derivatives Steering Committee proposed a change to the CDS contract intended to prevent artificial defaults (i.e., defaults that do not necessarily reflect a genuine inability of a reference entity to make a payment) from triggering the CDS contracts.

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 prebankruptcy original issue discount issues.

The original issue discount-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. The updated definitions will impact the determination-making process and the predictability of determinations, among other things.

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 enabling market participants to amend, en masse, the terms of their CDS contracts with all other swap counterparties adhering to the protocol.

On July 26, ISDA confirmed that the protocol will be released on Sept. 16, and will be open for adherence through Oct. 14. A pre-adherence period runs from Aug. 26 through Sept. 13. 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, ensuring that the protocol is published already with significant backing. 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.

Initial Guidance

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.

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 make 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 determinations of the Credit Derivatives Determinations Committees, or the implications of trading in a pool with more limited liquidity as a result of nonadherence, 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 a possible lack of dealer appetite to enter into such trades, among other things.

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