Creditflux
August 2019 | Online
Global credit funds & CLOs

Big questions for CDS shorters as Isda protocol countdown begins

With only a month to go until the International Swaps & Derivatives Association rolls out its protocol for narrowly tailored credit events, law firm Kramer Levin has sounded a rallying call for CDS investors to conduct the analysis they will need for internal approvals.

Market participants with a big net buy position across their CDS book should consider the ramifications of the updated definitions, says Kramer, weighing the value of their CDS protection versus following the market and ensuring liquidity in their trades.

"In most instances, the updated definitions limit the circumstances under which CDS contracts will be triggered and makes the determination process more subjective and less predictable," Kramer lawyers write. "Naturally, this is somewhat unappetising 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."

As such, notes Kramer, further reducing the liquidity of protection buyers' positions by retaining a contract that does not include the updated definitions might not be viable.

The updated definitions subject any failure-to-pay credit event determination to a creditworthiness deterioration requirement, which will depend on a number of factors. Other changes include preventing market participants from taking advantage of debt issued with an original issue discount, which could otherwise artificially impact CDS settlement amounts.

Isda has confirmed it will release the protocol on 16 September and it will be open for adherence until 14 October. A pre-adherence period will run from 26 August, through to 13 September.

The updated definitions will impact both new and existing CDS trades. The protocol will update the terms of legacy trades, whereas the physical settlement matrix will be updated for all trades executed after the updated definitions become effective.

Market participants cannot cherry-pick which legacy trades are impacted, warns Kramer. Therefore, they will need to consider the advantages and disadvantages of adherence for their CDS book as a whole.

"For many market participants, adherence to the protocol will be a relatively natural step," the lawyers write. "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.