21 May 2013 │ 9 pages
Europe

Financial CDS to get a re-vamp

ISDA to introduce a new CDS contract to accommodate bail-ins

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- **Existing protection potentially worthless under current CDS contracts**: Recent credit events at SNS and Bankia have done much to highlight the risk that existing CDS contracts do not give expected payouts under bail-in scenarios.

- **New financial CDS contract proposed**: ISDA has proposed a new contract featuring an additional bail-in trigger and an expansion of deliverable obligations. The main characteristics of the proposed new contract are:

  – New "bail-in" credit event to capture scenarios where bank debt is bailed-in by government agencies or regulators. The existing credit events (bankruptcy, failure to pay and restructuring) will not change and will still be included in the new contract.

  – Changes to deliverability: protection buyers will be able to deliver the "bailed-in" bonds or whatever they receive in exchange for them. If they receive nothing, the CDS will cash settle with a 0% recovery rate — i.e. the protection buyer is paid 100% of the CDS notional.

- **When will the new contract be launched?** Although there is no mention of a target date in ISDA's proposal, press reports suggest the new contract, along with amended credit definitions, may be launched by the end of the year.

- **No solace for existing protection holders**: while the new contract should do much to ensure that financial CDS in future "works" as expected, we think the chance of the new provisions being applied retroactively is close to zero.

- **Sub CDS has started to aggressively outperform both senior CDS and sub debt**. Either the market is only now coming to terms with the problems of existing CDS contracts or it is expecting a wave of investors rolling into the new contracts when they are launched, or both — in any case, sub CDS is tightening aggressively.

- **The current proposal is still work in progress and circulated to gather feedback.** The released proposal outlines the broad characteristics of the new potential contract, providing more details than what we outline in this note (which should be viewed as our interpretation only). However there are many questions which ISDA will have to tackle before the new contract is launched — specifically around the details/mechanics of the credit event trigger and its settlement.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

- On May 9th, ISDA circulated a proposal to its Credit Derivatives Market Practice Committee for feedback on a new Financial CDS contract. Although the proposal is still a work in progress, it outlines the main characteristics of the potential new contract.

- **The new "CDS" contract will be only for financials globally, but not for corporates**. We assume that it will apply both to banks and insurance companies.

- **"Old and new" financial CDS contracts will trade in parallel**. When this "new" CDS contract is eventually introduced, it will trade alongside the current (which will then become "old") financial CDS contract — substantially wider given the additional credit event and larger pool of deliverable instruments. We envision liquidity in the "old" CDS contract will likely suffer, with many investors potentially "rolling" to the "new" contract.

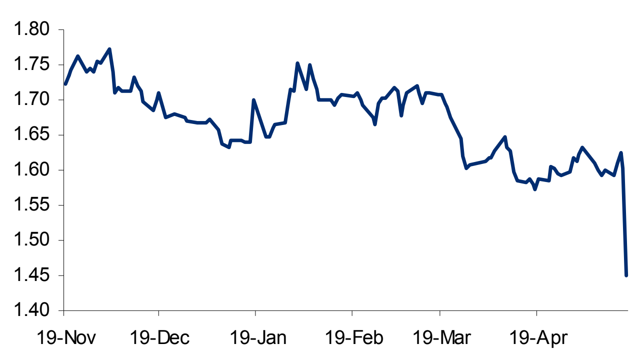
- **Is there any way these new provisions could be applied to existing contracts?** Frankly we see this as impossible. Much as protection buyers might wish for this, protection sellers would have such a strong case that their price would have been different had these provisions been applied, that we see no scope for this to be applied retroactively.

Was it expected? How has the market reacted?

- **It should have been expected ….** Although ISDA had not explicitly mentioned any potential changes to financial CDS contracts, it should have been clear that, with the weaknesses exhibited by current financial CDS contracts in bail-in events, changes in this direction were highly likely.[1] As we wrote in a recent note, "unless these issues are addressed, we could see a significant decline in bank CDS liquidity, with negative consequences for the bank bond market as a result. However, we think the issue could be avoided entirely if there were better drafting of bail-in legislation by lawmakers, or perhaps a redrafting of future CDS contracts by ISDA."

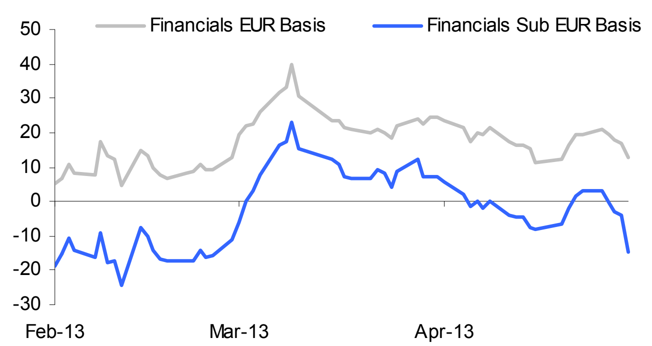
- **… although the market only seemed to have started reacting last Friday**.

Figure 1. Sub/senior ratio – iTraxx Financials indices
5y sub/senior spread ratio.



Source: Citi Research, Markit. Data as of COB 20 May.

Figure 2. Average bond-CDS basis
In basis points. For EUR IG bonds only.



Source: Citi Research, iBoxx, Markit. Data as of COB 17 May.

[1] ISDA has been working on revamping sovereign CDS contracts for some time, with amendments to the current 2003 definitions also being contemplated.

- **Sub CDS is tightening vs. both senior CDS and vs. sub bonds** (Figure 1 and Figure 2). Either the market is only now coming to terms with the problems of current CDS contracts or it is expecting a wave of investors rolling into the new contracts when they are launched, or both — in any case, sub CDS is tightening aggressively. In our view, the failure to react prior to this is probably because, without a better alternative, holders of sub CDS protection chose to remain in the (only) existing contract. With talk of a new contract, the market is probably discounting the fact that many protection buyers will roll into the new contract, and/or finally recognizing that the loopholes in the old contract were not just confined to expropriation, but could prove problems for protection holders under bail-in more broadly.

- The market reaction is currently only centered around sub CDS — although senior CDS will also be potentially impacted by investors rolling to the "new" contract. The market appears to be pricing that the probability of senior debt bail-ins is limited, or at least much lower than sub debt bail-ins.

What's the problem with current financial CDS contracts?

- **Several European countries have already adopted new legislation, which grants them powers to bail-in financial institution's debt**.[2] This legislation has effectively "brought forward", in the countries that have already introduced them, the implementation of the bail-in European-wide legislation ("DRR") which is expected to be introduced in 2015 and 2018 for sub and senior debt respectively.[3]

- **Current CDS contracts have been shown to be potentially ineffective (for protection buyers) in bail-in scenarios**.[4] The two latest credit events in European banks, SNS and Bankia, have clearly highlighted that current financial CDS contracts may be not deliver the anticipated protection when banks are bailed-in, i.e. not providing compensation (to protection buyers) in line with the economic losses suffered by bondholders in a bail-in event. Our recent report on SNS, *"What bail-in means for CDS"* describes the main potential problems of current financial CDS contracts with tackling bail-in credit events. The SNS auction turned out almost exactly as we anticipated (with only senior bonds being available for delivery, and very low recovery); at Bankia, the auction has yet to occur but a government decree means that sub bonds are no longer free to trade, which is likely to lead to the same result.

- **Essentially, current CDS contracts face challenges because (i) they may not trigger a credit event in a bail-in scenario and, even if they do trigger a credit event** (as it happened with SNS), **(ii) the compensation that protection buyers receive from their contract may be much lower than the losses bondholders suffer on their bonds**. This is because, among other things, the

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[2] UK, Germany, Denmark, Ireland and Spain.

[3] European Union's Recovery and Resolution Directive (DRR) of Credit Institutions and Investment Firms (the "DRR").

[4] For the effectiveness of CDS contracts, under the current ISDA definitions, it is not the bail-in per se but the way in which it is implemented that matters. In particular, for CDS protection buyers to be paid out as they had expected, the bail-in approach needs to (i) constitute a credit event, (ii) leave enough deliverable obligations with which to settle the CDS contracts, and (iii) result in a market price of these deliverable obligations which is in line with the losses that bondholders suffered in the bailed-in bonds.

bail-in may leave no deliverable obligations, or only deliverable obligations which are senior to the debt the CDS was referring to (as at SNS).[5]

What's the proposed solution?

- **A new financial CDS contract with an additional new bail-in credit event**. ISDA is proposing to introduce a new financial CDS contract, which will add a new credit event — to specifically address bail-in scenarios — to the three credit events which current CDS contracts already include (bankruptcy, failure to pay and restructuring).

- **The new credit event will trigger when a financial institution is bailed-in.** As stated in ISDA's proposal, this will occur when a "Governmental Authority"[6] uses bail-in legislation (including the forthcoming European directive) to "write down, expropriate, convert, exchange or transfer any such Obligation(s) or otherwise affect creditors' rights so as to reduce the interest payable, reduce the principal payable at maturity, defer the maturity, or change the ranking in priority of payment of such Obligation(s) causing its Subordination to any other Obligation."

- **How will the deliverability problems of current contracts be addressed?** According to ISDA's proposal, upon a "bail-in" credit event, **the protection buyer will be able to deliver**:

  – **the written-down bonds** (based on their outstanding principal balance <u>before</u> the write down), **or**

  – **the conversion/exchange proceeds of the "bailed in" bonds,** which could include instruments such as equity, compensation claims against the government or the issuer, cash, warrants etc.

  "provided that the bailed-in bonds would have qualified as Deliverable Obligations immediately before the Credit Event."

  What if the debt is written down to zero and there is nothing to deliver? ISDA proposes a cash-settlement with a 0% recovery in that case, the equivalent effect of the protection buyer "delivering the bond shell that has been written down to nothing in exchange for par payment."

- **Elimination of cross-default trigger — i.e. sub CDS could trigger without senior CDS being triggered if the bail-in affects only sub debt** — something not possible under the current contracts. In particular, if the bail-in is applied to sub debt only, this will only constitute a credit event in sub CDS contracts, not in senior CDS contracts — on the other hand, sub CDS contracts will trigger

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5 In particular, and as stated by ISDA in their "Proposed Amendments to the 2003 ISDA Credit Derivatives Definitions – "Bail In" and Financial CDS" (9 May, 2013): "*Assuming a write down or loss absorption does constitute a Credit Event, there are a number of additional issues which may cause the debt to fail to qualify as a Deliverable Obligation, such as: (A) debt may move to another entity in a good bank/bad bank split and no longer be an obligation of the CDS Reference Entity; (B) inclusion of write down provisions within the terms and conditions of the debt could cause the debt to fail the Not Contingent Deliverable Obligation Characteristic; or (C) debt could be converted into equity or perpetual bonds or a non-financial instrument. Debt could also be completely written down or otherwise impaired in a manner that, in effect, leaves no deliverable obligations at all. If debt has been written down, then even if it qualifies as a Deliverable Obligation, it might be uneconomic for [the] Buyer to deliver that debt based on its written-down outstanding principal balance*."

6 According to ISDA, "*the current definition of "Governmental Authority" will be reviewed to ensure it is broad enough to capture government agencies that can take action under financial institution restructuring and resolution laws*".

whenever senior CDS contracts trigger (i.e. if the bail-in is applied to unsubordinated debt).

Successor provisions will be applied independently to sub and senior CDS contracts, each tracking sub and senior debt separately in a succession event.

Appendix A-1

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