

## 2014 CDS Definitions getting closer II

### Update on protocol and CoCo supplement

- **More clarity on the Protocol and on the CoCo supplement** on the back of ISDA's recently released draft protocol, draft 2014 CoCo supplement and FAQs document, as well as on the recent ISDA market call. We highlight the most important features.
- **Protocol & trade migration from 2003 to 2014 definitions – What happens with portfolio trades like iTraxx Main / Financials / Crossover indices which refer to both excluded (e.g. European banks / Societe Air France) and non-excluded companies?**
- **CoCos & new sub bank CDS contracts.** Market participants will have the option to trade bank sub CDS with or without the CoCo supplement. In CDS contracts including the CoCo supplement (i) the CoCo conversion / write-down will trigger a credit event (Governmental Intervention), and (ii) CoCos will be deliverable in these instances.
  - The CoCo supplement has been designed having in mind Swiss banks, but it could be applied to any bank.
  - Will new iTraxx Financials contracts include the CoCo supplement? For all banks, or only for Swiss banks?
- **Next steps:**
  - ISDA to release the final version of the protocol, announce the date from which investors can adhere to it (around mid-August) and its implementation date (most likely 22<sup>nd</sup> Sept).
  - Trading on the new 2014 contracts will start on Sept. 22<sup>nd</sup>, coinciding with the index roll. Newly launched indices will trade on the 2014 definitions.
- This short note is based on our understanding of the draft documents, it is not intended to be comprehensive and it does not represent legal advice.

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## New Definitions

See our February note on the [New 2014 CDS Definitions](#) for details.

- **The New 2014 CDS Definitions were published by ISDA back in February**, including two new standard contracts (for Financials – banks – and for Sovereigns) and introducing a wide range of changes in the CDS definitions.
- **The contracts under the new 2014 definitions will begin trading on Sept. 22nd.**
- A protocol will allow market participants to convert their current (2003) contracts into 2014 contracts – more details below.
- After the new 2014 definitions are launched on Sept. 22th, market participants will be able to trade CDS contracts referring to both the new (2014) and the old (2003) definitions; however, we expect the liquidity to move to the new contracts.
- **CoCos in new sub bank CDS contracts:** Market participants will have the option to trade bank CDS with or without the CoCo supplement – more details below.

## Draft Protocol

- The protocol will, on its final version, **allow market participants to migrate trades entered before the September roll from the 2003 to the 2014 definitions.**
  - 2003 contracts between two parties will move to the 2014 definitions if both parties adhere to the protocol.
- A draft protocol has already been published by ISDA.<sup>1</sup>
  - The final protocol is expected to be published in the first half of August and market participants will be able to adhere to it from mid-August to its implementation date (expected to be Sept. 22<sup>nd</sup>).
  - Below we highlight some of the features included in the draft protocol.
- The draft protocol **excludes the following reference entities:**
  - **European Financials (banks).**
  - **Sovereigns** (globally).
  - Two European corporates: Ineos Group Holdings Limited and Societe Air France.

Trades referring to the above entities will remain under the 2003 definitions whether or not investors adhere to the protocol.<sup>2</sup> Market participants who want to move their 2003 single name CDS trades referring to the above excluded transactions to the 2014 definitions will have to close the 2003 contracts and open 2014 contracts. We expect “roll” markets between 2003 and 2014 contracts to be quoted by dealers.

<sup>1</sup> The deadline for market participants to send comments to ISDA is July 21st.

<sup>2</sup> As we explained in our recent note, the new 2014 contracts will be materially different from the 2003 ones for European banks and for Sovereigns. Changes in the treatment of, among others, qualifying guarantees will also have a significant economic impact for Ineos and Societe Air France.

**Index trades referring to excluded and non-excluded entities:**

**iTraxx Main & Senior Financials (Senior and Sub) – All Series:** contain European banks (excluded from the protocol) and European corporates and insurance companies (not excluded from the protocol).

**iTraxx Crossover – Series 10 onwards:** contain Societe Air France (excluded from the protocol).

Crossover S21 contains Ineos Group Holdings SA, which will be included in the protocol. The entity excluded from the protocol, Ineos Group Holdings Limited was included in Crossover Series 17-18.

- The protocol will apply to transactions including single name CDS, CDS indices, CDS index options and CDS index tranches.

- **Implications for “Basket/portfolio/index trades”** (i.e. trades referring to a portfolio of single name CDS contracts):

**When signing the protocol ...**

**... what happens with basket transactions referring to both entities excluded and non-excluded from the protocol** (e.g. indices / options / tranches on the indices mentioned on the side comment)?

The exposure of these transactions to excluded reference entities will remain under the 2003 definitions and the exposure to non-excluded transactions will move to the 2014 definitions. For example, an iTraxx Main S21 contract traded before Sept. 22<sup>nd</sup> will, if both parties sign the protocol, migrate into a new contract in which the underlying bank CDS are governed by the 2003 definitions and the rest of the underlying CDS contracts are governed by the 2014 definitions.

- The above applies to both standard and bespoke “basket trades”.

- **New trades on non-excluded entities executed between adhering parties after Sept. 22<sup>nd</sup> (and for a 1y period) will move to the 2014 definitions, even if they are traded under the 2003 definitions.** This provision should push the liquidity in non-excluded entities almost exclusively to the new 2014 contracts.

- Thus, parties adhering to the protocol will not be able to add “2003 risk” on non-excluded entities, via new trades, during ~1y after the protocol implementation date: the 2003 contracts they trade will automatically migrate to 2014 contracts.
- This will only apply to new trades, not to novations, on non-excluded reference entities.
- This has been done having in mind market participants who cannot, from a logistical/operational point of view, get ready to trade under the 2014 definitions before the protocol implementation date; however, it applies to any market participant adhering to the protocol.

## CoCos in new sub bank CDS contracts

- ISDA has released a draft “CoCo supplement” to the CDS Definitions. **Market participants will have the option to trade bank sub CDS with or without the CoCo supplement.**<sup>3</sup>

- In CDS contracts including the CoCo supplement:

- The “CoCo provision” will trigger a Governmental Intervention credit event.

The “CoCo provision” is defined, in the draft CoCo supplement, as a provision which requires (i) a permanent or temporary reduction of the amount of principal payable at redemption or (ii) a conversion of principal into shares or another instrument, in each case, at or below the Trigger Percentage of the Capital Ratio. “Trigger Percentage” means the trigger percentage specified in the Confirmation (or if no such trigger percentage is specified, 7% per cent). “Capital Ratio” means the ratio of capital to risk weighted assets applicable to the Obligation, as described in the terms thereof in effect from time to time.

- **CoCos will be deliverable** in Government Intervention credit events due to the CoCo provision being triggered; provided they satisfy all the other deliverable characteristics (e.g. be senior or pari passu to the RefOb etc).<sup>4</sup>

Given that subordinated CDS contracts have Tier 2 reference obligations, this **supplement will only apply to Tier 2 host CoCos**, i.e. CoCos which do not include coupon deferral features, not to Tier 1 CoCos.

What if a Tier 1 CoCo is written down / converts into equity, without the Tier 2 CoCos having done so? We understand that, in this case, a subordinated bank CDS with a Tier 2 reference obligation will not trigger a Government Intervention (GI) credit event. This is due to the concept of “Further Subordinated Obligation” (FSO) introduced for subordinated CDS contracts: If the RefOb is a subordinated obligation, any obligation which is further subordinated to it is considered to be a FSO, and GI or Restructuring of FSOs will not trigger the subordinated CDS contract.

- In CDS contracts not including the CoCo instrument, our understanding is that:

- CoCo features contemplated within the bond terms (e.g. conversion to equity, principal reduction, coupon deferral ...) will not trigger a credit event.
- CoCos will not be deliverable.<sup>5</sup>

- **The CoCo supplement has been designed having in mind Swiss banks**, whose Tier 2 debt is required to include CoCo provisions going forward (in order to qualify for capital requirements). **However, it could be applied to any bank.**

- **Will iTraxx Subordinated Financials indices include the CoCo supplement? For all banks or just for the Swiss banks?** This still needs to be clarified by Markit.

<sup>3</sup> This can, in theory, be applied to both 2003 and 2014 contracts.

<sup>4</sup> “Asset Package Delivery” will apply, i.e. protection buyers will be able to deliver whatever the CoCo converts into – see our February note on the New 2014 CDS Definitions for details.

<sup>5</sup> Given that their outstanding principal balance is deemed to be zero in the 2014 definitions and that they would be considered contingent instruments in the 2003 definitions.

## Analytics, Past Trade Ideas & Publications

### Analytics – Available at Citi Velocity

Options	<a href="#">iTraxx Volatility Report</a> <a href="#">CDX Volatility Report</a> <a href="#">European Cross-Asset Volatility Report</a> <a href="#">Volatility P&amp;L Report – Credit Indices</a>	Tranches	<a href="#">iTraxx Series 9 Tranche Report</a> <a href="#">iTraxx Series 19 Tranche Report</a> <a href="#">iTraxx Series 21 Tranche Report</a>
Curves	<a href="#">iTraxx Curve P&amp;L Report</a>	Indices	<a href="#">Main Report</a> <a href="#">Crossover Report</a> <a href="#">CDS Indices Positioning Report</a> <a href="#">CDS Indices Trading Volumes Report</a>
Returns	<a href="#">European Credit Derivatives Returns</a>		

### Recent Trade Ideas

Options -	<a href="#">Main receiver 1x2s</a>	13-Jun-14
Options -	<a href="#">Main bearish risk reversal</a>	13-Jun-14
Curves -	<a href="#">5s10s Senior Fin flattener</a> (J. Faith)	30-May-14
Options -	<a href="#">European vs. US credit vol</a>	28-May-14
Tranches -	<a href="#">Sell 0-3% Jun-15 S9 protection: outright, vs. CDX IG 5y or vs. SX5E</a>	21-May-15
Indices -	<a href="#">Sub/Senior Financials compression</a> (J. Faith)	20-May-15
Curves -	<a href="#">5s10s Main Flatteners</a>	25-Apr-14
Options -	<a href="#">Main 70-75 May Receiver 1x2</a>	2 Apr 2014
Options -	<a href="#">Buy SenFin vs. Sell CDX IG straddles</a>	18 Mar 2014
Single names vs. Index	<a href="#">Releveraging Trade</a> (H. Lorenzen)	24 Feb 2014
Tranches vs. Options -	<a href="#">Sell protection and monetize the positive convexity by selling straddles</a>	20 Feb 2014
Tranches -	<a href="#">Buy 9-100% S9 Jun-18 protection, delta-hedged</a>	20 Feb 2014
Tranches -	<a href="#">Sell 3-6% S9 Jun-18 protection, delta-hedged</a>	20 Feb 2014
Options vs. Curves -	<a href="#">Flatteners vs. OTM payers</a>	13 Feb 2014
Options -	<a href="#">Sell Main vol, buy SenFin vol</a>	21 Jan 2014
Tranches -	<a href="#">More mezz, less seniors - 3-6% vs. super senior</a>	15 Jan 2014
Options -	<a href="#">SenFin vs. Xover Recs</a>	9 Jan 2014
Options -	<a href="#">Payer spread vs. index long</a>	9 Jan 2014
Options -	<a href="#">Sell 1m Main straddles</a>	9 Jan 2014
Options -	<a href="#">Sell Crossover Receiver</a>	9 Jan 2014
Options -	<a href="#">Sell strangles and go on holidays: Position for spreads to stay in the recent range in mid-January</a>	9 Dec 2013
Tranches -	<a href="#">Sell S9 Jun-18 6-9% protection vs. Xover 5y S20</a>	15 Nov 2013
Tranches -	<a href="#">Sell S9 Jun-18 22-100% protection vs. light delta</a>	15 Nov 2013
Indices -	<a href="#">Long risk Senior Fins. vs. short risk Main</a>	5 Nov 2013
Options -	<a href="#">Crossover receiver ladders</a>	23 Oct 2013
Options -	<a href="#">Long risk CDX IG vs. Main via Receivers</a>	15 Oct 2013
Options -	<a href="#">Buy Senior Financials straddles vs. sell Crossover straddles</a>	9 Oct 2013
Tranches -	<a href="#">Long risk equity vs. short risk 3-6% in S19 Jun-16 (3y)</a>	26 Sep 2013
Tranches -	<a href="#">Long risk S19 Jun-18 (5y) 3-6% vs. 5y S20 Crossover</a>	26 Sep 2013

“[European Credit Derivatives Views & Trades](#)” Investor Presentation

Teach-in presentations: [Options](#) / [Tranches](#)

### Other publications

<a href="#">Hedging the tail – Why real money should consider all options</a> (with H. Lorenzen)	1 Jul 2014
<a href="#">Lazy longs for July</a>	23 Jun 2014
<a href="#">Where do we expect iTraxx rolls to trade?</a>	19 Mar 2014
<a href="#">Our preferred carry trades in indices, options and tranches</a>	11 Mar 2014
<a href="#">New 2014 CDS Definitions - What's new? What's changing? Why? When? How?</a>	26 Feb 2014
<a href="#">iTraxx Roll - Potential Changes: Crossover number of constituents will increase to 60 names</a>	10 Feb 2014
<a href="#">2014 European Credit Outlook: Strategy // Positioning and Trades</a>	13 Jan 2014
<a href="#">Global Structured Credit Outlook: A Rockier Ride</a> (R Roy, A Basu, K Malhotra, R Brauchler)	20 Dec 2013
<a href="#">2013 Trading Volumes in European Credit: CDS Indices, Single Name CDS and IG Bonds</a>	5 Dec 2013
<a href="#">Credit Options - What did investors do in 2013? What will they do in 2014?</a> (2013 European Credit Conference Presentation)	4 Dec 2013
<a href="#">Credit Index Options 1-0-1: Launching our option pricing tool @ CitiVelocity</a> (2013 European Credit Conference Presentation)	2 Dec 2013
<a href="#">Europe Returns: Assessing value across flow and structured credit assets</a>	22 Nov 2013
<a href="#">iTraxx Tranches Views &amp; Trades: Mezz may be back next year</a>	15 Nov 2013
<a href="#">Financial CDS to get a re-vamp</a>	7 Aug 2013
<a href="#">Hedging menu: payer spreads, 3s5s flatteners and Jun 15/18 equity tranche flatteners</a>	28 Mar 2013
<a href="#">What bail-in means for CDS</a>	11 Feb 2013

Source: Citi Research.

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