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Credit Derivatives
Western Europe

New 2014 CDS Definitions

What's new? What's changing? Why? When? How?

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- **Events over the past few years highlighted limitations on CDS contracts** – The Greek restructuring and recent European bank bail-in events (SNS, Bankia) exposed weaknesses in CDS contracts as effective hedges for cash bonds.
- **ISDA is launching two new standard contracts (for Financials and for Sovereigns) and introducing a wide range of changes in the CDS definitions** – Addressing the limitations of current contracts and comprehensively improving other parts of the current (2003) definitions.
  - The new Financials (banks) contract includes an additional credit event, "Governmental Intervention", addressing the deliverability issues caused in current contracts by any government intervention, including bank bail-in.
  - The new Sovereign contract also seeks to avoid no-deliverable situations in restructurings involving bondholders receiving packages containing non-debt components.
  - Changes in the definitions include: new treatment of currency redenomination for credit event triggering, deliverability of Solvency II style bonds in sub insurance contracts, standardization of reference obligations, introduction of "Outstanding Principal Balance" concept for deliverability purposes, plus changes in succession provisions, auctioning of restructuring credit events and qualifying guarantee tests (among others).
- **The scope of the changes is global** – However, the changes have a larger impact on the European market.
- **Implemented in September 2014, coinciding with the index roll**.
  - The new Financials and Sovereign contracts will be launched.
  - The new definitions will be applied to new contracts for all reference entities.
  - **A protocol will be rolled out, before the new definitions are implemented, for market participants to convert their current (2003) contracts into 2014 contracts** (except for Financials, Sovereigns and potentially some carved-out names).
- **First major change in the CDS market since the Big and Small Bang Protocols in 2009** – Unlike the current changes, focusing on the CDS definitions, the 2009 changes were operational in nature, introducing changes to facilitate clearing and netting of contracts, streamlining the auction process and introducing the ISDA CDS Determinations Committee (DC).

Contents

What's new? What's changing?

Last week ISDA released the final version of the new 2014 CDS definitions, introducing two new standard contract types plus a number of changes to the current 2003 definitions[1]:

Two new standard contracts: Financials and Sovereigns

- **New contract for Financial reference entities (banks)** – Designed to avoid the shortcomings of current contracts when dealing with government interventions (including bail-ins), i.e. improving the hedging efficiency of the contracts.
- **New contract for Sovereign reference entities** – Designed to avoid the shortcomings of current contracts when dealing with sovereign restructurings leaving protection buyers with no or limited deliverable obligations. Again, the intention is to make Sovereign CDS contracts a better hedging tool, better aligning the payout of CDS contracts with the losses for bondholders in sovereign restructurings.

Changes to existing contract standards

To be introduced by a protocol later this year

- Changes in the definitions, among others:
  - How currency **redenomination** affects CDS contracts – Designed to deal with potential euro-exit situations. New contracts require a redenomination to be accompanied by a "haircut test" in order to trigger a credit event.
  - Making **Solvency II style debt** deliverable into subordinated insurance CDS contracts.
  - **Standardizing reference obligations** to improve the netting and clearing of CDS contracts and reduce basis risk.
  - Changes in the auctioning process on **restructuring credit events**.
  - Changes in CDS **succession** provisions.
  - Changes in the definition of **Qualifying Guarantees**.
  - Removal of the "Not-Contingent" characteristic of deliverable obligations, subsuming it within the new "**Outstanding Principal Balance**" concept.

Global scope

The scope of the new definitions is global, although the changes have a larger impact on the European market (in particular the two new standard contracts for Financials and Sovereigns). The new definitions and contract types (for Financials and Sovereigns) are expected to be used in **CDS indices** once they are implemented.

[1] When we talk about the "2003 definitions" we refer to the original definitions plus (i) the 2009 ISDA Credit Derivatives Determinations Committees, Auction Settlement and Restructuring Supplement and (ii) the May 2003 Supplement.

When? September 2014

- **The two new contract standards (Financials and Sovereigns) plus the new definitions for all (new) contracts are expected to be rolled out in September, coinciding with the index roll**.
  - **"Financials" are expected to only include banks,** excluding insurance companies.
  - We expect the liquidity in Financials and Sovereign contracts to move to the new 2014 contracts and, as a consequence, many investors will likely "roll" their positions in the current 2003 contracts to the new contract.
  - CDS index contracts are expected to use the new definitions from the September roll onwards.

How? Protocol

- **A protocol to convert current contracts (i.e. under the 2003 definitions) into the new (i.e. 2014) definitions will be launched before September.**
  - The protocol is expected to exclude Financials and Sovereigns, where the contract changes have a larger economic impact.
  - Market participants will have the choice to adhere to the protocol.[2] We expect many of them to do so given that the liquidity in 2003 contracts will likely diminish significantly once the new 2014 contracts start trading.
  - We expect that, when signing the protocol, market participants will be agreeing to convert all their current 2003 contracts into 2014 contracts, except out-of-scope transactions and any potential carved-out names.[3]
  - 2003 contracts which are converted into 2014 contracts by means of the protocol will be fully fungible with newly opened 2014 contracts.
- **Since Financials and Sovereigns will be excluded from the Protocol: two market standards for these names will trade in parallel (2003 and 2014 terms)**.
  - Market participants who want to move their Financials and Sovereigns 2003 contracts into the new contracts 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.

[2] We expect the list of market participants signing the protocol to be made publicly available, in order for their counterparties to be aware whether their open contracts do or do not migrate to the new 2014 definitions.

[3] The protocol may have carve-outs for names for which the migration from the 2003 to the 2014 definitions have a meaningful economic impact.

What's left to do?

- We expect ISDA to **update the DC Rules** to accommodate some of the changes introduced by the new definitions. Among others: (i) provisions regarding the choice of "Standard Reference Obligations", (ii) the methodology for valuing non-financial instruments and non-transferrable assets in "Asset Package Deliveries" for the new Financial and Sovereign contracts, and (iii) the methodology for selecting "Package Observable Bonds" for the new Sovereign contracts. We review these concepts in the next Section.

- We expect the **protocol** to migrate contracts from the current to the new definitions to be launched by ISDA ahead of the September implementation of the new definitions.

The changes in more detail

In this section we provide more details around the topics for which the new 2014 definitions introduce changes vs. the current 2003 definitions. It is based on our interpretation of the new definitions and should not be interpreted as legal advice.

New Financial (i.e. Bank) CDS Contract

As we highlighted in several research pieces, 2013 credit events at SNS and Bankia did much to highlight the risk that existing CDS contracts do not give expected payouts under bail-in scenarios.[4] The risk that bail-ins do not trigger CDS credit events or, if they do, result in the absence of deliverable obligations prompted ISDA to include substantial changes to Financial CDS contracts in the new definitions.

As we explain below, the changes include an additional credit event to capture debt restructurings under "bail-in" and similar interventions and the incorporation of "asset package delivery" to minimize the risk of there being no deliverable obligations in such circumstances (the big weakness of current CDS contracts). As a consequence, Financial contracts under the new definitions will likely trade wide to contracts under the current definitions; especially for subordinated CDS where the risk of government intervention is larger.

As far as we understand, "Financials" means banks only, excluding insurance companies, for the purposes of the 2014 definitions. However, in principle, nothing would prevent market participants from using the new contract standard for an insurance company or even a corporate.

"Governmental Intervention" (GI): additional credit event

- **A new credit event**, triggered by a government-initiated intervention (for example, pursuant to EU measures to be introduced in respect of financial institutions resolution and restructuring regimes) has been included.
  - Thus, the credit events in new Financial CDS contracts will include: bankruptcy, failure to pay, restructuring (where applicable) and governmental intervention.
- GI is intended to capture actions by a Governmental Authority under a "bail-in" (or similar legislation/intervention) which result in, among others, write-down, expropriation, conversion, exchange or transfer of obligations of the financial entity causing, for example, reductions of their interest/principal, extension of their maturity, changes in subordination[5]; i.e. effectively having a Governmental Authority causing a Restructuring event.
- GI will constitute a "hard" credit event, i.e. there'll be just one auction and recovery rate (with no maturity buckets) as in the case of bankruptcy and failure to pay.

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[4] See What bail-in means for CDS, M. King, A. Elizalde, J Faith, 11 Feb; Financial CDS to get a re-vamp, A. Elizalde, M. King, 21 May.

[5] Additionally, GI does not require deterioration in the creditworthiness of the entity and the "Multiple Holder Obligation" limitation of "normal" restructuring credit events does not apply. In "normal" restructuring credit events the restructuring needs to affect a "Multiple Holder Obligation" (essentially held by more than three holders that are not affiliates of each other).

Deliverable obligations in a GI credit event

- According to the new definitions, **upon a GI credit event, the protection buyer will be able to deliver the conversion/exchange proceeds of the "bailed in / intervened" bonds**, which could include instruments such as new bonds, equity, compensation claims against the government or the issuer, cash, warrants etc; always provided that the bailed-in / intervened bonds would have qualified as Deliverable Obligations immediately before the Credit Event.

  – In other words, the protection buyer will be able to deliver whatever a "Prior Deliverable Obligation" has been converted into as a result of the GI, taking into account the notional of the obligation before the event.

    - *Example*: if a €100m bond which would have been deliverable into CDS before a GI is converted into a package consisting of a new €10m bond, €10m equity and €10m cash, a protection buyer would be able to deliver that package into a €100m notional CDS position (under the new 2014 contract).

      In current 2003 CDS contracts, (i) the protection buyer would have only been able to deliver the new bond (provided it satisfied the deliverability characteristics), and (ii) the notional delivered would have needed to be €100m of the new notional (i.e. an investor who had a €100m CDS short and owned €100m of the original bond would only have received €10m of the new bond and would have needed to source an additional €90m – assuming physical delivery).

  – **What if the debt is written down to zero and there is nothing to deliver (e.g. like in the case of SNS subordinated CDS contracts)? Cash-settlement with a 0% recovery**, i.e. the equivalent effect of the protection buyer delivering the bond that has been written down to nothing in exchange for par payment.

    The 2014 definitions refer to this concept as "Asset Package Delivery".

"Asset Package Credit Events" and "Asset Package Delivery"

- "Asset Package Delivery" generally applies whenever an "Asset Package Credit Event" occurs,[6] where "Asset Package Credit Events" include:
  - **GI credit events for Financial entities**,[7]
  - **(Non-GI) restructurings of the Reference Obligation of Financial entities**, and
  - **Sovereign restructuring credit events**.

  We explain the last two cases in later sections.

  If an asset package credit event occurs and there is an earlier credit event, such as a failure to pay, the asset package can be delivered in lieu to settle the failure to pay credit event.

- If an asset package credit event results in more than one package, then the "Largest Asset Package" will be the deliverable one; where "largest" means "the package of assets for which the greatest amount of principal has been or will be exchanged or converted".[8]

- Given that assets forming part of an Asset Package can be non-transferable and/or non-financial instruments, the 2014 Definitions deem such assets to be an amount of cash equal to the Asset Market Value which would be based on the methodology determined by the Credit Derivatives Determinations Committee (DC). We expect more clarity on these provisions when the DC rule amendments are finalized later this year. [9]

[6] Unless (i) the APCE occurs prior to the Credit Event Backstop Date for the Credit Event or (ii) if the Reference Entity is a Sovereign, no Package Observable Bond exists immediately prior to such Asset Package Credit Event.

[7] If trade is MMR and restrictions on deliverability apply in accordance with MMR terms, the restrictions will not apply where the Deliverable Obligation is a Prior Deliverable Obligation and Asset Package Delivery applies due to a GI.

[8] "If this cannot be determined, the Largest Asset Package will be the package of assets with the highest immediately realizable value, as the Calculation Agent shall determine or in accordance with a methodology determined by the Credit Derivatives Determinations Committee."

[9] The DC would also be responsible for determining the Largest Asset Package if information on the package of assets for which the greatest amount of principal is exchanged or converted is not available and the package with the highest immediately realizable value is to be determined based on DC methodology.

"Senior" vs. "Subordinated Transactions"

- Under the current 2003 definitions, "sub" and "senior" CDS contracts have only one difference: their Reference Obligation (RefOb) – which essentially determines that only senior obligations could be delivered into "senior" CDS (i.e. CDS with a senior RefOb) and both sub and senior obligations could be delivered into "sub" CDS (i.e. CDS with a sub RefOb). There is no other difference between sub and senior CDS:

  – Both contracts trigger at the same time, irrespective of whether the obligations subject to the credit event were sub or senior, i.e. there is "cross-trigger" between senior and sub contracts. For example, in the case of SNS, even though only sub debt was "restructured" (i.e. bailed-in), both sub and senior CDS contracts triggered.

  – The fate of both contracts in a CDS succession is the same, based on how the total "Relevant" debt was split between the successor entities.

    • *Example*: if a bank with €90m senior and €10m sub ("Relevant") debt is succeeded by two banks, one *A* taking all the senior debt and another *B* taking all the sub debt, all sub and senior CDS contracts would move to the bank taking the senior debt *A*, because more than 75% of the "Relevant" debt was moved to that bank.

- Under the new 2014 definitions, Financial CDS contracts will specify if the contract is a "Senior" or a "Subordinated Transaction", with the following implications:

  – GI or Restructuring credit events affecting only sub debt will trigger sub CDS but not senior CDS. Any credit event affecting senior debt will trigger both senior and sub CDS.

    Failure to pay or bankruptcy credit events will trigger both senior and sub CDS. In other words, the "cross-trigger" between sub and senior contracts will be "loosened".

  – For the purposes of determining Successor Reference Entities, senior and subordinated debt will be tracked separately: essentially, senior CDS contracts will follow senior debt and sub CDS contracts will follow sub debt.[10]

    • In our *example* above, all senior CDS contracts will move to bank *A* and all sub CDS contracts to *B*.

  – The concept of "Further Subordinated Obligation" (FSO) for Subordinated CDS has been introduced: If the RefOb is a subordinated obligation, any obligation which is further subordinated to it is considered to be a FSO. GI or Restructuring of FSOs will not trigger the subordinated CDS contract. Additionally, in succession events relating to subordinated CDS, transfer of FSOs will not count for purposes of the threshold tests.

[10] Sub CDS contracts will follow senior debt if there is no ("Relevant") sub debt.

"Asset Package Delivery" in a (normal) Restructuring

- Restructuring credit events in Financial CDS contracts will change slightly to accommodate the concept of "Asset Package Delivery", which also applies to GI and Sovereign restructurings credit events.

Remember that a (non-GI) restructuring credit event requires a change to a bond or loan documentation involving a reduction or postponement of payment of interest and/or principal, a change in subordination or currency. Moreover, it needs be due to deterioration in the creditworthiness of the reference entity and it must be binding on all holders of the obligation(s) being restructured.

- Whenever a restructuring credit event (a "normal" one, i.e. not a GI one) occurs in a Financial reference entity, **protection buyers will be able to deliver (i) any deliverable obligation (this is not new) plus (ii) the asset package which the RefOb has been converted into (if any) – this is the change between the 2003 and 2014 definitions**.

    - *Example*: if a bank restructures part of its debt, including the RefOb, into equity, protection buyers will be able to deliver the equity package received in exchange of the RefOb into the CDS (plus any other deliverable obligation, but not the equity received in exchange of obligations different from the RefOb).

  – As a consequence, if a bank restructures all its debt, including the RefOb into, for example equity (or anything else which wouldn't be deliverable in its own right like cash), 2014 CDS contracts will not be rendered worthless given that the equity received in exchange of the RefOb will be deliverable.

- **This change is intended to capture those instances where a bank pre-empts a government intervention by restructuring the debt in a similar fashion as the intervention would have taken place, i.e. potentially leaving no deliverable obligations**.

- The unintended consequence of this change is as follows:

  – Imagine that a bank restructures part of its debt, including the RefOb (which we assume had a maturity of 6y). The usual "maturity bucketing" is applied, with enough deliverable obligations to run auctions for the 0-2.5, 2.5-5 and 5-7.5y buckets. If the value of the package into which the RefOb has been converted is much lower than the value of the other deliverable obligations left, the recovery on the 5-7.5y bucket (i.e. the bucket into which the RefOb can be delivered) will be very low compared to the recovery on the other buckets.

  – This problem could be solved if Reference Obligations for Financial CDS are chosen to have maturities below 2.5y, in which case they would be deliverable into any bucket. The introduction of "Standard Reference Obligations" (see a later section) would facilitate this.

New Sovereign CDS Contract

The Greek credit event raised many concerns regarding the risk of leaving protection buyers with no deliverable obligations after a credit event if the debt is restructured into non-deliverable securities such as cash, warrants etc.[11] The new CDS definitions try to address these issues, like in the case of Financials, by applying the concept of "Asset Package Delivery".

The new definitions specify that if a Restructuring credit event occurs in a sovereign reference entity, the "Asset Package Delivery" concept will apply to what is called "Package Observable Bonds" (POBs).

- ISDA will maintain a list of bonds, the POBs, such that if any of those bonds are restructured, triggering a Restructuring credit event, then the "package" into which those bonds are converted will be deliverable into CDS (in addition to any other deliverable obligation).
  - *Example*: A €100m POB is converted into a €30m new bond, €10m cash and €10m GDP warrants. An investor with a €100m CDS short (risk) position – in the new 2014 contract – will be able to deliver the entire package (€30m new bond, €10m cash, €10m warrant), receiving €100 cash – assuming physical delivery.

    Under the current (2003) definitions, only the €30m new bond would have been deliverable, and the investor would have to deliver €100m of it (not €30m).
  - We expect POBs to be pre-identified benchmark liquid bonds of different maturities and large outstanding notional. We expect more clarity on the methodology relating the selection of these bonds when the DC rules are finalized.
  - As in the case of Financials, if the restructuring of the POBs results in more than one package, then the "Largest Asset Package" one will be the deliverable one.

[11] See Greek CDS Auction and Settlement, M. Hampden-Turner, 16-Mar-12, and Sovereign rescheduling: what triggers CDS?, M. Hampden-Turner, 18-May-11.

Changes in Currency Redenomination

- In current 2003 CDS contracts, redenominating the currency of an obligation (principal or interest) into a Non-"Permitted Currency" triggers a Restructuring credit event; "Permitted currencies" being one of a G7 or AAA-rated OECD countries.
  - Thus, if Germany, Italy or France redenominated its debt into a new currency, CDS wouldn't trigger – because they are G7 countries; but if Spain (or any other euro member) did, CDS would trigger.
- New 2014 contracts would trigger a Restructuring Credit Event if the currency is redenominated to[12] the currencies of Canada, Japan, Switzerland, the United Kingdom, the United States of America, the euro and any successor currency to any of the aforementioned currencies (which in the case of the euro, shall mean the currency which succeeds to and replaces the euro in whole).
  - This change involves just changing the set of currencies which would not trigger a credit event if the currency was to be redenominated into them.
  - **The new contract unifies the treatment of all euro members (irrespective of whether they are G7 or AAA-rated) in the case of a euro exit**.

Euro Exit by EU Member State

- **New 2014 contracts require a redenomination to be accompanied by a haircut in order to trigger a restructuring credit event**. Redenomination from euros into another currency will not trigger (a Restructuring credit event in) CDS contracts as long as:
  - (i) A "freely available market rate of conversion" existed at the time of the redenomination,
  - (ii) Such rate was used for the currency conversion and principal / interest / premium has not been reduced, and
  - (iii) The redenomination occurred as a result of an action taken by a Governmental Authority of a Member State of the EU which is of general application in the jurisdiction of such Governmental Authority.

  A redenomination from euros into another currency would only trigger a Restructuring credit event if either (ii) there is no a "freely available market rate of conversion" or (ii) there is one but the principal, interest or premium have been reduced (based on such conversion rate). There will be no need to show that the redenomination is on the back of deterioration in creditworthiness; there will just be a "haircut test".[13]

  These changes makes new 2014 Sovereign CDS contracts a lot less valuable (as a hedge, vs. current 2003 contracts) in those cases where the potential cause of a trigger (in the old contract) was likely to be a redenomination (e.g. Spain leaving the euro).

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[12] Unless the CDS Confirmation specifies otherwise.

[13] A failure to pay will not be triggered if (i) redenomination occurs as a result of action taken by a Governmental Authority which is of general application in the jurisdiction of such Governmental Authority and (ii) a freely available market rate of conversion existed at the time of the redenomination. Thus, no Failure to Pay will then occur unless there is a haircut (a reduction in the rate or amount of interest, principal or premium payable) determined by reference to such freely available market rate of conversion at the time of such redenomination. This applies to any redenomination, not only for euro redenominated debt.

Sub Insurance CDS and Solvency II bonds

- **Only for subordinated CDS in insurance companies, obligations with a remaining maturity below 30y but which could be extended above 30y (potentially indefinitely) by "Solvency Capital Provisions"[14] will not fail the maximum maturity deliverability test and will therefore be deliverable** (provided they satisfy the other deliverability criteria).[15]

- What's the rationale behind this change?

  – Solvency II-compliant subordinated bonds must have a mandatory deferral trigger if regulatory solvency is breached, giving the regulator the ability to extend the final maturity if solvency is an issue at the time.

    Solvency II subordinated debt is not deliverable into current 2003 CDS contracts given that their maturity can be extended above 30y. **The new definitions make Solvency II subordinated debt deliverable into new 2014 CDS contracts**.

  – Since insurance companies are likely to only issue Solvency II-compliant subordinated bonds going forward, this is being made to avoid subordinated insurance CDS contracts eventually running out of deliverable obligations.

  – In a recent ruling, the ISDA DC allowed a Solvency II bond to become the substitute reference obligation of Generali's subordinated CDS, effectively making it deliverable. The change introduced in the new definitions is in-line with the direction taken by ISDA DC in this recent case.

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[14] According to the new definitions, "Solvency Capital Provisions" means any terms which expressly or indirectly permit the Reference Entity's payment obligations to be deferred, suspended, cancelled, converted, reduced or otherwise varied, which are necessary in order for the obligation to constitute capital resources of the intended tier.

[15] Similarly, "Solvency Capital Provisions" will not cause an obligation to fail the Qualifying Guarantee test and will be considered a permitted contingency for the "Outstanding Principal Balance" determination – in the sense that no deductions will be made from the non-contingent amount.

"Standard Reference Obligations"

- Current 2003 CDS contracts specify a particular obligation as "Reference Obligation" (RefOb), for the purposes of establishing the "seniority" of the contract (only pari-passu or senior obligations to the RefOb can be delivered).[16] However, different CDS contracts may have different RefObs, potentially causing issues when netting or clearing contracts.

- New 2014 contracts, at least in the most liquid entities, will "standardize" the RefOb by introducing a "Standard Reference Obligation" (SRO). CDS contracts will have, as RefOb, the corresponding SRO in a "SRO List".

  - Investors will still be able to specify a particular RefOb, "opting-out" of the SRO feature.[17]

  - If the SRO is substituted, the RefOb of those contracts is expected change as well. Thus, contracts applying SRO will always have the same RefOb.

  - We expect ISDA to maintain an "SRO List" for the most liquid reference entities. We expect ISDA to publish further details on this topic.[18]

- For CDS which trade without a SRO, the provisions for selecting Substitute Reference Obligations have also been updated.[19]

[16] Additionally, the Reference Obligation is always deliverable.

[17] The RefOb of a contract will therefore be the Standard Reference Obligation, unless: (a) "Standard Reference Obligation Not Applicable" is specified in the related Confirmation, or (b) "Standard Reference Obligation Not Applicable" is not specified in the related Confirmation and there is no Standard Reference Obligation.

[18] The extent of the application of SRO terms to legacy trades and certain Reference Entities is expected to be subject to the forthcoming Protocol.

[19] These provisions are expected to apply to SRO substitutions, although ISDA still needs to update the DC rules in this respect.

"Outstanding principal balance"

- Under the current 2003 CDS definitions, for an obligation to be deliverable, it needs to be "Not Contingent", i.e. its outstanding principal may not be reduced except by way of payment. This renders bonds whose principal can be reduced by any amount non-deliverable, even if that amount is small and capped.

  - *Example*: Imagine a reference entity has a call option which can reduce the principal amount of a bond to 70% of its original notional. This bond would not have been deliverable under the 2013 definitions given that it would have been considered contingent.

- The new definitions look at the "outstanding principal balance" OPB of an obligation, which can be thought of as the part of the principal (plus accrued interest if applicable) not subject to any contingency, i.e. the minimum level at which the principal can fall due to contingencies before payment.[20]

  - In our example above, under the 2014 definitions, the bond would still be deliverable, but only for 70% of its notional. If a protection buyer holds €100m of the bond and a €100m CDS on that reference entity, in the case of a credit event and physical settlement, the bond would only count for €70m for deliverability purposes, and the protection buyer would have to source an additional €42.83m of bonds (which would count for €30m of notional for deliverability purposes).

  – **Contingent Convertible bonds (CoCos)** have contingent features which make them non-deliverable into 2003 CDS contracts. The removal of the "Not contingent" test for deliverability purposes in 2014 contracts means that (as far as we understand), if CoCos were to satisfy all other deliverability criteria, their OPB would have to be established. We understand that CoCos which can be fully written down or converted into equities would have a zero OPB, making them non-deliverable in practice. However, this is our interpretation only and there is no explicit reference to CoCos in the 2014 definitions.

[20] Taking into consideration the lowest amount of claim that may be asserted against the reference entity (after maturity, acceleration, termination etc.) at time of determination. In case of guarantees with a cap, the OPB will not exceed such cap.

Changes in CDS Succession

- **New "Universal Successor" concept**: If entity A assumes *all* obligations[21] of another entity B and entity B ceases to exist or is in the process of being dissolved,[22] entity A will become the sole successor for CDS purposes.[23]

  – Difference with respect to the previous definition: The "Universal Successor" clause will apply even if the succession is not raised within the 90-day look-back period in order to avoid orphaning of CDS contracts when, as in the case of UnityMedia, a company is dissolved after moving all its debt to another company without the CDS market being aware of it within 90 days of the event.

  – It only applies to non-Sovereign CDS contracts.

- **A "Succession Event" is not needed in order for a CDS succession to take place**.

  – A "Succession Event" is defined, in the current 2003 definitions, as an event (such as a merger, consolidation, amalgamation, transfer of assets or liabilities, demerger, spin-off or other similar event) in which one entity succeeds the obligations of another entity.

  – Difference with respect to the previous definition: The transfer of a sufficient amount of obligations[24] from one entity to another will be enough for a CDS succession to take place in the new CDS contract.

  – It only applies to non-Sovereign CDS contracts. CDS succession in Sovereign CDS still requires a Succession Event (e.g. annexation, unification, secession, partition, dissolution, consolidation, reconstitution etc.)

- **CDS succession provisions will take into account debt transfers that take place over a period of time**[25], not just one-off debt transfers.

  – All the debt transferred under a so-called "Steps Plan" will be considered to determine the CDS successors, thresholds to split the CDS notional among the successors etc.[26]

- Provisions have been included to clarify treatment of **joint successors** where the relevant obligations are treated to be split in equal parts by those succeeding jointly.

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[21] Including at least one Relevant Obligation.

[22] Entity B must also not have issued any new debt after the succession.

[23] Provided that the reference entity has not issued or incurred any borrowed money obligation since date of assumption and the successor assumes at least one relevant obligation.

[24] The requirements in this regard have not changed.

[25] If there is a "a steps plan evidenced by Eligible Information contemplating that there will be a series of successions to some or all of the Relevant Obligations of the Reference Entity, by one or more entities."

[26] If there is a "Steps Plan", the "Relevant Obligations" considered will be the bonds and loans outstanding at the effective date of the first succession, and the "Succession Date" will be the earlier of (i) effective date of the final succession contemplated by the "Steps Plan" and (ii) the date when the Successor determination will not be affected by any successors (provided, in both cases, that there is no Credit Event before such date).

- **Guarantees will be treated in the same way for the purposes of both Succession and Deliverability provisions**.

  – The current 2003 CDS definitions prevent a succession when the debt is still guaranteed by the original reference entity; where this guarantee does not need to be a "qualifying" one. However, in order for this debt to be deliverable in a CDS credit event, such guarantee must be a "qualifying" (irrevocable) one.

  – The 2014 new definitions will use the concept of "qualifying" guarantee for both purposes in order to avoid situations where a succession is avoided because there are guarantees but these are non-qualifying guarantees, effectively "orphaning" the CDS contract.

Changes in Restructuring Events

- **"Legally binding" bond exchanges will trigger restructuring credit events under the new 2014 definitions** (provided the exchange meets at least one of the criteria used in restructuring credit events – e.g. maturity extension, notional or interest reduction, change of subordination). These exchanges used to trigger a credit event under the 1999 definitions, but their treatment changed under the current 2003 definitions – there is uncertainty with respect to interpretations as to whether such events could constitute credit events under the 2003 definitions.

- **Changes in the auctioning process for restructuring credit events under MMR contracts:**

  – Removal of the "Rounding-Down Convention" applied to define maturity buckets on CDS auctions as a result of restructuring events. The concept of "Enabling Obligation" has been removed in order to achieve this outcome.[27] This change also applies to MR contracts.

  – Limit the auction maturity buckets in MMR contracts to four (0-2.5, 2.5-5, 5-7.5, 7.5-10), with contracts with remaining maturities above 10y settling physically.

  – In order to determine the maturity bucket for restructured obligations under MMR contracts with new (i.e. restructured) maturities below 10y, the relevant maturity to be used will be the earlier of the new maturity and the original maturity. For example, if the maturity of a bond has been restructured from 3 to 9y, the bond will be included in the 2.5-5y bucket.

- **The optional trigger-ability of "Old-R will be eliminated**, i.e. "Old-R" contracts will trigger automatically upon the occurrence of an event determination date.[28] "Old-R" provisions are typically used in EM CDS contracts, with a 30y maturity limitation and no restrictions on the transferability of deliverable obligations; maturity bucketing upon a credit event is not used.

[27] Round-down convention: CDS contracts with maturities falling in a bucket with only longer-maturity deliverables round down to the next earlier maturity bucket. For example, if there is only a 6.5y deliverable obligation in the 5-7.5y bucket, CDS contracts with maturities below 6.5y are allocated to the 2.5-5y maturity bucket. In other words, CDS contracts are rounded down to a lower bucket unless an "enabling deliverable obligation" exists (defined as a deliverable obligation with a maturity above the bucket lower bound, but below the contract maturity).

[28] In other words, no Credit Event Notice would be required to trigger an "Old-R" standard contract; the occurrence of the Event Determination Date would be enough.

Changes in Guarantee Definitions

- Upon a CDS credit event, obligations not issued but guaranteed by the reference entity are deliverable as long as the guarantee is a "Qualifying Guarantee" (QG) – provided they satisfy all the other deliverability characteristics and the underlying satisfies certain deliverability criteria. The new definitions will incorporate changes in the definition of QG, relaxing the tests for a guarantee to be a QG.

  The changes in the 2014 definitions include, among others, that a guarantee will not fail the "Qualifying Guarantee" standard if:

  – It covers all amounts of principal and interest under the obligation. In the 2003 definitions for a guarantee to be a qualifying one it needed to cover all amounts under the obligation – including, for example, withholding taxes.

  – It contains a fixed cap on the guarantor's liability, where the cap amount is sufficient to cover the principal and interest of the underlying obligation.[29]

  – It can be released or discharged as a result of payment or operation of law.[30]

  – It has provisions anticipating a Governmental Intervention (for Financial reference entities only).

  – It has provisions allowing for payment obligations to be deferred, suspended, cancelled, converted, reduced or otherwise varied and such terms are necessary to constitute capital for an intended tier (for Subordinated European Insurance Entities only).

  – It contains release provisions in connection with the transfer to, or the assumption by, a single transferee of the guarantee and all (or substantially all) of the assets and liabilities of a guarantor on the same (or substantially the same) terms.

    The new definitions also clarify that statutory or regulatory guarantees will be considered as "written instruments" and therefore will pass the QG test.

[29] The fixed caps permissible for Qualifying Guarantees must not be a limit or cap determined by reference to a formula with one or more variable inputs. It has been clarified that for these purposes, the outstanding principal or other amounts payable pursuant to the Underlying Obligation shall not be considered to be variable inputs. For example the following would be acceptable caps: 50% of the outstanding principal balance or 50% of principal and interest.

[30] If the guarantee or underlying obligation contains release or discharge provisions and such provisions have ceased to apply or are suspended, due to non-payment in respect of the guarantee or the underlying obligation, or due to a bankruptcy of the reference entity or the underlying obligor, the cessation or suspension is treated as permanent and the Qualifyinng Guarantee test will not fail.

Appendix A-1

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