

# The “Small Bang”: Current Issues in European CDS

## Update from the Markit European CDS Conference

### Key findings

- North American changes have been a success
- Industry confident that Europe will follow suit
- Central clearing will benefit CDS market

### The Gathering

The CDS market has come under intense fire during the current financial crisis. It has been portrayed as a villain by the media, described as “toxic” and “unregulated”, the “wild west” of the financial sector. This criticism is unwarranted. But the industry has never rested on its laurels, and recognises that changes need to be made to make the market more efficient. Markit hosted a conference this week at the London School of Economics to discuss upcoming changes to the CDS market. Participants attended from all over Europe, and all agreed that the event was a great success.

### Changes Afoot

The first session, “North American and European Convention Changes”, provided the background on why and how the CDS market is changing. The panel consisted of John Cortese (Barclays Capital) and Arne Groes (BNP Paribas) from the dealer community and Jeff Kushner (BlueMountain Capital Partners) from the buy-side. The moderator was Charles Longden of Markit.

They began by discussing the recent changes to North American CDS trading. These consist of:

- Fixed coupon of 100 and 500
- Full first coupon

- No restructuring
- Standard North American Contract (SNAC)
- All applied from April 8th, 2009

### Why move to fixed coupon?

Prior to the recent changes, the North American CDS market previously traded on a “par spread” basis, i.e. deals are struck at the spread quoted by market makers. This was unusual and different from most markets. Fixed coupon trading – where the coupon is fixed and an upfront fee is exchanged – has several advantages, as highlighted by the panel:

- Fungibility. The uniform nature of the product makes central clearing and trade compression – two of the industry’s most crucial issues – far easier. Par spread trading has slowed progress on these issues.
- Consistency. The bond market trades on price (an upfront exchange) and the CDS index market (Markit iTraxx, Markit CDX) has always traded with a fixed coupon. Many high-yield CDS trade points upfront and have done for some time.
- Standardisation. The industry has established standard assumptions that can be used in calculating upfront payments and spreads. This reduces disagreements and improves operational efficiency. In particular, the assumptions create an incentive to cancel trades rather than offset, thus reducing gross notional outstanding. An upfront/spread calculator using these assumptions can be found on Markit’s website at <http://www.markit.com/cds/>
- Transparency and liquidity. The three factors above should make the market more transparent and easier to understand for buy-side investors
- Regulation. Financial market regulators are keen to get a central clearing house up and running for

the CDS market. The shift to a fixed coupon should quicken progress.

Both sell- and buy-side panellists agreed that the transition to fixed-coupon trading in North America had been smooth. Dealers were quoting 100bp and 500bp from day one.

The buy-side has welcomed the changes, highlighting the importance of the standard assumptions. Liquidity has not improved since the changes were introduced, but there was a consensus that this was due to general market conditions rather than the new conventions.

### Europe's turn

The European CDS market is set to follow North American and switch to fixed coupon trading. The convention changes are similar:

- Fixed coupon of 25, 100, 500 or 1000
- Additional coupons of 300 and 750 for recouping of old trades
- First full coupon
- Proposed implementation date of June 20<sup>th</sup> 2009
- Restructuring to remain in the European contract.

The panel agreed that the upcoming changes in Europe were driven by the same fundamental reasons as North America: clearing; compression; transparency; and regulation.

Buy-side investors have often complained about their lack of representation on industry initiatives but that was not an issue here. The ISDA consultation process was inclusive, ensuring all market participants are happy with the changes.

The panel highlighted the advantage Europe has in learning from the North American experience. The main difference from across the Atlantic – four coupons instead of two – emanated from this as well as investor requirements in Europe. Though there was a consensus that liquidity will be concentrated around 100 and 500, the panellists expect that the 25 coupon could become relevant given the recent spread tightening.

On the practical issues, the dealers expect to see one contract per name, i.e. a credit will trade either with a 100 coupon or 500. This eliminates the slim risk of arbitrage. The US experience will again be vital in

meeting operational challenges, though the panellists expect these to be small given that CDS indices are commonly traded.

### The Small Bang

The second session, "Restructuring and its Impact on the Auction Process", discussed one of the most difficult issues in the European CDS market. The panel was made up of Paul Glasgow (JPMorgan), Andrew Downes (UBS), Simon Davidson (Credit Suisse) and Athanassios Diplas (Deutsche Bank). Tom McNerney of Markit moderated.

The discussion began with an overview of the Big Bang protocol. This was introduced at the same time as fixed coupons in North America, though most of its measures were global in scope. They can be summarised as follows:

- Determinations Committees. These are five regional committees, with buy- and sell-side representation, that determine whether a credit or succession event has occurred. Previously this was a bilateral process between the two counterparties that could result in disagreements. The committees also have the power to determine whether a credit event auction will take place and under what parameters. Finally, they publish the list of deliverable bond obligations.
- Hardwiring of auctions. Credit event auctions are now hardwired into the standard ISDA CDS contract, making the settlement process more efficient.
- Look-back period. The effective date of a CDS contract is no longer fixed but rolls. There is now a 60 day rolling period from the current date for credit events and 90 days from the current date for succession events.

### Restructuring?

The Big Bang did not take into account the issue of restructuring. This was a deliberate action by the industry. As part of the convention changes, North American CDS now trade without restructuring. The US' bankruptcy laws (Chapter 11) enable firms to file for bankruptcy protection and then restructure their debts. This means that the bankruptcy credit event is

usually sufficient (high yield CDS have long traded without restructuring).

Europe has a plethora of legal jurisdictions, each with their own way of dealing with bankruptcies. Most bear little resemblance to Chapter 11. The Basel II capital requirements provide another reason for the European market to keep restructuring. Banks receive additional capital relief if they hedge exposure with CDS including restructuring.

So restructuring is here to stay in Europe, at least in the medium-term. The industry faced the challenge of bringing the restructuring credit event into the auction age, as one of the panellists put it. The Small Bang protocol was the answer. The measures to be introduced are as follows:

- Hardwires the auction mechanism for restructuring credit events
- Defines maturity buckets for deliverables following a restructuring credit event. Mod-Mod restructuring in Europe places a maturity cap on deliverables. It depends on the maturity of the CDS contract. This means that it is not possible to hold a single auction for a restructuring credit event. The proposed solution is to hold several auctions, with a list of deliverables for each bucket. The determination committee decides the terms of the auction and the deliverables.
- 'Use it or Lose it'. If there is an auction, the trades that aren't triggered before the auction will not be able to be triggered afterwards.

There was a consensus among the panel that the proposed measures, though more complicated than the previous conventions, provide the best solution for the CDS market. Dealers, investors and regulators all see the need for central clearing and the Small Bang Protocol should make this process easier. The panel was hopeful that it would be in place by the July 31<sup>st</sup> deadline set by EU regulators.

## Regulation

The final session of the conference was called "Regulatory and Clearing Update". Typically, this would be a signal for attendees to make their excuses and head for the exit. But, like the other sessions, the lecture hall was full. The moderator, Jeff Gooch of Markit, said this was indicative of the turbulent times

we now live in, a view hard to disagree with. An excellent panel also contributed to the high attendance. Anne Wetherilt (Bank of England) and David Bailey (FSA) represented the regulators, while Tim Frost (Cairn Capital) and Richard Metcalfe (ISDA) came from the industry.

The format was different from the other sessions, with each panel member giving a brief account of their views on regulation and clearing. Wetherilt opened with a discussion of systemic risk, an area she specialises in. Central banks view financial markets as networks, and networks can collapse under stress. In her opinion, the main weak points relate to counterparty risk and settlement risk. She welcomed the industry initiatives that are addressing these issues, namely central clearing houses and trade compression.

David Bailey, representing the FSA, concurred with many of Wetherilt's points. The regulator is focusing on clearing in particular, and he highlighted the common misconception that clearing and exchange trading have to go hand-in-hand. The crucial issue is how the trade is settled, not where it is traded.

Tim Frost, a well-known figure in the CDS industry, spoke engagingly on a broad range of subjects. From a buy-side perspective, Frost said investors are looking for stability in financial markets. The current uncertainty in regulation is unnerving investors, and he urged the authorities to resolve the situation quickly. He also expressed the contrarian view that differing regulatory regimes across countries is not necessarily a bad thing.

Richard Metcalfe of industry body ISDA highlighted the importance of standardised documentation in facilitating central clearing.

It could be expected that the panel would split into two camps. But this wasn't apparent from the discussion, a fact indicative of the cooperation between the financial industry and regulators. Transparency is a buzzword at the moment and events such as this conference held by Markit are shedding light on the challenges facing the financial markets.

**Gavan Nolan**

**Credit Analyst**

Markit

Tel: +44 20 7260 2232

Email: [gavan.nolan@markit.com](mailto:gavan.nolan@markit.com)

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