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# **Credit Derivatives Glossary**

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## Credit Derivatives Glossary

**ABCDS** – A CDS where the underlying is an Asset Backed Security.

**Basis Point** – 1/100<sup>th</sup> of 1%. 100 basis points = 1%. A common term in fixed income and credit derivative markets.

**Basket CDS** – A CDS where a group of reference entities are specified in one contract. There are several types of basket CDS including first or N<sup>th</sup>-to-default swaps (where settlement is triggered when the first or N<sup>th</sup> entity defaults).

**Big Bang Protocol** - Protocol taking effect on April 8, 2009. The Protocol affects new trades and all legacy trades to adherents. The changes include the hardwiring of the auction mechanism, the definition of the ISDA Determination Committee, and the Lookback Period (today minus 60 days for credit events, and today minus 90 days for succession events).

**Calculation Agent** – The party responsible for determining when a credit event or succession event has occurred, and for calculating the amount of payment required by the Protection Seller.

**CDS Spread** – Also called a premium. The amount paid by the Protection Buyer to the Protection Seller, typically denominated in basis points and paid quarterly. For example if the spread for The Widget Company is 200 basis points, the Protection Buyer will pay the Protection Seller 200 basis points multiplied by the notional of the trade annually (typically paid quarterly, on an actual number of days per period/360 basis).

**Credit Default Swap (CDS)** – A credit derivative transaction in which two parties enter into an agreement, whereby one party (the Protection Buyer) pays the other party (the Protection Seller) periodic payments for the specified life of the agreement. The Protection Seller makes no payment unless a credit event relating to a predetermined reference asset occurs. If such an event occurs, it triggers the Protection Seller's settlement obligation, which can be either cash or physical.

**Credit Derivative** – A form of derivative transaction, for example a Credit Default Swap, designed to transfer credit risk from one party to another.

**Credit Event Auction** – Industry standard mechanism designed to ease the settlement of credit derivative trades following a credit event. The auction process determines the cash settlement price of a CDS, with the compensation received by the protection buyer based on the final agreed auction price. Markit and Creditex have jointly acted as administrators of the auctions since their inception in June 2005.

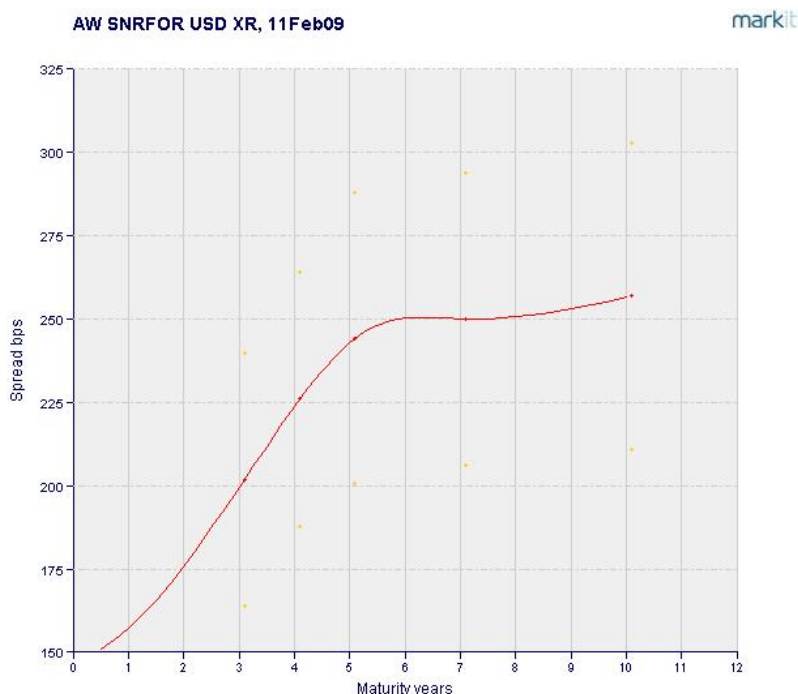
**Derivative** – A broad term describing financial instruments that “derive” their value from an underlying asset or benchmark. Many derivatives are designed to transfer some form of risk from one party to another. Included in this broad definition would be: Futures, Options (including caps and floors), Swaps (including CDS and interest rate swaps), Forwards and hybrids of the above.

**Credit Event** – This is the event triggering settlement under the CDS contract. Since the original ISDA Agreement in 1999, six categories of Credit Events have been defined:

- **Bankruptcy** – Although the ISDA 2003 Definitions refer to different ways a bankruptcy can occur, the experience has been that the reference entity has filed for relief under bankruptcy law (or equivalent law).
- **Failure to pay** - The reference entity fails to make interest or principal payments when due, after the grace period expires (if grace period is applicable in the trading documentation).
- **Debt restructuring** - The configuration of debt obligations is changed in such a way that the credit holder is unfavorably affected (maturity extended and/or coupon reduced).

- **Obligation default, obligation acceleration, and repudiation/moratorium** – The 2003 ISDA definitions define these three credit events, but they are very rare.

**Credit Spread Curve** – The curve display of the credit spread for a unique reference entity/tier/currency/docclause combination over different tenors. Find below a picture of a Caterpillar credit spread curve from Markit's CDS pricing service:



**DTCC** – Depository Trust & Clearing Corporation provides clearance, settlement and information services for equities, corporate and municipal bonds, government and mortgage-backed securities and over-the-counter derivatives. The CDS matching and confirmation service provides automated, real-time matching and confirmation for standard single reference entity CDS (including North American, European, Asian corporate credits, and sovereign credits), as well as CDS indices.

**Index Roll** - Process which, for the Markit iTraxx and Markit CDX indices, takes place twice a year in March and September to create a new index series. The previous index becomes off-the-run, and the new index is the new on-the-run series.

**ISDA** – The International Swaps and Derivatives Association is the global trade association representing participants in the privately negotiated derivatives industry, a business covering swaps and options across all asset classes (interest rate, currency, commodity and energy, credit and equity). ISDA was chartered in 1985.

**LCDS** – A CDS contract where the underlying instrument is a syndicated loan, senior secured in the capital structure.

**LIBOR** – London Interbank Offered Rate – An interest rate fixing in the interbank market, representing the rate at which highly-rated banks will lend to one another. Also widely used as a floating rate reference on interest rate and currency swaps, and floating rate notes. LIBOR is calculated daily for a variety of currencies including USD and GBP. The EUR equivalent is EURIBOR and the JPY equivalent is TIBOR.

**Long Credit** – Refers to the position of the CDS Protection Seller who is exposed to the credit risk and who receives periodic payments from the Protection Buyer.

**Markit CDX** – Markit credit indices focused on North America. Investment Grade, High Yield, and Emerging Markets are the three major sub-indices.

**Markit iTraxx** – European and Asian CDS indices owned by Markit. The Markit iTraxx represents the most liquid part of the CDS market for Asia and Europe.

**Markit RED™** – Markit's Reference Entity Database. Markit RED is the industry standard identifier for reference entities and reference obligations in the credit derivative market.

**MCDS** – A CDS contract where the underlying is a municipality, and the reference obligation is either a Revenue Liability, a General Obligation Liability, a Moral Obligation Liability or a Full Faith and Credit Liability.

**Notional Principal** – The quantity of the underlying asset or benchmark to which the derivative contract applies.

**Off-the-run / On-the-run** – Markit iTraxx and CDX indices 'roll' every six months when a new series of the index is created with updated constituents. The previous series continues trading although liquidity is concentrated on the new series. The new series is referred to as being on-the-run, with previous series referred to as being off-the-run.

**OTC** – Over The Counter – Refers to trades negotiated and conducted directly between two parties. This contrasts with trades conducted on exchanges, where the trades are defined by the rules of the particular exchange. CDS are examples of an OTC-traded instrument.

**Present Value** – An asset valuation method, which maps future cash flows from an asset and discounts the future cash flows by an appropriate discount rate.

**Protection Buyer** – This is the party to a CDS contract which pays a premium for protection in case a credit event occurs. The Protection Buyer can also speculate that the cost of protection will rise and profit from selling the CDS contract at a higher price than was paid.

**Protection Seller** – This is the party to a CDS contract receiving the premium payments, and who is exposed to the credit risk of the reference entity.

**Recovery Rate** – Estimate of percentage of par value that bondholders will receive after a credit event. CDS for investment grade bonds generally assume a 40% recovery rate when valuing CDS trades. However, CDS for lower rated bonds are more dynamic and often reflect lower estimated recovery rates.

**Reference Entity** – Refers to the legal entity that is the subject of a CDS contract. The reference entity can be the issuer or the guarantor of the debt.

**Reference Obligation** – The specific bond (debt obligation) that is referenced in the CDS contract.

**Restructuring Credit Event** – One of the types of credit events (defined above). It is a "soft" event, in which the loss to the owner of the reference obligation is not obvious. In addition, restructuring often retains a complex maturity structure, so that debt of different maturities may remain outstanding with significant differences in value.

**Series** - Term which identifies the series of a specific index, and its main characteristics. In September 2008, Markit rolled the Markit CDX IG index to series 11. Series 11 has a maturity of December 20, 2013, and fixed coupon of 150 basis points. In March 2009, Markit will roll the Markit CDX IG index to series 12.

**Settlement** – What occurs in the case of a credit event. Settlement can be cash or physical delivery, depending on the terms of the contract. Traditionally, CDS specified physical delivery but in the last three years numerous auctions have been held to allow for cash settlement.

**Short Credit** – This is the credit risk position of the Protection Buyer, who sold the credit risk of a bond to the Protection Seller.

**SNAC (Standard North American Corporate Contract)** - Defines trades confirmed on the new CDS conventions, with full coupon, subject to the Big Bang Protocol (determination committee, auction hardwiring, lookback period).

**Swap** – An agreement between two parties to exchange future cash flows or credit risk.

**Tenor** – Refers to the duration of a CDS contract. Most CDS are written with 5 year terms, and this remains the most liquid and frequently quoted part of the credit curve; however other tenors, such as the 10 year, are becoming more common.

**Tier** – Refers to one of four levels of debt in the capital structure of the reference entities. Each tier represents a different level of seniority or preference in liquidation or bankruptcy. There will generally be different levels for CDS protection for each of the tiers.

- Senior
- Subordinated
- Junior
- Preferred

**Upfront** – Refers to the initial (i.e. upfront) lump sum payment made when entering a CDS transaction. Upfront payments tend to apply to transactions where the credit quality of the entity referenced is poor – in other words, where the perceived risk of the entity defaulting is high. It ensures the Protection Seller receives a payment upon trade execution that reflects the riskiness of the contract.

**Version** - Each index series is identified by a version number. After an index rolls, the initial version will be one. To represent removal of constituents because of credit events and early termination (for LCDX), a new version of the index is published. For example Markit CDX HY 11 v1 was the version of the Markit CDX HY index launched at the roll of September 2008. After the removal of Tribune Company because of bankruptcy, a new version Markit CDX HY 11 v2 was published. After the removal of Nortel Networks Corporation, a new version was published, Markit CDX HY 11 v3.