

## Big Bang Theory

Will the move to standardize CDS contracts be good for markets?

BY MARY BROWN, CFA

The major corporate bankruptcies that occurred in 2008 rocked financial markets and shook investors. As public consciousness grew about credit default swaps (CDS), many who thought these derivatives had contributed to last year's market turbulence called for greater regulation of the over-the-counter (OTC) CDS market.

The CDS market is broad and deep. At mid-year 2009, the gross notional value of outstanding CDS contracts was US\$31.2 trillion, with approximately 1,000 actively quoted credits. The size of the market, along with AIG's near failure, has made politicians a little squeamish.

To quell detractors, Wall Street accelerated the move toward standardization of CDS contracts to prepare for central clearing. (Some have also argued that single-name CDS contracts should be traded on an exchange because, by default, exchange trading would be regulated. I will return to that issue later in the article.)

In the United States, the first step toward standardization occurred in April 2009 with the Big Bang Protocol. Europe followed with the Small Bang Protocol in July. The question is whether the outcome of these changes will be a net gain or loss for global CDS markets.

Although CDS contracts are basically insurance policies against the default of a bond issuer and a tool to manage credit risk, many investors use these securities to take a view on a particular credit and hold "naked" positions in single-name CDS contracts.

The major bankruptcies that occurred in 2008 brought about a true test of the procedures and systems developed to settle credit derivatives after a credit event. In all, 10 credit events resulting in CDS auctions occurred from September 2008 through year-end. During the cash settlement of the CDS auction for Lehman Brothers, at least US\$6 billion (and perhaps as much as US\$8 billion) changed hands. The amount is staggering, especially considering that it happened less than a month after Lehman's failure and that Lehman was a major swap counterparty. This speaks to the efficiency of the CDS auction process.

In the past, prior to standardization, most single-name CDS contracts in the United States included the following credit events as triggering events: reference-entity bankruptcy, failure to pay, obligation acceleration, repudiation, and moratorium. In addition, investment-grade CDS also included restructuring (which covered such events as a principal or interest rate reduction) as a credit event.

Prior to 2005, credit events were settled via physical

settlement. Buyers of protection actually delivered a bond to the seller of protection for par. This form of settlement worked as long as the CDS contract holder actually held the underlying bond. As CDS trading volumes increased, CDS were increasingly used as a way to make a bet on certain credits. In fact, the number of CDS contracts written outstripped the number of cash bonds. The size of the corporate bond market at the end of June 2009 was US\$6.8 trillion, whereas the gross notional value of CDS contracts was US\$31.2 trillion. If all CDS buyers of protection chose to settle the bonds physically, the result would be a nightmare. Cash settlement was introduced to make the settlement of single-name CDS contracts more efficient when credit events occurred. That change was an evolutionary step toward eventual standardization.

In the spring and summer of 2009, the International Swaps and Derivatives Association (ISDA) implemented several changes in the single-name CDS market. The first wave of changes, called the Big Bang Protocol, came in April 2009 and entailed changes for global and North American contracts. The second wave, pertaining to the European market and dubbed the Small Bang Protocol, arrived in July 2009.

ISDA's stated purpose was to standardize the contracts in anticipation of centralized clearing, thereby enhancing transparency in the CDS market. The immediate goal of the new protocol was to get a majority of swap contract holders to agree, en masse, to do three things: settle future credit events via cash by default, further specify auction settlement procedures, and standardize CDS contracts traded in North America. Previously, the auction process was voluntary and investors had to sign up for each auction protocol individually. The Big Bang gives investors the ability to "opt out" of the protocol if they want to settle their contracts outside of the auction process (using a pre-approved list of deliverable obligations). By the 7 April deadline, more than 2,000 parties had agreed to adhere to the protocol.

As part of the Big Bang, the ISDA also announced the new standard North American contract (SNAC). SNACs trade with a fixed coupon of 100 bps or 500 bps per annum. The 100 bps fixed-coupon contracts are for investment-grade reference entities, and the 500 bps coupons are for high-yield reference entities. This approach is similar to the way the CDX indices trade. The up-front payment differs based on the perceived credit risk of the underlying bond issuer, with riskier credits quoted wider.

The Small Bang Protocol applies to future European

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CDS transactions. It pertains specifically to restructuring as a credit event and “hardwires” auction settlement for restructuring credit events. The goal was to standardize the auction process for these events by creating maturity buckets tailored to fit with the remaining tenor of the CDS that had been triggered, as opposed to relying on deliverable obligations that differ from trade to trade. Standardizing the deliverable obligations meant that contracts specifying restructuring as a credit event could be brought into the auction hardwiring process.

In the past, banks in both the United States and Europe, as buyers of protection, benefited from the inclusion of restructuring as a credit event in CDS contracts. Banks could use single-name CDS to hedge their bank loan portfolios. (Banks have this type of long exposure via their loan assets—not for the purpose of taking a particular view on a credit but as a result of banking relationships and revolver commitments with corporate clients. Such arrangements are separate from banks’ proprietary trading desks.)

Banking regulations offer capital relief to encourage banks to hedge against these commitments, and banks could lay off some of their exposure by buying protection via a single-name CDS. The hedge benefit given to a single-name CDS contract under Basel II is 100 percent if the contract includes restructuring as an eligible credit event and 60 percent if it does not. Under the Big Bang Protocol, SNACs no longer include modified restructuring as a credit event. Thus, the change amounts to a 40 percent loss of hedging benefit for U.S. banks. Clearly, with restructuring as a credit event, the former contracts represented a more comprehensive hedge for capital-relief purposes.

European CDS contracts did not drop restructuring as a credit event because of the benefit it provides for capital relief under Basel II and because of the traditional contract differences between U.S. and European markets. The European CDS contract specifications that are popular in Europe are more liberal in terms of deliverable obligations, allowing buyers of protection to deliver bonds with a maturity of up to 60 months, as opposed to 30 months under the contract convention used in North America. In other words, according to Alex Yavorsky, a senior banking analyst with Moody’s Investors Service, “From a practical standpoint, the restructuring credit event presented less of a headache to administer under European convention. Therefore, the reasons for removing it—namely, that it made standardized CDS settlement auctions difficult—were not as compelling in Europe.”

In most cases, standardization serves to make a market more liquid, but the OTC CDS market was very liquid prior to the contract changes. Although the interest rate swap market is much larger, with a gross notional value of more than US\$400 trillion as of June 2009, the CDS market still had US\$31 trillion outstanding at mid-

year 2009, down from US\$54.6 trillion at mid-year 2008. This market is certainly not a minor part of global financial markets.

Will the Big Bang be beneficial? One must look at what has been gained with the new contracts versus what has been lost to determine the overall benefit to the market. Although OTC financial products are more useful to a broader range of users than a standardized one-size-fits-all solution, standardization and central clearing will benefit the market over the long term. U.S.-based market participants, including the major dealers, recognize this fact and are willing to give up customization (and hedging benefits) in the name of standardization, with the hope of proving to regulators that they don’t need “help” in the form of onerous regulation that could render the financial product useless and send business to Europe.

The removal of restructuring takes a lot of the subjectivity out of determining a credit event. This change is beneficial to the dealers and the auction process in general. Movement toward central clearing is also beneficial because it removes counterparty risk. And given the experience after the collapse of Lehman Brothers, removal of counterparty risk is a major goal of the reforms. To avoid a repeat of the global financial meltdown, central clearing—and the transparency it provides—is needed.

What has been lost? Unregulated OTC markets have the ability to be nimble, and that nimbleness can be very valuable to different market participants. Proponents of standardization have mentioned that those seeking restructuring in the U.S. market can still do one-off trades if they can find a willing counterparty. Relative to SNACs, such one-off contracts would be more expensive to acquire and practically illiquid. Even though the removal of restructuring helps make the SNAC contracts more fungible, it does remove some benefits to those participants looking to hedge this specific risk. On balance, the standardization of the contracts and their settlement is a definite positive, but standardization has never been achieved in any market without some kind of trade-off. Central clearing, already in the works, makes sense for these securities. It will accomplish the goals of improving transparency, mitigating counterparty risk, and making sure sellers of protection have “skin in the game” via margin requirements.

Exchange trading, however, is a different story. On a notional basis, the numbers are large, but the trading volume is not nearly great enough to support an active exchange-traded market. Despite a major push to reform the market quickly, the eventual goal of exchange-traded contracts may never make sense. At best, sorting out all the issues involved will take significant time. /

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