ISDA Safe, Efficient Markets

July 29 th, 2019

ISDA response to the ESMA survey on collection of evidence on undue short-term pressure from the financial sector on corporations

(Section VII. Use of CDS by investment funds).

Introduction

The International Swaps and Derivatives Association ("ISDA") thank the European Securities and Markets Authority ("ESMA") for the opportunity to comment on the ESMA survey on collection of evidence on undue short-term pressure from the financial sector on corporations.

The comments in this response reflect the membership of ISDA, which represents a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, ISDA members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearinghouses and repositories, as well as law firms, accounting firms and other service providers.

Representing the global derivatives market, ISDA's mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. Our focus is to be the source for global industry standards and legal documentation, an advocate for effective risk and capital management, a strong proponent for a safe, efficient derivatives market structure for derivatives trading, clearing and reporting, and the pre-eminent voice of the global derivatives market.

ISDA welcomes the opportunity to provide feedback to ESMA. We hope that the feedback below is timely and helpful to ESMA in preparing its interim report on the subject. We look forward to engaging in a dialogue with ESMA on the issues addressed in this response and stand ready to discuss our views in more detail and consider providing further information if useful to ESMA.

Net-short CDS as an example of undue short-term pressure from the financial sector on corporate decision-making

Section VII of the consultation on the use of CDS by investment funds questions whether taking sell-only or net sell CDS positions may indicate increased short-term risk taking by funds in order to generate short-term profits – and whether this may in turn divert funds from investment in the real economy and indirectly contribute to a short-term profit taking approach.

As discussed further below, funds and investment managers may use CDS for a variety of reasons, including as credit risk-management tools or as an alternative to bond investments. They are sophisticated investors and have the ability to appropriately assess the risk of default. In addition, mandated initial margin and variation margin, both for bilateral and cleared transactions, have a significant risk-mitigation effect in case such risk of default was underestimated.

ISDA considers it is important that investment managers are not prevented or restricted from using CDS in these ways. Use of CDS can also bring other benefits, such as increased liquidity and supply of credit to the market. We note that short-term market liquidity is an important factor in allowing long-term investors to value their assets appropriately and to invest and disinvest efficiently.

We have observed a tendency in the regulation of financial markets since the 2007-2008 financial crisis to create incentives for asset-holders to reduce the risk and duration of their investments. This has resulted in investors concentrating their holdings in the shorter-term and lower-risk spectrum of investable assets. It should thus be noted that the resulting abundance of short-term investors and shortage of long-term investors may be a factor influencing corporate decision-making.

However, we do not see investment managers taking net-sell CDS positions as a source of undue pressure on corporate decision-makers to focus on the short-term, given that the corporation will generally be unaware of the net-short CDS position(s) that investment managers may hold at any given time. Therefore, there is no clear channel through which such pressure might be exerted.

We note that the hypothesis that investors influence corporate short-termism could itself be challenged in light of the many examples of financial markets being prepared to place a high value on the long-term potential of a company at the expense of short-term profits (e.g. Netflix, Amazon, Tesla etc).

Social Utility of Derivatives

Derivatives allow the risks of variable costs and risks of production, such as the price of raw materials, interest rates, foreign exchange rates, and default risks, to be transferred from those who cannot afford them or do not have the expertise to manage them to those who can and have the expertise and appetite to take them on. Derivatives serve the needs of society to help moderate prices, supply and other risks to free up capital for economic growth and job creation. For example, derivatives allow farmers to hedge production costs and expected delivery prices. They help stabilize prices of consumer goods, they influence the price and availability of energy to heat homes and run factories, the interest rate borrowers pay on their mortgages and the return workers earn on their retirement savings.

In addition, derivatives contribute to the societally beneficial generation of information and the dissemination of that information to the public. For example, farmers can observe the price set for derivatives to determine whether they are getting a fair price for their crop.

In short, derivatives help stabilize the cost of living and are an important contributor to price transparency and information dissemination.

Overview of Credit Default Swaps

A credit default swap (CDS) is effectively an agreement to transfer the risk of default of a specific borrower (e.g. a corporate or sovereign entity) from one party to another. It allows market participants to hedge against the default of the entity referenced in the CDS contract (the 'Reference Entity').

A CDS can reference a single Reference Entity or an index or basket of Reference Entities. One party (the 'Buyer') pays the other party (the 'Seller") a fixed premium for an agreed amount or 'notional amount' of protection for a fixed period. The Buyer receives a payment upon the occurrence of a default or 'Credit Event' with respect to the Reference Entity. For a European corporate Reference Entity, a Credit Event is triggered either by a bankruptcy of the Reference Entity, a failure to pay interest or principal on (or by a restructuring of) certain debt obligations of the Reference Entity. CDS are highly standardized over-the-counter (OTC) derivatives in terms of contractual terms and definitions, trading conventions and settlement. Increasingly, CDS contracts are cleared via central counterparties (CCPs).

Developments in the CDS market

ISDA supports the many efforts of global policymakers in examining the CDS and other derivatives markets to ensure they are safe and efficient. ISDA would like to take this opportunity to highlight some of the key developments in CDS markets, particulary since the 2007-2008 financial crisis, to make them safer and more efficient – such as contract and processing standardization, the development of auction settlement, the increased use of central clearing, collateralization for non-cleared CDS, regulatory reporting and transparency. We describe these areas in detail in the Annex to this response.

Benefits of CDS

CDS allow investors to express a view on the cost of credit and has introduced a degree of transparency to the pricing of credit that did not exist before. Market participants use CDS for a variety of reasons. Below we describe the most frequently noted benefits of CDS to both their users and to the market as a whole.

CDS as an effective tool for credit risk management

CDS are an efficient risk-management solution for lenders to manage their credit exposures to borrowers. If for example, the owner of a corporate bond is concerned about the credit risk of that particular corporation (e.g. in response to a downgrade, an adverse price move, or a news event), rather than being forced to sell the bond, the bondholder can buy CDS protection on that corporation. This is a more efficient and precise way to manage credit risk. In addition to being a more efficient risk management tool, because CDS markets are more liquid than corporate bond markets, CDS are more accessible to hedgers and therefore positions can be hedged immediately – it may be that market liquidity for the bond that they are trying to sell is poor at the time they elect to reduce their exposure, making it difficult to find an acceptable price or to find a market for their

full size. In this case they could turn to the CDS market – buying protection in the relevant Reference Entity, and so neutralizing their credit exposure until liquidity improves in the cash bond market to exit their bond position at more favorable terms.

The credit risk management applications of CDS can be classified into two categories: (i) the purchase of CDS to hedge future potential losses that would be realized following the occurrence of a Credit Event; and (ii) the purchase of CDS to hedge the risk of changes in the market value of an entities' obligations, resulting from the market's expectations of future potential adverse credit related losses and other market factors.

The value of a CDS contract fluctuates based on the increasing or decreasing probability that a Credit Event will occur with respect to the Reference Entity – increased probability of such an event would make the contract more valuable for the Buyer and less valuable for the Seller. The opposite occurs if the probability of a Credit Event decreases. This increase or decrease in value can be realized by selling or novating the CDS to another party.

CDS increases the supply of credit to the market

CDS enable banks to hedge their credit risk exposures to borrowers and also frees up capital of banks to enable them to increase the supply of credit to either the Reference Entities underlying the CDS and to other firms more generally. A study conducted by ISDA in 2016, Single-name Credit Default Swaps (A Review of the Empirical Academic Literature'[1]) sheds further light on the link between CDS and bond market liquidity. According to the study, the CDS market has a positive impact on the supply of credit to many Reference Entities underlying traded CDS, suggesting that the ability of lenders to hedge their credit exposures can make them more willing to extend credit. The study cites research that finds banks make larger and longer-dated loans to CDS Reference Entities. In addition, the study sites empirical evidence suggesting that the availability of CDS often results in lower borrowing costs for corporate and sovereign entities.

CDS as a synthetic bond investment

CDS can be used by investors to take a position on the credit risk of the Reference Entity, either to add to or reduce/neutralize an existing bond position or to create a new exposure. CDS facilitate the efficient standardized trading of credit exposures, therefore investors can make a precise economic trade in the underlying bond by selling CDS protection rather than trading in an illiquid, fragmented bond market. This is particularly useful where liquidity in the underlying bond is poor, or where the CDS is implicitly cheaper than the reference entity bonds ('positive basis'). For some investors, selling CDS may also be more efficient, and less risky than using the repo market. The ability to use CDS as a synthetic bond investment also benefits hedgers by bringing additional liquidity to the CDS market.

[1] https://www.isda.org/2016/09/12/single-name-credit-default-swaps-a-review-of-the-empirical-academic-literature/

Price discovery

CDS markets generate and disseminate valuable information about a Reference Entity to the broader economy. CDS market prices reveal market participants' expectation of the probability that the Reference Entity will experience a default before the contract matures and/or that the expected recovery rate will change, often well before the bond markets.

Interestingly, the ECB's assessment of the Financial Regulatory Reform After the Crisis[2] reveals that despite more stringent liquidity and capital rules, the CDS rates of large banks are much higher than they were before the financial crisis. This suggests that creditors are more convinced than before that banks may indeed be allowed to fail, and that senior unsecured long term bonds (bank debt obligations that are both covered by CDS and subject to bail-in) will bear a disproportionate share of expected default losses, relative to deposits and other operating liabilities.

Uses of CDS by investment funds

Investment funds use the CDS market in a number of ways. As noted above, CDS are an essential risk management tool and investment funds may therefore use CDS as a portfolio hedging tool. Alternatively, they may sell CDS protection to obtain a credit exposure to the CDS Reference Entity as an alternative to buying bonds (as described above).

Some funds may look at entering arbitrage strategies involving CDS in order to exploit price discrepancies between different products. Trading strategies of this type may include:

- Basis trades, i.e. taking opposite positions in cash bonds and CDS to monetize any temporary price anomalies between the two.
- Exploiting CDS index 'skew' – this is where the trading level of a CDS index deviates from its intrinsic value implied by the market levels of the constituent CDS. Depending on the size and direction of the skew, investors will either buy or sell the index contract, and then sell or buy each of the underlying CDS, subsequently unwinding the trade once the index price normalizes.
- 'curve trading' (also used in other asset classes such as cash bonds, bond futures, and interest rate swaps), whereby market participants take opposite positions in CDS with different terms, e.g. buying a short-dated contract and selling a longer-dated one, to benefit from price inconsistencies between individual contracts referencing the same entity.

These strategies not only provide profitable trading opportunities, but importantly, they also help support market efficiency, keeping prices in line with fair value.

Additionally, sovereign CDS play a vital role in supporting investor confidence in government debt markets. They enable investors to manage their risks and so contribute to market liquidity and lower funding costs. The provision of liquidity in particular for some sovereign CDS instruments outside of trading venues is important, as such venues may not provide enough liquidity, flexibility or tailored solutions to support all trading needs in large, bespoke and/or illiquid transactions.

[2] https://www.ecb.europa.eu/pub/conferences/ecbforum/shared/pdf/2016/duffie_paper.pdf

Adverse consequences if restrictions were placed on use of CDS

It is important that investment firms are not prevented from using CDS in these ways. Placing restrictions on, for example, investment fund managers' ability to be net Sellers of CDS protection could have a number of adverse consequences if such restrictions reduce liquidity in CDS markets. In particular, it could result in a) the inability of bond holders to perform essential risk management activities involving CDS (described in the above section) and b) a decrease of the supply of credit to corporations that are Reference Entities underlying CDS and to other firms more generally as it will reduce lenders ability to hedge their exposures which may make them less willing to exted credit.

Moreover, placing restrictions on the use of CDS could negatively impact price discovery as CDS market prices would no longer be in a position to reveal all market participants' expectation of the probability that the Reference Entity will experience a default before the contract matures and/or that the expected recovery rate will change.

It should be highlighted that the risks associated with net short CDS positions have significantly diminished due to the developments in the CDS market as described in the Annex, particulary the increased used of clearing, collateral requirements for non-cleared CDS and reporting requirements:

1. Clearing - risks are spread across members of clearing houses and the clearinghouse manages the default risk including monitoring if any firm is building up large positions for which it may find difficult to maintain margin payments;
2. Collateral requirements for non cleared CDS – requirements to post margin based on the mark-to-market value of CDS contracts have reduced the risk of a large shock to the Seller when a Credit Event occurs as well as the ability of firms to build up large positions that they would not be able to settle;
3. Reporting – improved transparency resulting from regulatory reporting requirements allows regulators to monitor if any firm is building up a large position that may be of a systemic nature.

It should be also remembered that when a CDS is settled, a recovery amount is calculated – the higher the recovery amount, the less the amount that the Seller is required to pay to the Buyer. The Seller is only required to pay the full notional amount if the recovery amount is zero.

CDS and the financial crisis

We would like to conclude by addressing concerns that CDS played a major role in the 2007-2008 global financial crisis and eurozone sovereign debt crisis of 2010.

Although CDS on corporate and banking Reference Entities are a source of interconnectedness and contain information that may be valuable to policy makers in measuring systemic risk, ISDA's 2016 study

'Single-name Credit Default Swaps: A Review of the Empirical Academic Literature'[3] finds no significant empirical evidence indicating that CDS are inherently de-stabilizing or a major threat to systemic stability. Additionally, the study finds little evidence to suggest that CDS were a casual factor in the eurozone sovereign debt crisis, but instead reflected underlying fiscal problems (e.g. poor lending decisions in housing finance) in the single currency system and global macroeconomic risk factors. It is now widely acknowledged that CDS are risk-shifting tools, allowing investors to hedge credit risk in many ways, and not a primary driver behind lending decisions.

[3] https://www.isda.org/2016/09/12/single-name-credit-default-swaps-a-review-of-the-empirical-academic-literature/

Annex: Standardization/transparency of the CDS market

ISDA supports the many efforts of global policymakers in examining the CDS and other derivatives markets to ensure they are safe and efficient. ISDA is pleased to take this opportunity to highlight some of the key developments regarding the standardization and transparency of CDS markets over the last 20 years.

Documentation evolution

The 1999 and 2003 Definitions.

The first Credit Derivatives Definitions were published by ISDA in 1999 (the '1999 ISDA Credit Derivatives Definitions') and provided the basic framework for documenting CDS transactions and included standard definitions of six types of Credit Events. Prior to 1999 CDS were highly bespoke bilaterally negotiated contracts. In 2003, ISDA published an updated version (the '2003 Definitions') which brought in further standardization to, amongst other things, Restructuring Credit Events and alternative settlement procedures.

The 2009 Supplement.

Prior to 2009, a CDS Buyer bilaterally notified the Seller when it believed a Credit Event had occurred – in the event of a dispute between the Buyer and Seller that could not be resolved, the Credit Event would be subject to the determination of a court. In March 2009, ISDA released a supplement to the 2003 Definitions (the '2009 Supplement') and a protocol that implemented such supplement. This supplement created further transparency and stability in the CDS market. Under the 2009 Supplement, regional 'Determination Committees' were created, comprising of dealers and investors, to arbitrate when a Credit Event has occurred and to determine Successors to the Reference Entity.These Determination Committees make binding decisions that determine when Buyers can demand payment, following the occurrence of a Credit Event. In addition, the 2009 Supplement introduced 'Auction Settlement' as a default settlement method for CDS (we describe this is more detail below). Another significant change introduced by the 2009 Supplement was to effective dates of CDS – prior to the supplement, the effective date of a CDS contract was the day after it was traded – this caused mismatches between CDS with different trade dates. This issue was addressed by the creation of common look-back periods for Credit Events and Successors that ensured fundability between CDS contracts regardless of the date traded.

The 2014 Definitions.

In February 2014, ISDA published a new and substantively revised Credit Derivatives Definitions (the '2014 Definitions'). The changes introduced further standardization and reflected lessons-learned from experiences, including the 2008 financial crisis and the eurozone sovereign debt crisis, and implemented subsequent reforms such as bail-in legislation. Significant changes included: (i) a new Credit Event triggered by a government-initiated bail-in; (ii) introduction of the ability to settle a Credit Event by delivery of assets into which sovereign debt is converted; and (iii) the adoption of a standardized Reference Obligations across all market-standard CDS contracts.

The 2019 NTCE Supplement.

ISDA recently published the 2019 Narrowly Tailored Credit Event Supplement, which contains amendments to the 2014 Definitions to address concerns regarding narrowly tailored credit events ("NTCEs"). In summary NTCEs are arrangements with corporations that cause a credit event to occur which in turn leads to settlement of CDS contracts while minimizing the impact on the corporation. The supplement removes the incentive for a party to create such an event by amending the definition of the "Failure to Pay" to add a requirement that the relevant payment failure must result from or in a deterioration in creditworthiness or financial condition of the Reference Entity in order to trigger a settlement of the CDS contract. The changes in this supplement are important in order to maintain confidence in the effective functioning of the CDS market.

Settlement process

Physical Settlement.

Prior to 2005 most CDS were physically settled.Under physical settlement a Buyer must deliver an eligible obligation (the 'Deliverable Obligation') to the Seller in return for a cash payment equal to the notional amount stated in the relevant CDS contract. In 2005, concerns began to be expressed regarding the physical settlement process, particularly when the total value of CDS outstanding was greater than the nominal value of obligations of the Reference Entity – in such circumstances Buyers of CDS protection found it difficult to source Deliverable Obligations and realize the benefits of the CDS via physical settlement as holders of the assets would only sell them for more than they were actually worth – known as a 'short squeeze'.

Auction Settlement.

Introduced by ISDA in 2005 and hardcoded into CDS contracts via the 2009 Supplement, auction settlement was a key innovation that addressed the shortcomings of physical CDS settlement, notably the above-mentioned short squeeze. Under auction settlement, physical settlement is effectively transformed into cash settlement, whereby the price (or recovery rate) of the Deliverable Obligations is established through an auction process. In a two-phase process, a composite or 'initial market midpoint' is initially established on the basis of bids and offers submitted by CDS liquidity providers. Subsequently, clients of liquidity providers submit limit orders which together form market-clearing auction prices. The process incorporates the trading of bonds so that parties have the option to physically deliver or receive Deliverable Obligations, but only on their net open position, thereby vastly reducing the amount of bond/loan trades required to settle the outstanding CDS contracts in the market. A key benefit of auction settlement is the setting of a market-wide price – the use of the same price to settle all CDS contracts across the market eliminates basis risk for investors.

Market conventions

Standard coupons.

Since 2009, CDS have been traded on the basis of fixed coupons. CDS coupons are paid every quarter by the Buyer on fixed dates – each 20 March, 20 June, 20 September and 20 December and calculated on an Actual/360 basis. In Europe, fixed coupons for corporate CDS are either 25 or 100 basis points (for investment grade), and 500 or 1000 basis points (for high yield), while 100 or 500 basis point coupons are used in North America. In addition, a 'full first coupon' payment is made by the Buyer to the Seller on the initial coupon date. The Seller, in turn, makes a payment to the Buyer for the part of the coupon preceding the value date of the CDS contract (similar to payments of accrued interest for bonds). Benefits of standard coupons include greater operational efficiency and enhanced suitability for clearing.

Standard maturity dates

Since December 2015, the standard maturity dates for single-name CDS have been aligned with CDS indices, falling on the 20 June and 20 December each year. On each of these dates, the market moves to the next standard maturity date – i.e. from 20 June to 20 December, and from 20 December to 20 June the following year. These dates are called 'roll dates'. Similar to bonds, CDS contracts are deemed 'on-the-run' if the standard maturity date is the latest.

Standard 'Transaction Types'

Reference Entities are categorized into different 'Transaction Types' depending on the type of entity and location of that entity. This helps standardize the CDS market and assists with processing automation. An investor knows that if it trades a CDS with a party of a particular Transaction Type (e.g. the STANDARD EUROPEAN CORPORATE Transaction Type), all the terms of such CDS (including types of applicable Credit Events, Obligation Category/Characteristics, Deliverable Obligation Category/Characteristics etc.), will be the same as any other CDS of such Transaction Type that they have in place. All the terms applicable to each Transaction Type are set out by ISDA in the 'Credit Derivatives Physical Settlement Matrix'.

Transparency

ISDA believes policymakers should have the supervisory tools and authority to take action should any abuses be found in the operations of any financial market. ISDA and the industry are committed to providing regulators with complete transparency for OTC derivatives, including CDS. The Association supports proposals that require the use of, and reporting to, trade repositories for OTC derivatives.

CDS markets are now highly transparent. Trade reporting under the EMIR and MiFIR regimes has become a well-established regulatory requirement for EU firms executing CDS contracts. EMIR trade reporting has been in place since February 2014 with a substantial rewrite of the rules coming into force in November 2017. EMIR rules obligate EU firms to report a wide range of data pertaining to derivative contracts – including CDS contracts that firms enters into. This includes trade data, collateral and valuation data, and reference data. Dual-sided reporting is required under EMIR meaning both parties to a trade have a reporting obligation. The two sides to each trade are paired together and a number of key fields are

checked to ensure the details match. The purpose of EMIR trade reporting is to identify systemic risk within the market.

CDS contracts also have been reportable under MiFID II since that regime come into force in January 2018. The purpose of MiFID II is to identify market abuse and covers both transparency reporting and transaction reporting. Post-trade transparency requires firms to report to an APA within 15 minutes of trading, so there is a near real-time view of market activity. Transaction reporting provides more details of the derivative contacts, including the trade economic data and reference data. Both EMIR and MiFID II reporting requirements are periodically reviewed by regulators to ensure the data submitted by the industry is suitable and relevant for the intended purposes of each regime.

Collateraliation

In recent years, collateralizing CDS has evolved in-step with derivatives regulatory requirements. After the Pittsburgh Summit in 2009, G-20 leaders put multiple risk mitigating factors in place to reduce systemic and counterparty credit risks for OTC derivatives inclusive of CDS.

BCBS/IOSCO provided guidelines for mandatory clearing of CDX and standardized single named CDS along with uncleared margin guidelines for non-standard structured CDS. These guidelines have been translated into rules and they help ensure appropriate collateral is available to offset losses caused by an event of counterparty default. The clearing mandate requires variation margin and initial margin to be calculated and collected by CCPs. The uncleared margin rules dictate posting and collecting of variation margin and initial margin, including calculation frequency, posting/collecting frequency, eligible collateral, product scope, and segregation specifically for initial margin.

The clearing mandates began in 2013, and implementation has continued by regulatory regime since then. From March 2017, many global regulators required posting and collecting of variation margin for uncleared in-scope products. The initial margin requirements are phased in through 2021, based on the gross notional of the legal entity, and the largest global dealers started posting and collecting initial margin in September 2016.

Clearing

Aside from Interest Rate Swaps, CDS are the second class of OTC products that was deemed to be sufficiently standardized for central clearing. CDS are cleared by ICE Clear Credit in the US, ICE Clear EU in London and LCH CDSClear in Paris. The clearing rate at the end of 2017 was 55%, up from 17% in 2011[4]. Furthermore, CDS index contracts were seen by regulators as sufficiently standardized to mandate these contracts for clearing, both in the US and the EU. Clearing provides multiple advantages, for instance reduced counterparty risk, multilateral netting, operational benefits and a central valuation.

[4] https://www.bis.org/publ/qtrpdf/r_qt1806b.pdf

Moreover, empirical evidence suggests a lowering of systemic risk following the introduction of central clearing given that the relation between CDS spreads and dealer credit risk has weakened. In addition, the matched sample analysis reveals that the increased post-trade transparency following central clearing is associated with an improvement in liquidity and trading activity.[5]

Operational processing

All CDS transactions today are recorded and processed in a central data repository – DTCC's Trade Information Warehouse (TIW). The TIW is a robust infrastructure that provides market participants globally with a wide range of automated operational processing capabilities for CDS transactions, including central settlement and the processing of Notations and Credit Events. The TIW holds the most current contract for both cleared and bilateral CDS transactions held by all dealers and more than 2,500 buy-side firms and other market participants around the globe.

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[5] https://www.sciencedirect.com/science/article/pii/S0304405X13003012