



# Credit Derivatives Conventions

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# 1. Description

The global OTC Credit Derivative market encompasses a number of specific instrument types.

The principal inter-bank product is the Credit Default Swap however the other key products are Total Rate of Return Swaps, Credit Linked Notes and Credit Spread Options.

Credit Derivatives isolate the credit risk of an underlying asset and allow this risk to be transferred from the Protection Buyer to the Protection Seller.

The contracts are negotiated under standardised International Swaps and Derivatives Association Inc (ISDA) documentation. The contractual terms and definitions contained in each trade confirmation refer specifically to a market accepted publication by ISDA.

The principal credit derivative traded in the interbank market is the Credit Default Swap (CDS) although some Total Rate of Return Swaps (TROR) and Credit-Linked Notes (CLN) are also being dealt between interbank counterparties. The following market conventions relate specifically to CDS and TROR's.

## 2. Products

### 2.1. Credit Default Swap

Credit Default Swaps (CDS) are notional principal instruments that isolate and transfer the credit risk on a defined 'Reference Entity' from the Protection Buyer to the Protection Seller, in exchange for a Fixed Rate payment payable by the Buyer. Upon the occurrence of a defined 'Credit Event' during the term of the contract, the Protection Seller pays a Floating Rate payment under either Cash Settlement, Physical Settlement or an Auction Settlement mechanism.

**Auction Settlement** is the market standard for the inter-bank market. Auction settlement requires cash to be paid as the differential between 100% and a Final Price determined via an ISDA-determined Auction Process multiplied by the notional principal amount of the contract. CDS may be written against individual Reference Entities or baskets of Reference Entities, and against a range of underlying credit risks, including Corporate / Sovereign Bonds; Corporate Loans; Trade Receivable Accounts; Derivative Contracts (e.g. Interest Rate Swaps); and any other form of identifiable credit risk.

There are a number of liquid CDS baskets traded globally, for which full details of each can be obtained from the index administrator Markit™ ([www.Markit.com](http://www.Markit.com))

The most liquid basket CDS traded in Australia is the **iTraxx Australia** Index. This is an index comprised of 25 of the most liquid single name investment grade Reference Entities. The current [selection rules](#) for determining the entities are detailed hereunder:

[http://www.markit.com/cds/documentation/resource/markit\\_itraxx\\_australia\\_index\\_rules\\_05062009.pdf](http://www.markit.com/cds/documentation/resource/markit_itraxx_australia_index_rules_05062009.pdf)

The terms and conditions that govern the mechanics of the CDS are strictly contractual, and are managed under standardised ISDA documentation.

Credit Default Swap market participants are reminded that the domicile of the Reference Entity gives rise to various market standard terms. These are defined at [http://www.isda.org/c\\_and\\_a/Credit-Derivatives-Physical-Settlement-Matrix.html](http://www.isda.org/c_and_a/Credit-Derivatives-Physical-Settlement-Matrix.html)

Further information on the mechanics of Credit Default Swaps can be found at [http://www.isdacdsmarketplace.com/about\\_cds\\_market](http://www.isdacdsmarketplace.com/about_cds_market)

## 2.2. Credit Linked Notes

A Credit Linked Note is a structured, synthetic cash security, issued by a Protection Buyer to a Protection Seller against the credit default risk on a specified Reference Entity, with the redemption calculation at maturity being dependent upon the occurrence of a defined Credit Event during the life of the Note. The coupon payments during the life of the Note are priced relative to the credit risk of the Reference Entity.

The generic terms and conditions of a Credit Linked Note are similar to that of a Credit Default Swap.

## 2.3. Total Rate of Return Swap

A Total Rate of Return Swap is an off-balance sheet transaction that creates a synthetic long position for an investor (referred to as the *Total Return Receiver*) on an underlying reference instrument. In effect, the *Total Return Receiver* enjoys the total economic returns and benefits of the underlying Reference Security, including cash flows and capital gain / loss while simultaneously assuming all the market, price and credit risk exposure of the security, without actually purchasing it. In return for the total return on the underlying Reference Security, the *Total Return Receiver* pays the *Total Return Payer* a spread over the relevant benchmark, to cover the latter's balance sheet and other costs.

## 2.4. Credit Spread Options

A Credit Spread Option is a bilateral financial contract in which the Buyer pays a premium to acquire the right, but not the obligation, to buy (call option) or sell (put option) a reference obligation at a predetermined spread (strike), on a fixed date (European) or at any time preceding the expiry (American).

A Buyer would exercise a credit spread put (call) option when the credit quality of the Reference Entity has deteriorated (improved). The credit spreads represent the margin relative to some reference rate charged to compensate the investor for the risk of default of the underlying credit risk.

## **3. Dealing**

### **3.1. Collateral**

Not applicable

### **3.2. Methods of Dealing**

Direct via telephone, fax, e-mail, internet and / or Bloomberg.

### **3.3. Electronic Dealing**

As determined by and at the discretion of the CDS market participants.

### **3.4. Business Days/Trading Times**

Trading times are as the parties require, normally 8:00am to 5:00pm in the physical location of the trading counterparties.

Business Days are to be negotiated bi-laterally at the time of dealing and specifically defined in the trade Confirmation as per the ISDA Standard Australia and New Zealand "Physical Settlement Matrix" found via: [http://www.isda.org/c\\_and\\_a/Credit-Derivatives-Physical-Settlement-Matrix.html](http://www.isda.org/c_and_a/Credit-Derivatives-Physical-Settlement-Matrix.html)

A Business Day is defined as any day on which banks are open for business in Sydney, New York and London (except Saturdays and Sundays).

Business Day Convention: Following (which, subject to Sections 1.4 and 1.6 of the ISDA Credit Derivatives Definitions, shall apply to any date referred to in this Confirmation that falls on a day that is not a Business Day).

#### **3.4.1 Good Business Day**

A Good Business Day is defined as any day on which banks in the State of New South Wales (NSW) are generally open for business, or a day other than one on which banks in NSW (Sydney) are obliged or permitted to close - specifically excluding Saturday and Sunday.

Essentially, Sydney or NSW business days are weekdays (Monday to Friday) other than NSW public holidays as gazetted under the NSW State Government's Banks and Bank Holidays Act 1912.

It is noted however that Australian OTC markets generally tend to operate in a reduced capacity on gazetted NSW public holidays that are not similarly gazetted in Victoria.

#### **3.4.2 Non Business Day**

A non-Business Day is defined as any day on which banks in the State of New South Wales (NSW) are generally obliged or permitted to close - including Saturday and Sunday.

**AFMA recommends that transactions should not be negotiated for settlement or price fixing (rollover) on a non-business day.**

It is noted however that Australian OTC markets generally tend to operate in a reduced capacity on gazetted NSW public holidays that are not similarly gazetted in Victoria.

### **3.5. Standard Transaction Size (market parcel)**

The notional amount of each transaction is USD5million unless otherwise specified and agreed to by the parties at the time of dealing.

Parties that have trading interest in sizes or currencies other than this market standard must specify as such at the time of stating their bid/offer.

### **3.6. Two-Way Pricing**

This refers to the practice where the counterparty quotes simultaneous bid and offer premiums for a given credit and term/maturity. Two-way prices may be shown through the broker market without disclosure (i.e. the same counterparty is on both sides of the position), or directly on a bilateral basis with disclosure.

Counterparties are not obliged to quote two-way prices, and may choose only to quote either a bid or offer premium against a given interest, unless otherwise specifically agreed to in advance.

### **3.7. Quotation and Dealing**

#### **3.7.1. Credit Default Swaps**

The **Fixed Rate** paid on a CDS transaction by the Protection Buyer to the Protection Seller is a basis point premium that has no reference to an interest rate benchmark. It is paid quarterly in arrears, in accordance with the agreed Day Count Convention and on the agreed Fixed Rate Payment Date(s).

Under Standard Australia and New Zealand Contract terms the **Fixed Rate** has been agreed to be quoted on a market standard basis as either **100bps or 500bps**.

The Dealt Rate is then applied to discount the Fixed Rate premiums and derive an upfront cash settlement on the transaction as determined under a standard model available at CDSW screen on Bloomberg, or at <http://www.cdsmodel.com/>.

Trades on the iTraxx™ index and under the Australia and New Zealand Standard have a fixed coupon and effective date, usually the first day of trading for a new index, and an upfront fee will be payable to reflect the difference from the coupon to the current market level and adjusting for any accrued interest.

Quoting convention is 'bid / offer', where 'bid' is the Fixed Rate the Protection Buyer will pay, and the 'offer' is the Fixed Rate the Protection Seller will receive.

### **3.7.2. Credit Linked Notes**

The spread paid by the Issuer of a Credit Linked Note is referenced to an agreed interest rate benchmark, depending on the denomination of the transaction (typically BBSW or USD-LIBOR). The terms governing the treatment of CLNs are the same as those for generic Debt Securities.

### **3.7.3 Total Rate of Return Swaps**

Conventions governing Total Return Swaps are negotiated bilaterally between the counterparties, and defined under the contractual terms of the transaction. ISDA has published the 2007 Master Corporate Bond Total Return Swap Confirmation Agreement.

## **3.8. Other Instrument Conventions**

### **3.8.1 Trading**

Having agreed to the contract terms as outlined under *Section 3.8.4 below*, inter-bank counterparties trading CDS and TRORS are considered to be 'dealt' as of the Trade Date. This notwithstanding, counterparties *may* specifically stipulate on the Trade Date that completion of the deal is conditional upon:

- **Credit** - A Buyer may require (internal) confirmation of counterparty credit limits on the Seller, and / or Seller may require (internal) confirmation of credit limits on the Reference Entity
- **Documentation** - Negotiated details of trades will be recorded on confirmations as per the ISDA Standard Physical Settlement Matrix with the confirmation to act as the final reference documentation to resolve any potential disagreement between parties.

### **3.8.2 Contract Terms**

The contractual terms for a credit derivative transaction between the counterparties remains subject to bilateral negotiation, however (at the time of writing), the terms below are accepted as the market standard CDS conventions.

Required deviations / alterations to these market standard terms should be clearly stated by the appropriate counterparty *at the time* that counterparty's dealing interest is stated. Required deviations / alternations may be communicated either verbally, by written or electronic mail, or with an indicative term sheet.

If no deviations / alterations are stated by either party at the inception of the transaction, the following standard market conventions shall be deemed to apply.

### 3.8.3 Confirmation

All CDS transactions are documented under a Confirmation form, incorporating the definitions and provisions contained in the most current ISDA Credit Derivatives Definitions as published by the International Swaps and Derivatives Association

### 3.8.4 ISDA® Documentation

Where the transaction counterparties already have an ISDA Master Agreement in place, the terms of the CDS will supplement, form part of and be subject to that Master Agreement. Where there is no ISDA Master Agreement, the counterparties agree that the CDS Confirmation evidences a complete and binding agreement between them, and that they will use all reasonable efforts to negotiate, execute and deliver an ISDA Master Agreement as promptly as possible.

#### 3.8.4.1 Trade Date

The business day on which the counterparties agree:

- Reference Entity;
  - (Reference Obligation is agreed to be that specified by Markit Partners Reference Entity Database (RED) available as REDL command under Bloomberg or at [www.markit.com](http://www.markit.com))
- Notional Amount and Denomination;
- Scheduled Termination Date;
- Fixed Rate Payment (premium level) - agreed at 100bps or 500bps
  - Upfront Cash Settlement amount determined by reference to the standard CDS model as available through Bloomberg CDSW screen or at <http://www.cdsmodel.com/>

Other Standard Australian Corporate contract terms are documented at ISDA and available at the following link: [http://www.isda.org/c\\_and\\_a/Credit-Derivatives-Physical-Settlement-Matrix.html](http://www.isda.org/c_and_a/Credit-Derivatives-Physical-Settlement-Matrix.html) Counterparties should highlight any deviations from the accepted market conventions, as stated herein, at the outset of the transaction. Where such non-standard deviations have been highlighted, the Trade Date will become the date on which the counterparties have agreed to all the above terms of the transaction and all of the proposed deviations.

#### 3.8.4.2 Effective Date

The trade date *plus* one Calendar Day.

#### 3.8.4.3 Calculation Agent

Seller

#### **3.8.4.4 Fixed Rate Payer Payment Dates**

Quarterly, in arrears, on that date of the month that is the same as the Scheduled Termination Date, and inclusive of the Scheduled Termination Date. eg : a Scheduled Termination Date of 20<sup>th</sup> June 2011, would mean Fixed Rate Payer Payment Dates on the 20<sup>th</sup> day of each March, June, September and December.

The first Fixed Rate Payment Date may be long (or short) to match the above dates.

### **3.9 Basis**

Basis quotation depends on the denomination of the transaction. AUD trades are quoted as actual/365 (Fix) and USD are quoted actual/360, using simple interest calculation payable in arrears.

### **3.10 Maturity Conventions**

Unless otherwise stated, scheduled maturities will be rolled to the next quarterly date, being the 20<sup>th</sup> of March, June, September or December. Thus, a five year trade dealt on March 15<sup>th</sup> 2008, or March 19<sup>th</sup> 2008, will terminate on March 20<sup>th</sup> 2013, and a five year trade on March 20<sup>th</sup> 2008 will terminate on June 20<sup>th</sup> 2013. The iTraxx™ indices are by convention rolling twice a year, with maturities in June and December.

### **3.11 Settlement Rate or Index**

Not applicable.

### **3.12 Premium Payment Date(s)**

As agreed by the counterparties and documented under Fixed Rate Payer Payment Dates.

### **3.13 Expiry Conventions**

The terms governing exercise / trigger are governed by the terms set out in the ISDA Standard Physical Settlement Matrix located here: [http://www.isda.org/c\\_and\\_a/docs/Credit-Derivatives-Physical-Settlement-Matrix.html](http://www.isda.org/c_and_a/docs/Credit-Derivatives-Physical-Settlement-Matrix.html)

### **3.14 Broker Conventions**

Quoted markets are for agreed market standard terms unless otherwise specified.

### **3.15 Confidentiality**

Given the nature of the underlying risk being transferred via the Credit Derivative product, counterparties agree that there is an implicit duty of confidentiality between them relating to disclosure of the details of any credit derivative transaction. Such a duty is deemed to apply to the counterparty as an individual and as an institution.

In addition to the above, the counterparties are free to execute bilateral Confidentiality Agreements as deemed necessary.

### **3.16 Credit**

Under a Credit Default Swap transaction, the following credit risks arise:

- The Seller takes direct credit risk on the Reference Entity;
- The Buyer takes counterparty / replacement credit risk on the Seller.

Dealings between two inter-bank counterparties will be automatically deemed to not require prior authorization of credit absent a stipulation from the outset and within the confirmation that the transaction is "subject to credit" approval.

### **3.17 Exercise of Options**

Not applicable.

### **3.18 Pricing Formula**

This is the standard for determination of the upfront amount when entering into a CDS as per the ISDA CDS Standard Model. This also applies for termination of existing deals.

### **3.19 Data Source**

Not applicable.

## **4. Confirmations**

### **4.1. Obligations of Dealers**

All trades must be confirmed in writing, in accordance with the conventions and conditions as outlined in section 3.8 above. The counterparties agree to negotiate the documentation in good faith and, using all reasonable efforts, to promptly negotiate, execute and deliver the Confirmation.

Dealers should ensure that tickets are produced in a timely fashion to allow for compliance with *Section 4.1*.

### **4.2. Documentation**

ISDA documentation and definitions apply, (*refer section 3.8.6.*) as per the most current ISDA Credit Derivatives Definitions, and any accompanying supplements as published time to time by the International Swaps and Derivatives Associations Inc.

The Protection Seller will prepare the documentation for the transaction (being indicative term sheets, draft and final confirmations) unless otherwise agreed to by the counterparties.

## **5. Settlements**

### **5.1. Physical Settlements**

The Terms Relating to Physical Settlement are governed by the ISDA Credit Derivatives Definitions, and the individual Confirmation

### **5.2. Cash Settlements**

The Terms Relating to Cash Settlement are governed by the ISDA Credit Derivatives Definitions, and the individual Confirmation.

### **5.3. Premium/Fixed Rate Payments**

Premiums / Fixed Rate Payments are payable by the Protection Buyer to the Protection Seller, in accordance with the terms set out by the ISDA Credit Derivatives Definitions, and the individual Confirmation.

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