CREDIT DERIVATIVES:
Mastering Key Legal and Documentation Issues
Minimizing Legal Risks Amid the Credit Market Crisis

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Overview of Credit Derivatives

Growth in the Volume of Credit Derivatives

- Outstanding credit derivatives have increased tenfold between 2004 and 2007, from $5 trillion notional amount to $51 trillion notional amount, according to the Bank for International Settlements December 2007 Triennial Survey.

- Credit is the fastest growing segment of the over-the-counter derivatives markets.

- Credit derivatives are a component of some of the complex structured transactions and structured products involved in the current credit crisis.

- Credit derivatives are instruments which isolate credit risk and allow parties to transfer that risk.

- At inception, credit derivatives were intended to allow a lender to take the credit risk of a customer out of its portfolio while retaining the customer relationship.

- The market for credit derivatives has grown as participants have stepped in to take positions on credit.

  – Buy credit protection if pessimistic view on credit.

  – Sell credit protection if expect creditworthiness of reference entity will be strong.

- In a single name credit default swap the buyer of credit protection on a particular company (the “reference entity”) pays a fee to the seller of credit protection. Upon the occurrence of specified credit events, the seller of protection makes a payment to the buyer.

- Credit derivatives can be physically settled (payment of pre-determined amount against delivery of obligations of the reference entity) or cash settled (payment of difference between a predetermined amount and the market value of predetermined obligations of the reference entity, with no delivery of obligations).

- Substantial growth of the market creates challenges for orderly settlement process.

Types of Credit Derivatives

- Single name credit default swaps
  - Credit protection on one reference entity
- First to default transactions
  - Credit protection on a basket of reference entities. Payout only upon the first to default.
- Nth to default transactions
  - Credit protection on a basket of reference entities. Payout on the nth to default.

- Credit default swaption
  - Right to buy or sell credit protection in the future at a specified rate
- Index Transaction
  - Credit protection on all names in an index
- Credit Linked Notes
  - Investor buys the note; receives principle and interest if no credit event; receives obligations of reference entity if credit event occurs.
- CDOs
  - Cash: tranched notes backed by a pool of assets
  - Synthetic: tranched structure based on credit default swaps

Credit Derivatives vs. Insurance

- Like insurance products, credit derivatives pay the buyer of protection upon the occurrence of specified adverse events.
- States have licensing requirement for entities engaged in insurance business.
  - State by state insurance laws
  - New York: monetary penalties for failure to obtain insurance license

- Is the seller of protection selling an insurance product or engaged in insurance business?
  - Look at the laws of relevant states
  - New York law gives some guidance
    - June 2000 interpretive letter of New York Insurance Department: credit default swap is not insurance because the seller of protection pays upon occurrence of specified event without regard to whether the buyer of protection has suffered a loss.
    - February 2000 interpretive letter of New York Insurance Department: weather derivative is not an insurance contract because payment is not dependent upon the buyer suffering a loss.

- Factors to consider
  - Nature of the product
    - Is payment tied to actual loss?
    - Can buyer transfer underlying assets without consent of or notice to seller of protection?
  - Nature of the business
    - Are credit derivatives the primary business of the seller of protection?
    - Who is protection sold to?

Index Transactions and Tranche Trading

- Index is a basket of reference entities, with rules for construction. Index composition is updated periodically.
- Examples
  - CDX indices
  - ABX indices
  - CMBX indices
  - iTraxx indices
- Indices increase liquidity and transparency in the credit derivatives market and allow exposure to a broad array of names.

- Market makers quote prices on index transactions.
- Credit default swap on an index of 100 names is effectively 100 single name credit default swaps.
- Upon the occurrence of a credit event with respect to one name in the index, the swap on that name will be settled and the name will be removed from the transaction.
- Index transactions significantly increase the volume of credit derivatives with respect to each name and multiply settlement complexity.
- Tranched index products allow a party to choose the degree of risk and the amount of leverage it prefers by selecting attachment and detachment points. Pricing is more transparent for standard tranches.

Regulators' Concerns

- General
  - Over-the-counter derivatives have historically been given light regulatory treatment.
  - Trades based on non-agricultural products not executed on a trading facility are unregulated as long as they are between "eligible contract participants."
  - Lawmakers have been cognizant of the need for innovation to keep US capital markets competitive.
  - Need for innovation must be balanced against systemic risk.

- Insider Trading
  - Insider trading is on the radar screen of the SEC
    - Increase in activity or pricing of credit derivatives referencing an entity just before a major announcement about that entity raises concern about insider trading.
    - SEC officials have noted the concern.
    - Does the buyer or seller of protection have material non-public information?
    - Is the derivative instrument a security?
    - For physically settled credit default swaps, is delivery of an obligation for purposes of settlement a sale of the security?

- Volume of Unconfirmed Trades
  - Concern over the volume of undocumented transactions was expressed by the U.K. Financial Services Authority in a February 2005 letter to financial institutions.
  - President of the New York Federal Reserve Bank expressed similar concerns in April 2005.
  - Undocumented transactions include initial transactions as well as assignment of transactions.
  - Transactions may be agreed to by phone, but the documentation lags behind.
  - The New York Federal Reserve Bank sought dealer accountability by obtaining a commitment from the dealer community to reduce the backlog of undocumented transactions and to increase efficiency in documenting new transactions.

- A series of meetings beginning in September 2005 between major derivatives dealers and the New York Federal Reserve Bank resulted in several commitments by the dealers.
- Meetings first addressed credit derivatives, then equity derivatives.
- Commitments included:
  - Successive timelines and targets for reduction in the backlog of unconfirmed transactions
  - Increased use of electronic processing of confirmations
  - Greater standardization of documentation
  - Improved settlement mechanism for credit default swaps
  - Implementation of ISDA's Novation Protocol

- Commitments are documented in letters to the New York Federal Reserve Bank dated October 4, 2005, December 16, 2005, March 10, 2006, November 21, 2006, May 15, 2007, October 24, 2007, and March 27, 2008.

- Initial participants in the efforts were fourteen derivatives dealers. The group grew to include four additional dealers and buy side representation (Managed Funds Association and Asset Management Group of SIFMA) as well as ISDA.

- Systemic Risk
  - Risk of events having a widespread impact
  - Examples:
    - Long Term Capital Management
    - Backlog in derivatives documentation
    - Bear Stearns
  - Who is responsible for managing systemic risk?

- Government attempts to address systemic risk
  - Bankruptcy code and bank insolvency law
  - President's Working Group on Financial Markets March 2008 Report
- Industry efforts to address systemic risk
  - ISDA's Settlement Protocols
  - ISDA's Novation Protocols
  - ISDA's Monoline Supplement Agreement

- Going Forward
  - The Department of the Treasury's March 2008 Blueprint for Modernized Financial Regulatory Structure
    - Federal Reserve Board would be charged with the responsibility for "overall issues of financial market stability"
    - No specific regulation of over-the-counter derivatives recommended
  - Will there be greater regulation of derivatives as a result of the current credit crisis?