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Credit Derivatives: Mastering Key Legal and Documentation Risks

Documentation and Operational Risk Issues

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Documentation and Operational Risk Issues

- Documentation Basics for Credit Derivatives
- Succession Events and Related Considerations
- Rating Agency Requirements
- Confirmation and Settlement Issues

Documentation Basics for Credit Derivatives

Standard Derivatives Documentation Architecture

- ISDA Master Agreement
- Schedule
- Credit Derivatives Definitions
- Confirmation
- Credit Support Documents

Documentation Basics for Credit Derivatives

Credit Derivatives Definitions

- 2003 Credit Derivatives Definitions
- Supplements:
  - 2003 Supplement
  - 2005 Monoline Supplement
  - Other Supplements
    - Secured Deliverable Obligation
    - Delivery Restrictions

Documentation Basics for Credit Derivatives

- Additional Documentation
  - Master Confirmation Agreements
  - Physical Settlement Matrix
    - Corporate
    - Sovereign
  - Standard Terms Supplements
    - Movement away from signed master confirmation agreements

Documentation Basics for Credit Derivatives

- Single-Name Product-Specific Forms
  - Syndicated Secured Loan Credit Default Swap (LCDS)-US
  - Leveraged Loan Credit Default Swap-European
  - Credit Default Swap on MBS
  - Credit Default Swap on CDO
- Index/Basket Product-Specific Forms
  - CDX
  - LCDX
  - LevX
  - ABX
  - CMBX
- Bespoke Index/Basket Documentation

Novation Documentation

- 2004 Novation Definitions
  - Basic form confirmation for 3-way and 4-way novations
- Novation Protocol
  - Intended to address undocumented, or improperly documentation, novations
  - Intended to create uniform practices for CDS novation
    - Clarify obligations of transferor, transferee and remaining party
    - Confirms requirement to obtain remaining party consent
    - Time frame for requesting and receiving consent
    - If consent not granted, transferor and transferee deemed to have entered into a back-to-back transaction

Succession Issues

What happens to CDS if Reference Entity merges or transfers assets?

- Does CDS protection transfer to the successor entity?
  - Possibility of multiple successor entities?
- Or is there a risk of being left with protection on a reference entity that has no outstanding debt (known as "orphaned CDS")?

- Key definition: Succession Event

Succession Events

Succession Event

- Merger, consolidation, transfer of assets or liabilities, spin-off or similar event in which one entity succeeds to obligations of another entity, whether by agreement or by operation of law
- Does not include exchange offers, unless in connection with one of the foregoing events
- Test for succession under Credit Derivatives Definitions looks at whether an entity "succeeds" to "Relevant Obligations" of the Reference Entity by way of a Succession Event

Succession Events

Succession Event

- "Succeed"—An entity (i) assumes or becomes liable for Relevant Obligations of the Reference Entity or (ii) issues Bonds in exchange for the Relevant Obligations and, in either case, the Reference Entity is no longer an obligor or guarantor on the Relevant Obligations
- "Relevant Obligations"—Obligations that are Bonds or Loans outstanding immediately prior to the effective date of the Succession Event, excluding interaffiliate debt

Succession Events

Results:

- Each entity that succeeds to more than 25% of the Relevant Obligations of the Reference Entity pursuant to a Succession Event will be a "Successor"
- If no entity succeeds to more than 25% of the Relevant Obligations, and the original Reference Entity ceases to exist, the entity succeeding to the greatest portion of the Relevant Obligation will be the sole Successor
- If no entity succeeds to more than 25% of the Relevant Obligations, and the Reference Entity continues to exist, the Succession Event will be deemed not to have occurred

Succession Events

Results:

- If multiple Successors, the CDS will be split evenly into new transactions referencing each Successor as a Reference Entity
- If multiple Successors and the original Reference Entity remains obligated under more than 25% of the Relevant Obligations, the CDS will be split evenly into new transactions referencing each Successor and the original Reference Entity as a Reference Entity

Succession Events

Certain Considerations

- Provisions for Succession Events can lead to different outcomes between CDS and cash bonds and loans of a Reference Entity
- CDS will not necessarily follow the entity that succeeds to the Reference Obligation, if any
- May have undesired result where CDS is used to hedge a specific obligation
- If original Reference Entity remains liable as guarantor (including “upstream” guarantor), there will not be a Successor

Succession Events

Orphaning

- Example: Reference Entity repays existing debt, and new financing is obtained by a different entity in the corporate group
- Not a Succession Event
- Even if no Deliverable Obligations outstanding, Protection Buyer under CDS still obligated to make premium payments for remaining term of CDS
  - Potentially different result under Loan CDS form of documentation
- Risk of orphaning can affect design of corporate transactions
  - In light of influence of bondholders that hedge in CDS market, companies have structured refinancings/reorganizations to constitute Succession Events and to avoid CDS orphaning

Rating Agency Requirements

- Credit derivatives are often incorporated into capital markets instruments:
  - Credit-linked notes
  - Credit-linked certificates
  - Synthetic CDOs
- These structures may involve a CDS between the issuer of the instrument and a dealer
  - Both “corporate” and ABS CDS
  - Increasing use of LCDS as well
- Where the instruments are rated by credit rating agencies, documentation for the CDS will need to comply with specific rating agency criteria

Rating agency requirements

- Limitations on events of default and termination events
  - Restricts ability to terminate transaction as a result of event relating to issuer
  - Disapplies "soft" events of default (e.g., breach of representation, breach of agreement)
- Rating requirements/downgrade threshold for dealer
  - If required ratings not maintained, dealer may be required to:
    - Post collateral
    - Prepay fixed premiums
    - Transfer to a replacement dealer meeting the rating requirements
    - Obtain a guarantee of its obligations from a guarantor meeting the rating requirements

Rating agency requirements

- Where transaction permits substitution of reference entities or other portfolio changes, criteria may be subject to rating agency guidelines and tests
- Limitations on amendments, modifications, assignments
  - Rating agency consent may be required

Confirmation and Settlement Issues

Problem: Significant backlog in CDS confirmations

- Additional operational/legal problems with novations

Result: "Fed Letter" process

- Group of major dealers (now 18) committed to FRBNY to improve OTC derivatives industry practices
  - Initial Focus: Credit Derivatives
  - Beginning in September 2005

Confirmation and Settlement Issues

Fed Letter Process

- Key commitments include:
  - Reduction in confirmation backlog
  - Improvements in netting procedures
  - Electronic trade confirmation and processing
  - Improvement in settlement

Confirmation and Settlement Issues

Fed Letter Process-Results

- Since 2005, among participating dealers:
  - Electronic processing of 90% of eligible credit derivatives
  - Reduced confirmations outstanding more than 30 days by 85%
  - Improvements in novation practices
- Continued concern with high volume of CDS trades, including during market stress
- Operational issues are ongoing focus of President's Working Group on Financial Markets

Confirmation and Settlement Issues

Electronic Confirmation

- Allows participants to electronically submit trade details for matching and confirmation
- Can be done manually or by “straight through processing”
- Templates for different product types (single-name, index, MBS)
- Can be used to confirm different types of transactions/events
  - New trades
  - Amendments of existing trades
  - Assignments and novations
  - Terminations

Confirmation and Settlement Issues

Electronic Confirmation

- System compares trade details from both parties and determines if they match
- If details match, confirmation system generates electronic record that replaces signed paper confirmation
- If details do not match, participants can resolve the discrepancy
- Examples:
  - DTCC Deriv/SERV
  - Swapswire

Confirmation and Settlement Issues

Additional Processing

- "Transaction Warehouse"
- Uses data from electronic confirmations (and other sources) to maintain an electronic record of the current state of a transaction
- Intended to capture all significant events over the term of a transaction, including:
  - Amendments
  - Terminations
  - Credit Events and Settlements
  - Other Adjustments
- Intended to be a definitive record of the transaction
  - Replaces the need for paper documents
  - Single source for all parties to determine transaction terms

Confirmation and Settlement Issues

Payment and Settlement

- Use of electronic data for automated payment calculation
- Link to credit event protocol/auction settlement process
- Goal of automated, centralized settlement
  - Example: DTCC-CLS Link
  - Fed letter: Commitment to centralized settlement among major dealers by fall 2008
  - Participation by "buy-side"?
- Possibility of clearing
  - The Clearing Corporation proposal