

ISDA Statement on Settlement of a Monoline Credit Event

ISDA members have noted that, in the current financial environment, it is prudent for ISDA to ensure that if a credit event occurs in respect of a widely traded reference entity, ISDA and market participants are prepared to implement a settlement auction or other mechanism that will serve the credit default swap market's needs. ISDA recognized early on that a credit event in respect of a monoline financial guaranty insurance company (a "Monoline") would present unique settlement challenges. This note explains ISDA's anticipated approach to settlement of a Monoline bankruptcy or failure to pay credit event. This note summarises the outcome of a long period of discussion and consideration by ISDA and its members. Its publication is not connected with events in relation to any particular entity and does not indicate that ISDA believes that a credit event with respect to any particular entity or class of entities is imminent or likely.

ISDA has in the past facilitated settlement of CDS transactions referencing corporate reference entities, using a final price determined by an auction. However a Monoline credit event would present unique and as yet untested settlement challenges due to the wide range of obligations guaranteed by the Monolines and the expected price dispersion of those obligations following a credit event. To address the Monoline-specific issues, ISDA convened a working group of CDS dealers with input from active end-users to determine whether to use an auction to settle a Monoline credit event.

One of the first tasks undertaken by the working group was to gather and disseminate information as to the range of obligations that market participants believe may be delivered upon the occurrence of a credit event under a standard Monoline CDS contract. ISDA has published lists of these obligations on its website, but these lists are only indicative and the appearance or non-appearance of an obligation on a list is not determinative of whether that obligation would be deliverable under a Monoline CDS. Following this work, the consensus of the group was to use the auction methodology previously tested for corporate credit events to settle a Monoline credit event, with one key difference. It was determined that the auction terms should not specify an exhaustive list of obligations that are deliverable, but that instead the deliverable obligations should be determined using the same requirements that apply to a standard CDS contract referencing a Monoline. This differs from past practice in that prior auctions had an exhaustive list of deliverable obligations that were individually specified in the relevant protocol. This difference reflects the range and number of obligations guaranteed by the Monolines.

ISDA therefore anticipates that, if a bankruptcy or failure to pay credit event were to occur in respect of a Monoline insurance company with a sufficiently high trade volume, including any Monoline insurance company that is a constituent reference entity in any index, a CDS protocol would be published. This protocol would allow parties to cash settle certain CDS transactions at an auction-generated final price, whilst preserving the ability to request physical settlement on net positions for parties that wish to do so, in the same manner as for a corporate credit event. The transactions covered by the protocol would be those that reference the relevant Monoline, i.e. that specifically reference the insurance company (as opposed to a holding company), and that are documented using the 2003

ISDA Credit Derivatives Definitions and one of the two published forms of monoline supplement. The difference outlined in the paragraph above would be effected in the CDS protocol by listing the deliverable obligation category and deliverable obligation characteristics (based on standard ISDA documentation) that any deliverable obligation would need to satisfy, instead of including a list of the specific individual deliverable obligations.

Separately ISDA is working to “hardwire” the auction terms as part of the standard CDS documentation for corporate reference entities, in the first instance for bankruptcy and failure to pay credit events. For the reasons outlined above, Monoline credit events are currently excluded from the scope of the hardwired standard auction terms.

The challenges outlined above do not exist for monoline holding companies and in the event of a monoline holding company credit event, if the decision is to hold an auction, it is expected that the existing auction methodology would be applied.