



June 23, 2009

# Applying Auction Settlement to Restructuring Credit Events

# Background

- Restructuring under the 2003 ISDA Credit Derivatives Definitions
  - Old R
  - Mod R
  - Mod Mod R
- Old R
  - No maturity limitations or additional restrictions on Deliverable Obligations
- Mod R
  - Restructuring Maturity Limitation Date
  - Fully Transferable Obligation
- Mod Mod R
  - Modified Restructuring Maturity Limitation Date
  - Conditionally Transferable Obligation

# The Auction Problem – What can be valued?

- Restructuring Maturity Limitation Date/  
Modified Restructuring Maturity Limitation Date
  - Limitations based upon Scheduled Termination Date of relevant Transaction
    - Mod R – RMLD earlier of (a) 2.5 years following the Restructuring Date and (b) latest final maturity date of any Restructured Bond or Loan. Never earlier than Scheduled Termination Date.
    - Mod Mod R – MRMLD later of (a) Scheduled Termination Date and (b) either (i) 5 years following the Restructuring Date for Restructured Bond or Loan or (ii) 2.5 years following the Restructuring Date for all other Deliverable Obligations
  - What is deliverable for a Transaction with one Scheduled Termination Date may not be deliverable for a Transaction with a different Scheduled Termination Date
  - Auction methodology requires a single list of Deliverable Obligations

# The Auction Solution for Mod R/Mod Mod R

- Multiple Auctions to be held for each Restructuring
- Allocate Transactions to Maturity Buckets by reference to Scheduled Termination Date
  - 8 Maturity Buckets – each Maturity Bucket runs from the Restructuring Date to the IMM Roll Date occurring on or immediately following the dates below:
    - 2.5 yr/ModMod 5 yr
    - 5 yr
    - 7.5 yr
    - 10 yr
    - 12.5 yr
    - 15 yr
    - 20 yr
    - 30 yr
  - For Mod R only, there may be an additional (pre-2.5 yr) Maturity Bucket
- Seller triggered Transactions all go to the 30 yr Maturity Bucket

# Maturity Buckets

- A Transaction is allocated to a Maturity Bucket if the Scheduled Termination Date of the relevant Transaction occurs on or prior to the Maturity Bucket End Date of the relevant Maturity Bucket (and after the Maturity Bucket End Date of any shorter dated Maturity Bucket) – subject to Rounding Down Convention
- The relevant DC will determine whether or not to hold an Auction for Transactions assigned to a Maturity Bucket, based upon DTCC trade data
- The relevant DC will generate lists of Deliverable Obligations for each Maturity Bucket whenever one or more Auctions will be held
- Maturity Bucket concept will apply in all circumstances, including where the relevant DC is not asked to determine whether a Restructuring has occurred

# Deliverable Obligation Lists

- A Deliverable Obligation will be assigned to a Maturity Bucket if its final maturity date is on or prior to the Maturity Bucket End Date
- Exception: ModMod 5 yr Maturity Bucket
  - Restructured Bonds or Loans with a final maturity date up to 5 yrs after the Restructuring Date will be deliverable to settle a Transaction with a Scheduled Termination Date occurring 2.5 yrs or less after the Restructuring Date
- All Deliverable Obligations assigned to a Maturity Bucket will be “deliverable” for purposes of Maturity Buckets with longer dated Maturity Bucket End Dates

## Rounding Down Convention

- If a Transaction has been assigned to a Maturity Bucket that contains no Deliverable Obligations with a final maturity date occurring on or prior to the Scheduled Termination Date, then such Transaction will be reassigned to the appropriate earlier Maturity Bucket
  - Eg: Transaction ST Date : 8yrs away  
Assigned to 10yr Maturity Bucket  
Only 9yr Bonds and 4yr Bonds  
Transaction moved to 5yr Maturity Bucket –  
skips the 7.5yr Maturity Bucket

## Requirement to trigger

- Unlike other Credit Events, if the DC determines that there has been a Restructuring, there is an Event Determination Date will not occur automatically
- Buyer and/or Seller retain the freedom to decide whether or not to trigger settlement following a Restructuring
- Once a Credit Event Notice is sent, if an Auction will be held, the date that the question was raised to the DC will be the common Event Determination Date
- In order to settle based upon the Auction, a Credit Event Notice must be effectively delivered prior to the **Exercise Deadline** (COB on the 5<sup>th</sup> Business Day following publication of the final list of Deliverable Obligations)



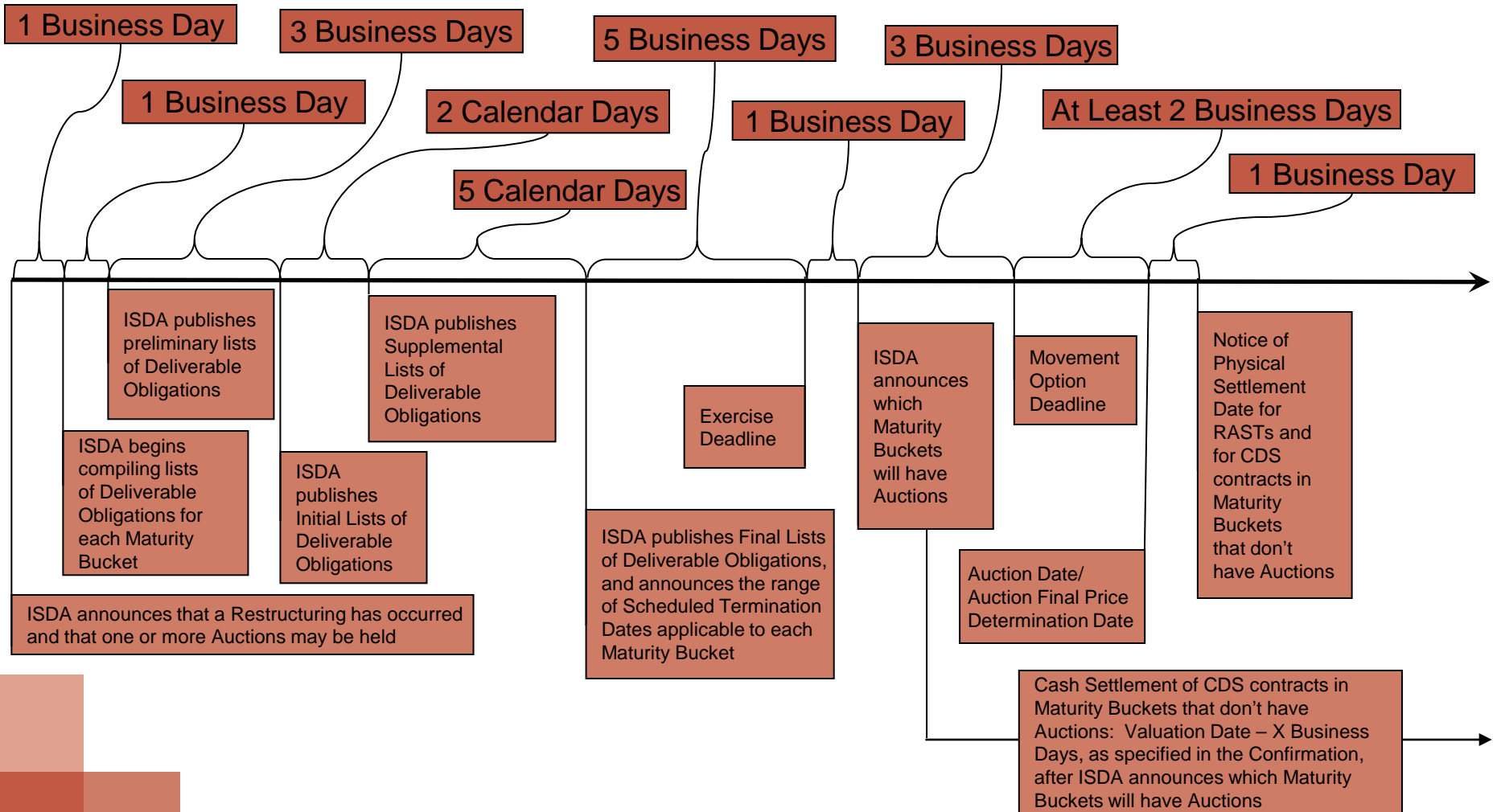
## Decision to hold one or more Auctions

- The DC will decide whether to hold an Auction for one or more Maturity Buckets based upon DTCC data of triggered Transactions
- If 500 or more Transactions assigned to a Maturity Bucket are triggered, and 5 or more Dealer Members of the DC are party to such Transactions, then an Auction will automatically be held for such Maturity Bucket
  - The relevant DC may decide to hold an Auction for a Maturity Bucket, even if the 500/5 Criteria are not met
- If no Auction is held for a Maturity Bucket, the Movement Option will apply to Transactions assigned to such Maturity Bucket

# Movement Option

- If no Auction is held for a Maturity Bucket:
  - Buyer can move a Transaction assigned to that Maturity Bucket down to the Maturity Bucket with the next earliest Maturity Bucket End Date for which an Auction is to be held
  - Seller can move the relevant Transaction to the 30yr Maturity Bucket, if there is an Auction for the 30yr Maturity Bucket
  - The Movement Option must be exercised within 3 Business Days of the Exercise Deadline
  - First party to exercise the option determines whether, and in which direction, the Transaction will move
  - If the Movement Option is not exercised, the Transaction will settle in accordance with the Fallback Settlement Method (ie, Cash or Physical Settlement), but will be subject to the Maturity Bucket limitations on what is deliverable if Buyer originally triggered

# Auction Settlement following a Restructuring



*Timeline subject to amendment by 80% vote.*

# iTraxx and CDX EM Transactions

- Untranched Transactions
  - If the DC determines that a Restructuring has occurred on a Reference Entity in the relevant index, the Reference Entity will be removed from the relevant index and a single-name Transaction will be created
    - This retains the optionality for the parties to decide whether or not to trigger settlement
    - Avoids the problem of generating multiple versions of the index, one where the name was triggered, the other whether the name was not triggered, which is exacerbated when there is more than one Restructuring in the same series of the index

## iTraxx and CDX EM Transactions (cont.)

- Tranched Transactions
  - Problem of splitting out the defaulted Reference Entity in the tranche context
  - A solution is still being worked on
  - Interim solution
    - Reference Entity remains in the index
    - If settlement is triggered, the Reference Entity will be “removed” from the index by operation of the settlement mechanic, so the index continues to look like the untranching version of the index
    - If settlement is not triggered, the Transaction becomes a bespoke tranched portfolio Transaction that continues to reference the Reference Entity

# Old R

- Single Auction – since no maturity limitations apply
- Section 3.9 disappplied – since no distinction between whether Buyer or Seller triggered
  - Section 3.9 is only needed where:
    - Party A sells protection under 2 transactions and hedges by buying protection under 1 large aggregated transaction
    - If only one of Party A's counterparties under the small transactions triggers, Party A will receive obligations that are subject to maturity limitations and the transferability conditions
    - Party A cannot trigger its other counterparty on its small transaction otherwise it may receive obligations that it cannot on-deliver under its large transaction if Party A triggers that transaction – therefore Party A needs to be able to trigger a portion of the large transaction only
    - This distinction does not apply under Old R, so Section 3.9 can be disappplied

## Next steps

- Restructuring Supplement to the 2003 ISDA Credit Derivatives Definitions
- “Small Bang” Protocol
- Revised version of the DC Rules
  - Remove the prohibition on holding an Auction following a Restructuring Resolution
  - Describe the DC’s involvement in the Maturity Buckets/Deliverable Obligation lists

## Questions?

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