

ISDA Credit Derivatives Risk Management Seminar –
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Credit Derivatives – Documentation, Operations and Industry Solutions

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Credit derivatives

1) Overview

Market evolution

2) Miscellaneous

Characterisation: Financial contracts vs Insurance

Chinese walls - JPMF I and II

Capital

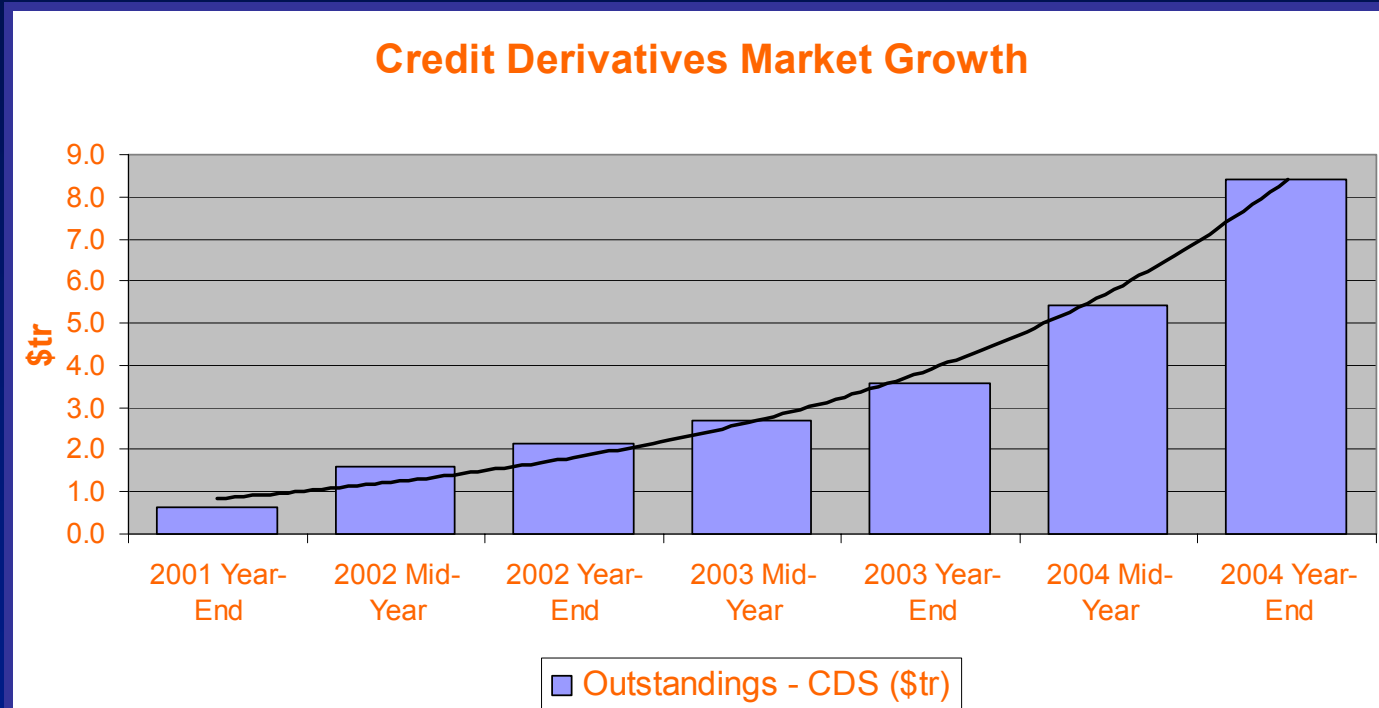
3) Documentation

4) Operations issues

Background; Strategic Plan; FpML

Overview

New market – liquidity growing



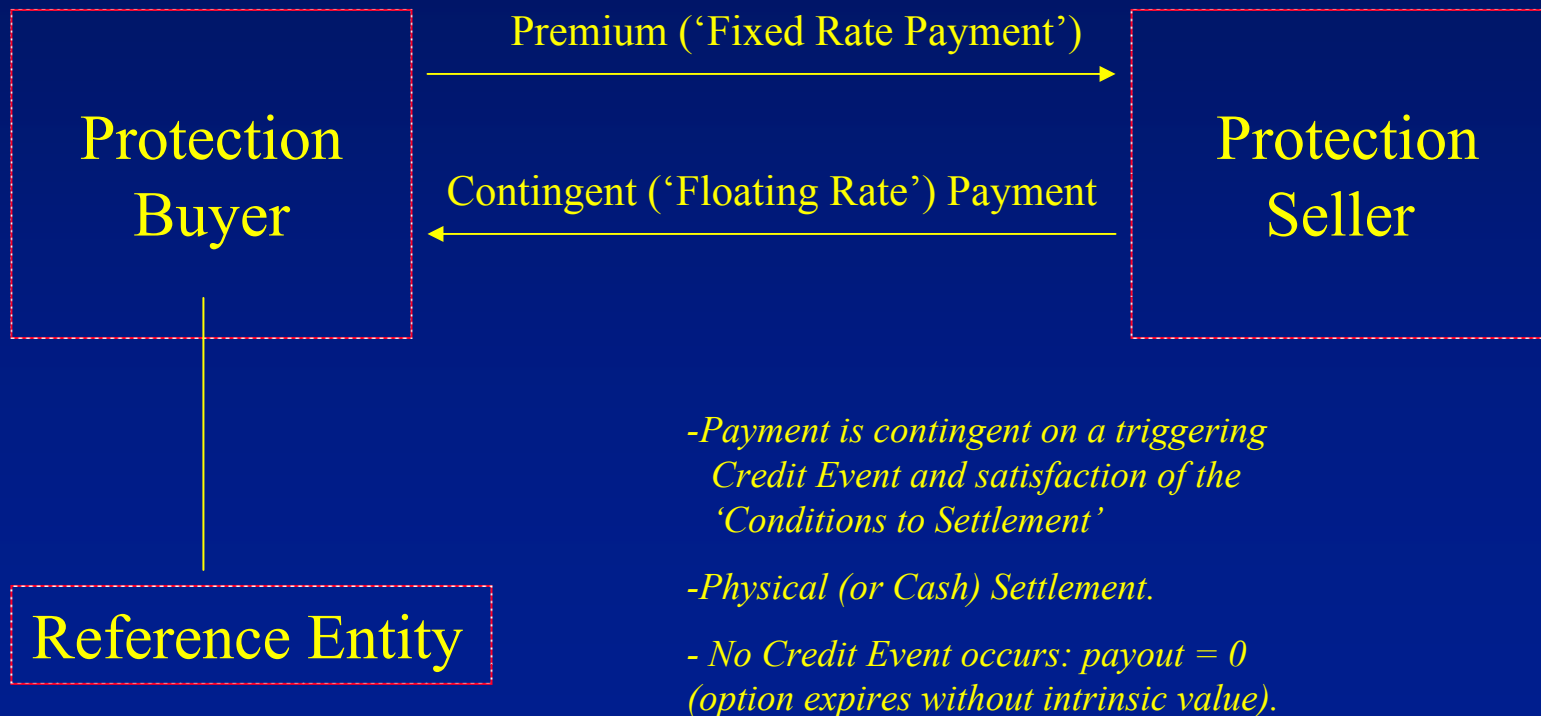
Source: ISDA (www.isda.org – Surveys)

Market evolution

- Circa 1994:
 - Asset swaps
 - Total Return Swaps, Spread Options, Nth-to-default baskets
- Circa 2004:
 - Credit Default Swaps – CDS (corporate, sovereign, index...)
 - Synthetic securitisations; single-tranche synthetics
 - Swaptions (option on CDS)
- Ca 2006?
 - ‘(Fixed) Recovery’ swaps, constant-maturity swaps

Credit default “swap” mechanics

- *Allows long/short positions in the credit risk of the Reference Entity*
- *Economically, more like an option than a swap*



Miscellaneous Issues

Characterisation

- Credit Derivatives are not insurance
 - payout linked to market values – *not* to proven loss
 - no ‘insurable interest’
 - ‘Potts’ opinion – 1997
 - International Accounting Standards
 - analogy with weather derivatives (debate in US)
- At stake: tax, accounting, as well as enforceability (‘vires’)
 - ISDA seeking statement from US tax authorities (IRS)

Chinese walls

- Loan originators obtain private information
- Credit is now traded in public markets
- Commentators fear insider trading
- JMPF
 - US: IACPM, ISDA, LSTA, TBMA – October 2003
 - Structures/procedures to segregate public and private sides
 - Relevant legislation – Exchange Act, Rule 10b-5
 - EU follow-on: IACPM, ISDA, LIBA, LMA, TBMA – May 2005
 - Relevant legislation – Market Abuse Directive

Capital – Operational Issues

- Legally binding and enforceable contract
- Procedures and processes for residual risks
- Also:
 - Some regulators (eg, France) do not recognise protection if derivative subject to netting.
 - ISDA considers this in-appropriate
 - Important to consider all scenarios – not just default of protection buyer

Documentation

ISDA CDS Documentation – history

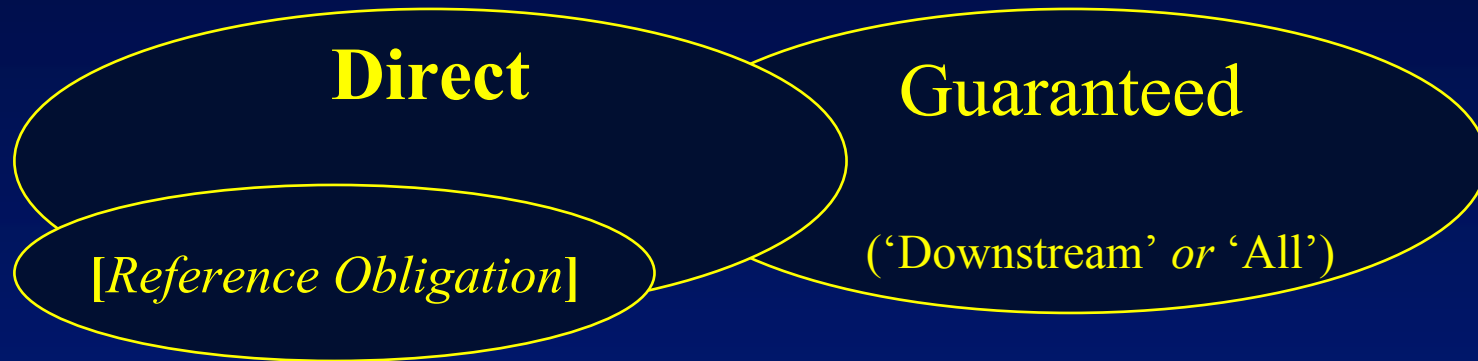
- ‘Prehistory’: adaptation interest-rate-swaps documentation
- 1998 ‘Long Form Confirmation’ (non-sovereign)
- 1999 ISDA Credit Derivatives Definitions
 - 2001 Supplements: Restructuring; Successors; Convertibles.
- **2003 Definitions**
 - including confirmation and novation templates
- Plus
 - Swaption (ie, option on CDS) confirmation
 - First-to-Default basket confirmation
 - Reference Entities: Monoline Insurer; US Municipal; Asset-Backed Securities
 - **Settlement ‘Matrix’** [Master Confirmations (corporate and sovereign)]
 - ... and more in pipeline (eg, Constant maturity CDS)

Basic structure

- Protection scope
 - Obligations
- Credit Events*
 - eg, Bankruptcy, Restructuring
- Settlement*
 - Physical (Deliverable Obligations);
 - *or* Cash (Reference Obligation)

* NB Notices

‘Obligations’ (scope of protection)...



Typical terms for single-name, OECD-corporate trades:

Obligation *Category*

“Borrowed Money”

Obligation *Characteristics*

[None]

... & ‘Deliverable Obligations’

Obligation *Category*

eg, “Borrowed Money”

Obligation *Characteristics (extended list)*

[None]

Credit events

Typical corporate-trade events*

- Bankruptcy (*no longer 'action in furtherance of'*)
- Failure to Pay (*Payment Requirement, = \$1m?*)
- Restructuring (*restrictions on Obligation/Deliverable?*)
- Obligation Acceleration
- Obligation Default
- Repudiation/Moratorium (*authorised officer? 'hard' event follows?*)

*Favoured by Basel

Documentation – ops issues

- Notice of Physical Settlement
 - Delivery by e-mail (Parmalat volume/timing)
- CDX ‘protocol’ – May-June 2005
 - Collins-Aikman bankruptcy (→cash settlement)
- **Novations:**
 - No transfer without consent of remaining Party

Operations

- a) Background
- b) ISDA Strategic Plan
- c) Solutions (FpML)

Confirmations outstanding

Average number of confirmations sent but not finalised

(Business-days' worth of average confirmation volumes)

	2002	2003	2004	2005
FRAs	7.0	7.1	6.0	4.6
Vanilla swaps	9.1	8.9	8.9	10.1
Non-vanilla swaps	12.4	12.1	11.3	11.6
Interest rate options		10.7	9.3	8.1
Currency options		8.2	7.6	6.2
<u>Credit derivatives</u>	<u>20.8</u>	<u>21.1</u>	<u>17.8</u>	<u>13.3</u>
Equity derivatives	14.3	12.6	12.5	9.3
Commodity derivatives		9.5	12.1	10.0

Automation of trade-detail matching

(Percentage of deal tickets – not weighted by trade volumes)

	2003	2004	2005
FRAs	20	20	31
Vanilla swaps	11	7	17
Non-vanilla swaps	3	1	9
Interest rate options	3	0	11
Currency options	23	20	33
<u>Credit derivatives</u>	<u>1</u>	<u>5</u>	<u>16</u>
Equity derivatives	10	3	12
Commodity derivatives	5	4	12

Advisory: Actually 1/3?

Source: ISDA, Operations Benchmarking Survey 2005

Prioritisation factors

Weightings that firms assign to factors in determining which outstanding confirmations to prioritise

(Ranked by most heavily weighted)

	Precent monitoring	Average weight	(8 high, 1 low)
Days outstanding	93	7.1	
Net present value	61	5.3	
Master Agreement Signed	67	4.5	
Other	27	4.5	
Type of transaction	62	4.3	
Counterparty credit rating	46	4.2	
Counterparty type	64	4.2	
Collateral held / callable	49	4.1	

Source: ISDA, Operations Benchmarking Survey 2005

http://www.isda.org/c_and_a/pdf/ISDA-OBS-FpML-2005.pdf

b) Strategic Plan

A plan is born

- 2003 Annual Operations Summit... Strategy Group
 - Operational Heads, 15 major dealers
- Strategy paper published
 - **“Going Forward: A Strategic Plan”** (December 2003)
- Implementation Plan (March 2004)
 - **“Moving Forward: An Implementation Plan”**

- | | | |
|--------------------|--------------------------|--------------------------|
| • ABN Amro | • Deutsche Bank | • JP Morgan Chase |
| • Bank of America | • Dresdner Bank | • Morgan Stanley |
| • BNP Paribas | • Goldman Sachs | • Royal Bank of Scotland |
| • Barclays Capital | • Greenwich Capital | • Société Générale |
| • Citigroup | • Lehman Brothers | • UBS |
| • Commerzbank | • Merrill Lynch | |
| • CSFB | • Mizuho Capital Markets | |

Stretch targets

Process	OTC Product	Timeline
Verification (T+0) Confirmation Despatch (T+1/5) Legal Execution (T+5/10)	Interest Rate <u>Credit</u>	December 2004
	Equity FX Commodity	June 2005
Cashflow Matching ('S'-2)	<u>All OTC</u>	December 2005
Intra-Product Netting Portfolio Reconciliation (Daily)		December 2006

ISDA Operations Summit

- Immediate issues:
 - Novations (solutions from Creditex, DTCC....)
 - Quarterly settlement
 - Long-term outstandings
- Strategic issues
 - Novations! – oral consent? / ISDA protocol
 - Confirmations: auto-matching/affirmation
 - (Portfolio reconciliation)

(Protocols)

- Multilateral agreement mechanism
- ISDA:
 - logs adherence letters
 - posts names of adhering parties on web-site
- Previous applications:
 - EMU (substitution of euro for francs, marks etc)
 - CDX / Collins-Aikman cash-settlement

c) Solutions (FpML)

Various vendors – common language

- Commercial initiatives (DTCC, Swapswire...; TriOptima)
 - ‘affirmation’, confirmation...; tear-ups
- FpML – Financial products Mark-up Language
 - Enables e-commerce for OTC derivatives
 - XML-based ‘*lingua franca*’ for OTC derivatives
 - Standardises ‘labels’ attached to data items
 - format supports product complexity and variety
 - ISDA-supported since 2002
 - Informal consortium (1999) → FpML.org (2000)

The FpML vision



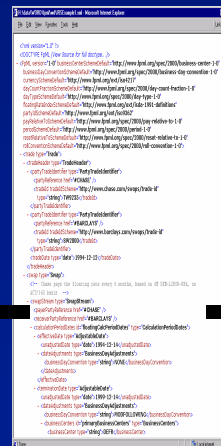
Front-Office



Front-Office



<FpML> to Company A
Systems



<FpML> to Company B
Systems

FpML: product coverage

- Scope:
 - Rates, FX, Equity, Credit Derivatives – swaps & options
 - + Loans/deposits
 - ‘Risk’ inputs (yield curve); Collateral
 - Related tools (eg, Validation, Editor-viewer, User Guide)
- Work in progress:
 - Messaging
 - Structured Products

Docs & Ops....

Settlement ‘matrix’ – standard terms

Physical settlement matrix (*extract*)

Transaction Type	NORTH AMERICAN CORPORATE ¹	EUROPEAN CORPORATE	AUSTRALIA CORPORATE
Business Days:	If the Floating Rate Payer Calculation Amount is denominated in USD: London & New York EUR: London, New York & TARGET GBP: London JPY: London & Tokyo CHF: London & Zurich	If the Floating Rate Payer Calculation Amount is denominated in USD: London & New York EUR: London & TARGET GBP: London JPY: London & Tokyo CHF: London & Zurich	If the Floating Rate Payer Calculation Amount is denominated in USD: London, New York & Sydney AUD: London, New York & Sydney EUR: London, New York, TARGET & Sydney
All Guarantees:	Not Applicable	Applicable	Applicable
Conditions to Settlement:	Notice of Publicly Available Information Applicable	Notice of Publicly Available Information Applicable	Notice of Publicly Available Information Applicable
Credit Events:	Bankruptcy Failure to Pay Restructuring, if specified as applicable in the relevant Confirmation Restructuring Maturity Limitation and Fully Transferable Obligation Applicable	Bankruptcy Failure to Pay Restructuring Modified Restructuring Maturity Limitation and Conditionally Transferable Obligation Applicable	Bankruptcy Failure to Pay Restructuring Restructuring Maturity Limitation and Fully Transferable Obligation Applicable

Version of March 7, 2005 (corporate).

http://www.isda.org/c_and_a/docs/Credit-Derivatives-Physical-Settlement-Matrix-20050307.xls

Credit Derivatives

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Conferences, Documentation, Comment Letters