CDS on US Sovereign Debt - FAQ

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The following are responses to some frequently-asked questions that ISDA has received in connection with a potential CDS Credit Event on US sovereign debt. The following does not constitute legal advice, and is subject in all respects to any determination that the ISDA Americas Credit Derivatives Determinations Committee may make in relation to CDS referencing the United States. ISDA makes no comment on the likelihood of the events described in this FAQ.

How are Credit Default Swaps documented?
The vast majority of Credit Default Swaps (CDS) are documented using the 2003 ISDA Credit Derivatives Definitions, as supplemented by the July 2009 Supplement. The Definitions can be obtained from ISDA's Bookstore.

What triggers CDS?
The CDS contract contains a number of elections that parties can make (for example, which events from a menu of potential Credit Events will apply, what obligations are relevant for triggering a Credit Event, what kind of obligation will be deliverable if a Credit Event occurs).

Of course, parties are free to agree to make whichever elections they wish, but standard elections are generally used for particular transaction types (so, for example, some of the elections for North American corporates, will be different from those for, say, Western European Sovereigns).

A CDS is triggered when a Credit Event occurs. There are three Credit Events that are typically used for Sovereigns such as the United States. They are: Failure to Pay; Repudiation/Moratorium and Restructuring. We will focus on Failure to Pay for these purposes.

The Failure to Pay credit event is defined as follows: "Failure to Pay means, after the expiration of any applicable Grace Period (after the satisfaction of any conditions precedent to the commencement of such Grace Period), the failure by a Reference Entity to make, when and where due, any payments in an aggregate amount of not less than the Payment requirement under one or more Obligations, in accordance with the terms of such Obligation at the time of such failure."

What is the Grace Period for CDS on US Sovereign Debt?
There is a three business day grace period for Failure to Pay specified in the Definitions. This is to avoid technical triggers that could be caused by natural disasters, human error or catastrophic events. This grace period would apply if there is no grace period or if the grace period is less than three business days under the terms of the reference entity's debt obligations. What this

means is that if the debt specifies payment on a certain day, the reference entity has three business days to make the payment before a credit event could be triggered.

Are CDS triggered by a declaration by a rating agency that the Reference Entity has been downgraded or is in "default"?
No.

What is the process for determining a Credit Event?
All firms entering into CDS transactions using the standard ISDA documentation (described above) have agreed to be bound by the decisions reached through the process for determining a Credit Event set out in the CDS Definitions. This process is fair, transparent and well tested, and was developed working closely with global regulators. The rules governing this process can be found at http://www.isda.org/credit/revisedcrules.html.

Under those rules, Credit Events are determined by one of five regional ISDA Credit Derivatives Determinations Committees (DCs). An event with respect to the US would be dealt with by the Americas DC. The composition of the DCs is explained below.

The process begins when a market participant puts a question to the DC for the relevant region. Any market participant (who need not be an ISDA member) with one or more CDS transactions can raise a question. A question is raised by submitting it, along with publicly-available information evidencing the event, using an online form on the ISDA website.

After a question is submitted, it must be accepted by one of the members of the appropriate DC. This step is included in order to filter out frivolous questions. Once a question is accepted, the DC will meet within a defined timeframe to consider it. The DC will weigh the publicly-available evidence and vote on whether a Credit Event has occurred within the terms of the CDS Definitions. It should be noted that the DC simply applies the Definitions to the public facts; it is not empowered to decide whether, as a matter of policy, a Credit Event should or should not occur in particular circumstances.

As soon as a vote has occurred, the determination is posted on the ISDA website. Each DC member's vote is made public.

Requests to the DCs and updates following meetings of the DCs are posted immediately on the ISDA website on the Credit Derivatives page at http://dc.isda.org/. In order to stay up to date on requests to any of the five DCs and the status of the requests the DCs are considering, you can subscribe to our RSS feed, which allows you to receive updates by e-mail or through a news aggregator. To subscribe to our RSS feed click here: http://dc.isda.org/feed/dc_requests_feed/. Further details of the operation of the DCs are available at http://dc.isda.org/about-dc-committees/.

Who are the members of the DCs?
Each DC consists of ten voting dealers and five voting non-dealers, plus two consultative (non-voting) dealers and one consultative non-dealer. The dealers are selected annually according to (and only to) their CDS trading volume over the past year and their compliance with certain requirements, notably to participate in CDS auctions, whilst the non-dealers are selected annually

at random from a pool of buyside market participants meeting certain specified size criteria. Non-dealer members' one-year terms are staggered so that they do not all finish their terms at once. A list of the firms that are members of the DCs is available at: http://dc.isda.org/about-dc-committees/current-dc-members/.

Would a Credit Event on the US lead to massive payments by protection sellers?
No. According to the Depository Trust & Clearing Corporation's CDS data warehouse, the total net exposure of market participants who have sold CDS credit protection on US sovereign debt is approximately $3.6bn as of October 4, 2013. It's important to note that the potential payout of $3.6 billion would be offset by the recovery value of the underlying obligations.

The net CDS figure is calculated by summing the net exposures of the protection sellers, and so it is impossible for any one firm selling protection to have more than $3.6bn in exposure and, of course, given that there are many net sellers, any one seller's exposure is likely to be far less.

Also, as noted, firms' net exposures are partially offset by the recovery value of underlying obligations. For example, if the CDS auction showed the recovery value of debt to be (hypothetically) 90%, the maximum aggregate amount payable would, in the US's case, be 10% of $3.6bn or $0.36bn.

Furthermore, in this example, of the $0.36bn payable, a large proportion is likely to have been transferred already in the form of variation margin.

Where can I get data on CDS exposures?
The data regarding CDS exposures on US sovereign debt, and for the top 1,000 reference entities, is publicly available here:
http://www.dtcc.com/products/derivserv/data_table_i.php?tbid=7. Regulators have access to additional data, including individual firm CDS exposures.

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