

# CREDIT DEFAULT SWAPS— RECENT DEVELOPMENTS

**NAVIGANT**  
CONSULTING

**JONES  
DAY**

AUGUST 5, 2009

# Agenda

- Introduction
- Presentation
  - Jayant W. Tambe, Jones Day
  - James K. Goldfarb, Jones Day
  - Gene L. Deetz, Navigant Consulting
  - Jeff Nielsen, Navigant Consulting
- Questions and Answers — (*anonymous*)
- Slides — now available on front page of Securities Docket
  - > [www.securitiesdocket.com](http://www.securitiesdocket.com)
- Wrap-up



# Webcast Series

- Series of webcasts — every other week
- [www.securitiesdocket.com/webcasts](http://www.securitiesdocket.com/webcasts)



# Panel



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## **CREDIT DEFAULT SWAPS – RECENT DEVELOPMENTS**

### ***A Securities Docket Webcast***

Jay Tambe, Jones Day  
James Goldfarb, Jones Day  
Gene Deetz, Navigant Consulting  
Jeff Nielsen, Navigant Consulting

August 5, 2009  
2:00 p.m. EDST

# Topics of Discussion

- ▶ The nuts and bolts of CDS
- ▶ Regulation – history and recent developments
- ▶ Payment
- ▶ CDS litigation themes and issues

# The Nuts & Bolts of CDS

- ▶ What is a CDS
- ▶ CDS in perspective
- ▶ CDS buyers, sellers, and reference obligations
- ▶ Why enter into CDS
- ▶ CDS documentation

# What is a CDS?

A bilateral financial contract in which a protection buyer makes periodic payments to a protection seller, in return for a contingent payment if a predefined credit event occurs in the reference credit, that is, the obligation on which the contract is written.

*See Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co.*, 375 F.3d 168, 172 (2d Cir. 2004)



# What is a CDS? (cont'd)

- ▶ A financial instrument for “swapping” specified risk associated with a specified instrument (the “reference obligation”)
- ▶ A private contract between a party seeking protection (buyer) and a party providing protection (seller)
- ▶ The protection buyer agrees to pay “premiums” to the protection seller over a set period of time
- ▶ The protection seller agrees to pay the buyer an amount of loss created by a “credit event” related to the reference obligation
- ▶ Common credit events include a default on a debt instrument (bond, ABS, CDO), failure to post collateral (mark-to-market accounting), bankruptcy or restructuring

# CDS Compared to Insurance

- ▶ The buyer of a CDS need not own the underlying reference entity
- ▶ The buyer need not suffer a loss from the default event
- ▶ The seller need not be a regulated entity
- ▶ The seller is not required to maintain any reserves to pay off buyers
- ▶ CDS dealers manage risk primarily be means of offsetting CDS (hedging) whereas insurers manage risk primarily through setting loss reserves
- ▶ In the U.S., CDS contracts are generally subject to mark to market accounting

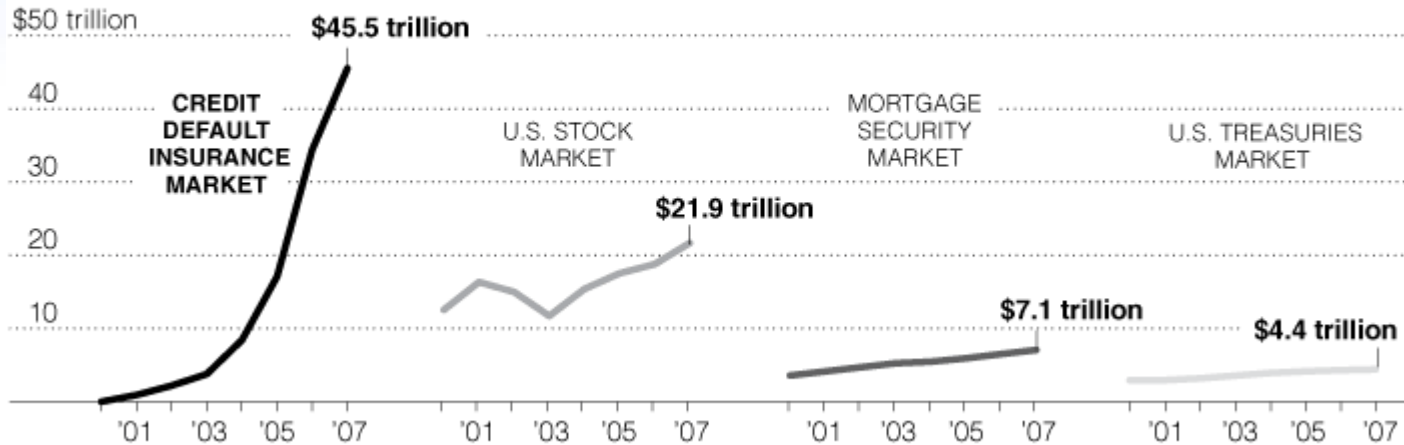
# CDS in Perspective – Market Size

- ▶ Estimated notional amounts outstanding for CDS:
  - \$62.2 trillion at year-end 2007
  - \$54.6 trillion at mid-year 2008
  - \$38.6 trillion at year-end 2008
  
- ▶ Estimates are overstated due to offsetting
  - For example, as per DTCC, for the week ending July 24, 2009 gross notional for single name CDS was \$15.3 trillion whereas net notional was \$1.4 trillion
  - Total gross notional CDS outstanding per DTCC for the week ending July 24, 2009 was \$26.5 trillion

# CDS in Perspective – The CDS Market Relative to Other Capital Markets, 2000 - 2007

## In the Shadow of an Unregulated Market

The value of the credit default insurance market is now much larger than the domestic stock market, mortgage securities market and United States Treasuries market.

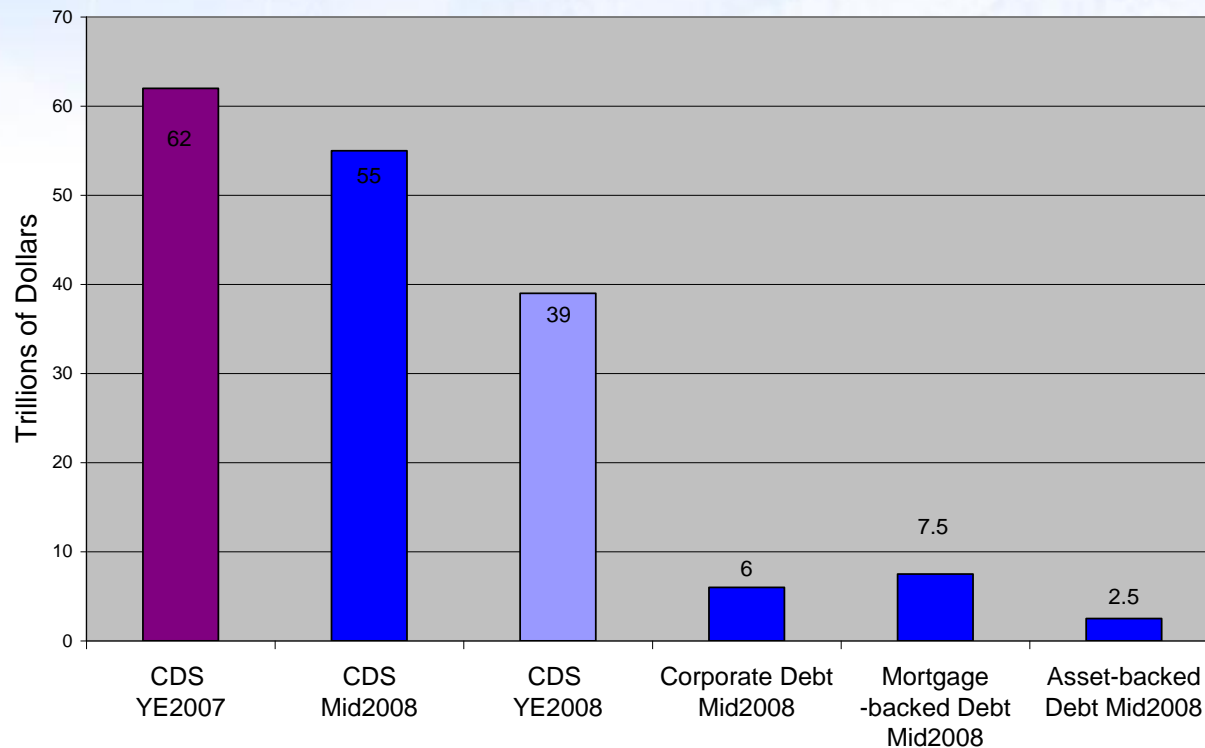


Sources: Thomson Proprietary Research; International Swaps and Derivatives Association

THE NEW YORK TIMES

# CDS in Perspective – The CDS Market Relative to other Credit Markets, 2007 – 2008

Estimated size of CDS market relative to other private sector debt markets



Sources: ISDA and Eric Dinallo, N.Y. Insurance Superintendent, Nov. 20, 2008, Testimony before the U.S. House of Representatives

# CDS Buyers, Seller, and Reference Obligations

## ▶ Typical Buyers of Protection

- Banks
- Investors with negative outlook on credit of the reference obligation

## ▶ Typical Sellers of Protection

- Banks
- Hedge Funds
- Insurers/Monolines

## ▶ Typical Reference Obligations

- Corporate Bonds
- Local Government Bonds
- Mortgage-backed Securities (“MBS”)
- Super Senior tranches of Collateralized Debt Obligations (“CDO”)

# Why Enter Into CDS?

## ▶ Originally

- Transfer credit exposure for commercial loans
- Free up regulatory capital in commercial banks

## ▶ More recently

- Risk management
  - Hedge against a credit event
  - Diversify portfolio
- Generate revenue
- Speculate, rebalance a portfolio, or pursue a related investment strategy

# CDS Documentation

- ▶ ISDA Master Agreement
- ▶ Schedule
- ▶ Confirmations
- ▶ Credit Support Annex



# Regulation – History and Recent Developments

- ▶ Past efforts
- ▶ Recent efforts
  - Central counterparties
- ▶ Regulatory model

# Regulation – Past Efforts

- ▶ 1998 – CFTC concept release on “how best to maintain adequate regulatory safeguards without impairing the ability of the OTC derivatives market to grow and the ability of U.S. entities to remain competitive in the global financial marketplace.”
- ▶ 2000 – Commodity Futures Modernization Act (“CFMA”)
  - Amended the 1933 Act and 1934 Act to clarify that the definition of “security” does not include certain swap agreements, including CDS
  - Prohibited SEC from regulating those certain swap agreements, except for anti-fraud enforcement
  - Created “Safe Harbor” for CDS by:
    - preempting state and local gaming and bucket shop laws except for general anti-fraud provisions
    - exempting certain derivative transactions on commodities and swap agreements, including CDS, from CFTC regulation

# Regulation – Recent Efforts

- ▶ 2008 – The New York Insurance Department’s proposal to regulate CDS
- ▶ 2008 – The President’s Working Group on Financial Markets initiative
  - Central counterparties
  - Cooperation among regulatory agencies
  - General policy objectives for the use and operation of OTC derivatives markets
- ▶ 2008/2009 – SEC approves Central Counterparties
- ▶ 2009 – Treasury Department proposals for the regulation of derivatives
- ▶ 2009 – Treasury secretary vows that Obama administration will impose tougher regulations on markets for derivatives like credit default swaps. The plan would include:
  - All “standardized” instruments be traded on regulated exchange or through a central clearinghouse
  - Participants disclose more information about transactions and meet strict new capital requirements

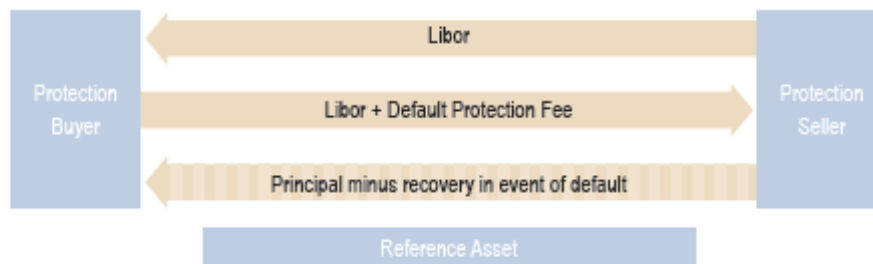
# Central Counterparties

- ▶ Sits in the middle of a trade
- ▶ Assumes the counterparty risk
- ▶ Legally bound to ensure the financial performance of the deal
- ▶ Collects collateral (commonly known as “margin”)
- ▶ If adequate margin is not posted by one of the trading counterparties, the trade is closed out and the collateral is used to settle the CCP’s obligations

# Current vs. Future Regulatory Model

- ▶ There is a significant amount of CDS transactions that are liquid and observable such as GE, GM, Ford, and Citi. These are observable on Bloomberg, Markit, etc.
- ▶ There is also a significant number of non-standard CDS transactions that are not observable and highly illiquid.

Figure 1. Current State



Currently, the buyer and seller work directly with one another to negotiate the terms and conditions of each individual swap. These highly tailored transactions result in:

- » A lack of standard settlement periods
- » Lack of transparency in pricing and valuation
- » Inconsistent minimum capital requirements
- » Non-existent licensing and registration requirements
- » No oversight of participant conduct

# Current vs. Future Regulatory Model (cont'd)

- ▶ Particularly for the non-observable illiquid CDS transactions
- ▶ Corporate are more observable, ABS RMBS are not as observable

Figure 2. Future State with Exchange

With the development of a regulated exchange, we can expect to see the following improvements, which will create a high degree of transparency:



# Payment

- ▶ Payment upon a Credit Event
- ▶ Payment upon an Event of Default/Early Termination
  - Calculations under the 1992 ISDA Master
  - Calculations under the 2002 ISDA Master
- ▶ Selected issues
  - Waiver and estoppel
  - Termination
  - Commercial reasonableness

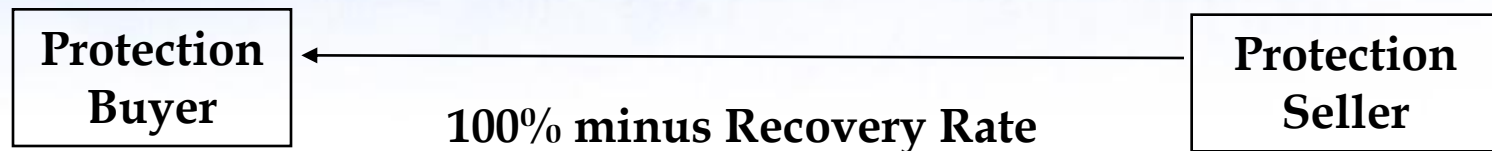
# Payment upon a Credit Event

- ▶ Credit Event
- ▶ Notice and Verification
- ▶ Settlement
  - Cash settlement
  - Physical settlement

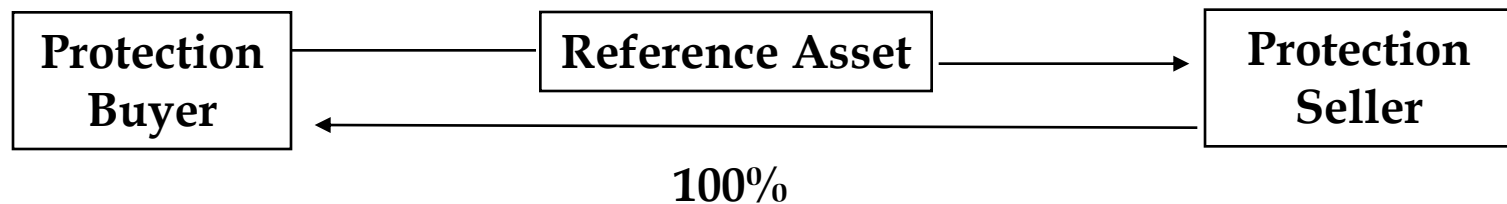


# Payment upon a Credit Event (cont'd)

## Cash Settlement



## Physical Settlement



# Payment upon an Event of Default/ Early Termination – 1992 ISDA Master

- ▶ Events of Default
- ▶ Early Termination Date
- ▶ Settlement Amount
- ▶ Measure of Settlement Amount
  - Market Quotation
  - Loss
  - Unpaid Amounts
- ▶ Methods of exchanging Settlement Amount
  - First Method
  - Second Method

# Market Quotation

- ▶ Measures the replacement cost of the transactions
- ▶ Determined on the basis of quotations from Reference Market-makers
- ▶ Minimum of three quotes
- ▶ Reference Market-makers are to act independently  
*(The High Risk Opportunities Hub Fund Ltd. v. Credit Lyonnais, Index No. 600229/2000, 2005 WL 6234513 (N.Y. Sup. Ct. N.Y. Cty. July 6, 2005))*
- ▶ Determined as of the relevant Early Termination Date or, if that is not reasonably practicable, as of the earliest date thereafter that is reasonably practicable

# Loss

- ▶ Indemnification provision
- ▶ Includes replacement costs
- ▶ Includes losses and costs (or gains) in respect of any payment or delivery required to have been made (assuming satisfaction of each applicable condition precedent) on or before the relevant Early Termination Date and not made, except, so as to avoid duplication, if Section 6(e)(i)(1) or (3) or 6(e)(ii)(2)(A) applies
- ▶ Does not include a party's legal fees and out-of-pocket expenses referred to under Section 11
- ▶ Determined as of the relevant Early Termination Date or, if that is not reasonably practicable, as of the earliest date thereafter that is reasonably practicable
- ▶ A party may (but need not) determine its Loss by reference to quotations of relevant rates or prices from one or more leading dealers in the relevant markets

# Payment upon an Event of Default/ Early Termination – 2002 ISDA Master

- ▶ Events of Default
- ▶ Early Termination Date
- ▶ Early Termination Amount
- ▶ Measure of Early Termination Amount
  - Close-out Amount
  - Unpaid Amounts
- ▶ No First or Second Method

# Close-out Amount

- ▶ Close-out Amount incorporates the following concepts:
  - “Then prevailing circumstances”
  - “Economic equivalence” of (i) the material terms of the Terminated Transactions, and (ii) option rights of the parties in respect of Terminated Transactions
  - Use of commercially reasonable procedures to obtain a commercially reasonable result
  - Creditworthiness of the Determining Party at the time the quotation is provided
  - When commercially reasonable, costs of terminating, liquidating or re-establishing any hedge related to a Terminated Transaction or group of Transactions
  - Use of different valuation methods for different Transactions or groups of Transactions
  - Use of information gleaned from internal sources if used in the normal course

# Selected Issues – Waiver and Estoppel

- ▶ Issue: Can a party be estopped from exercising, or be deemed to have waived, the right to terminate following an Event of Default?
- ▶ Waiver or estoppel can arise from a course of conduct, including:
  - Continuing to perform, make payments and receive payments
  - Entering into new transactions under a Master Agreement after an Event of Default or a Termination Event
  - Continuing to post collateral or demand collateral pursuant to a Credit Support Annex
    - *E.g.*, under CSA, each transfer of collateral is subject to the condition precedent that no Specified Condition or Early Termination Date exists. See CSA ¶ 4.
- ▶ What is the effect, if any, of the “no waiver” provision in the Master Agreement?

# Selected Issues – Waiver and Estoppel (cont'd)

## ► Some Key Cases

- *VCG Special Opportunities Master Fund Ltd. v. Citibank*, Case No. 08-cv-01563 (BSJ), 2008 WL 4809078, at \*6 (S.D.N.Y. Nov. 5, 2008) (protection seller waived objection (after the fact) to posting variation margin because it acceded to protection buyer's requests to post variation margin at the time), *mot. for reconsideration den.*, slip. op. (S.D.N.Y. Jan. 29, 2009)
- *CDO Plus Master Fund Ltd. v. Wachovia Bank, N.A.*, No. 07-cv-11098 (LTS) (AJP), 2009 WL 2033048, at \*6 (S.D.N.Y. July 13, 2009) (same)



# Selected Issues – Termination

- ▶ Issue: Must a party terminate a transaction following an Event of Default?
- ▶ Some Key Cases
  - *Enron Australia Finance Pty. Ltd. v. TXU Electricity Ltd.* [2003] NSWSC 1169 (counterparty may declare an Event of Default, cease payment, but not terminate)
  - *Metavante Motion (In re Lehman Brothers Holding Inc.)* (Debtor's position: counterparty may not declare an Event of Default due to bankruptcy, cease payment, but not terminate)

# Selected Issues – Commercial Reasonableness

- ▶ Commercial reasonableness referenced more frequently in 2002 Master Agreement than 1992 Master Agreement
- ▶ What if the quotes received seem commercially unreasonable?
- ▶ Who decides if a result is “commercially reasonable”?
- ▶ Is the test objective or subjective?
- ▶ Can the determination be made prior to seeking market quotes?
- ▶ Is commercial reasonableness necessarily a question of fact?
- ▶ Is there an interconnection between the ISDA valuation hierarchy and the FAS 157 hierarchy?

# Litigation Themes and Issues

- ▶ Traditional contract principles and rules of interpretation apply (*Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co.*, 375 F.3d 168, 177-78 (2d Cir. 2004); *Merrill Lynch Int'l v. XL Cap. Assur. Inc.*, 564 F. Supp. 2d 298, 205-206 & n.10 (S.D.N.Y. 2008)); *Ursa Minor Ltd. v. AON Fin. Prods., Inc.*, No. 00-cv-2474 (AGS), 2000 WL 1010278, at \*6 (S.D.N.Y. July 21, 2000), *aff'd*, 7 Fed. Appx. 129, 2001 WL 363515 (2d Cir. 2001)
- ▶ Has a credit event taken place?
  - *VCG Special Opportunities Master Fund Ltd. v. Citibank, N.A.*, Case No. 08-cv-01563 (BSJ), 2008 WL 4809078 (S.D.N.Y. Nov. 5, 2008), *mot. for reconsideration den.*, slip. op. (S.D.N.Y. Jan. 29, 2009)
  - *Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co.*
- ▶ Was a counterparty obligated to post additional collateral?
  - *VCG Special Opportunities Master Fund Ltd. v. Citibank, N.A.*
  - *CDO Plus Master Fund Ltd. v. Wachovia Bank, N.A.*, No. 07-cv-11098 (LTS) (AJP), 2009 WL 2033048 (S.D.N.Y. July 13, 2009)

# Litigation Themes and Issues (cont'd)

- ▶ Did the calculation or valuation agent act in good faith?
  - *CDO Plus Master Fund Ltd. v. Wachovia Bank, N.A.*
  - *The High Risk Opportunities Hub Fund Ltd. v. Credit Lyonnais*, Index No. 600229/2000, 2005 WL 6234513 (N.Y. Sup. Ct. N.Y. Cty. July 6, 2005)

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# Questions?



# Thank You

Thank you for attending this webcast.

