

October 3, 2007

MEMORANDUM TO: Clients and Friends of the Firm

FROM: Jon Kibbe
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RE: Tranched Loan-Only Credit Default Swap Index

The market for loan credit default swaps (LCDS) continues to evolve at a rapid pace. Since the May 2006 launch of the single-name LCDS, the product has shifted from physical to cash settlement through the introduction of market-wide cash-settlement auction mechanism, and we have seen the successful launch of the LCDS index, or LCDX.¹ Last week, the International Swaps and Derivatives Association published standard documentation for another LCDS variation -- the Tranched LCDX product.

Set forth below is a brief summary of the background to, and key terms of, the Tranched LCDX product.²

LCDX

The LCDX product is a standardized portfolio of component LCDS transactions referencing 100 equally weighted reference entities that have issued syndicated secured first lien loans. Parties transact by purchasing or selling credit protection on the entire portfolio of reference entities. If a reference entity experiences a credit event (bankruptcy or failure to pay), the amount owed by the protection seller to the protection buyer will be calculated and settlement will occur.

A syndicated secured first lien loan is identified as the reference obligation for each reference entity on the relevant secured list published by Markit Group. If a reference entity no longer has any syndicated secured first lien loans, its relevant secured list will be withdrawn. If the relevant secured list is not republished within 30 business days after such a withdrawal, that reference entity will be removed from the index.

If a succession event (merger, consolidation or another similar event) occurs with respect to a reference entity, the original reference entity will be removed from the index and the calculation agent will attempt to identify a successor reference entity. If there is a relevant secured list with respect to such successor reference entity, the relevant portion

¹ For our memorandum regarding the untranched LCDX product, please contact us.

² This is not a complete list of all of the important terms of the governing documentation, and we encourage you to contact us for additional details.

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of the transaction will continue based on the reference obligation identified on the relevant secured list for the successor reference entity. If there is no such relevant secured list, the relevant portion of the transaction will terminate. In all cases of removal of a reference entity from the index, or termination of a portion of the transaction with respect to a reference entity, the weightings of the remaining reference entities in the index remain unchanged.

Tranching

The Tranched LCDX product enables parties to transact based on a specific tranche of risk within the implicit portfolio,³ between an “attachment point” and an “exhaustion point.” The “attachment point” represents a level between 0% and 100% at which point the protection buyer’s coverage is triggered, and the “exhaustion point” represents a level between the attachment point and 100%, at which point such coverage expires. The standard tranches in the Tranched LCDX product are defined by the following attachment and exhaustion points: 0-5% (the “first loss” tranche), 5-8%, 8-12%, 12-15% and 15-100%.

The notional amount of the tranche of risk subject to the parties’ contract is called the swap notional amount, which is the maximum amount of loss that a protection seller can incur. The notional amount of the implicit portfolio between 0% and the attachment point is called the “loss threshold amount.” It represents the amount of loss that can be sustained by the implicit portfolio before the relevant tranche is affected. The notional amount of the implicit portfolio between the exhaustion point and 100% is called the “recovery threshold amount.” It represents the amount of recovery that can accumulate on the implicit portfolio before the relevant tranche is affected. The loss amount and recovery amount attributable to an individual reference entity after a credit event are determined based on the recovery rate relating to the corresponding deliverable obligation,⁴ which is in turn determined by an auction mechanism, as described in “Settlement of Tranched LCDX Transactions” below.

Incurred Loss and Incurred Recovery

The seller of protection starts to incur loss under the Tranched LCDX transaction when the *aggregate loss amount* on all previously settled reference entities (including those that settled prior to the trade date but after the previous roll date of the index)

³ The implicit portfolio can be the LCDX or a customized basket of reference entities.

⁴ For example, if a particular loan is determined to be the deliverable obligation of a reference entity after a credit event, and the recovery rate for that loan is determined to be 60%, the loss amount attributable to that reference entity is 40%, and the recovery amount is 60%, of the notional amount attributable to that reference entity.

reaches the loss threshold amount.⁵ The protection seller stops incurring loss, and the swap terminates, when the aggregate amount of loss incurred by the protection seller reaches the swap notional amount, *i.e.*, the aggregate loss amount for all reference entities reaches the notional amount represented by the exhaustion point.⁶

The protection seller's risk in the Tranche LCDX transaction, or the swap notional amount, starts to decrease when the *aggregate recovery amount* for all previously settled reference entities (including those that settled prior to the trade date but after the previous roll date of the index) reaches the recovery threshold amount.⁷ As recoveries continue to accumulate, the swap will also terminate, and the seller of protection will not incur any loss, when the aggregate recovery amount on all settled reference entities reaches the notional amount represented by one minus the attachment point. This is because the aggregate loss amount for all reference entities can no longer exceed the loss threshold amount, even if all remaining reference entities experience credit events with corresponding recoveries of zero.⁸

The protection buyer pays fixed rate payer payments based on the swap notional amount then outstanding, reflecting the total amount of potential loss that the protection

⁵ For example, consider a Tranche LCDX transaction with an implicit portfolio size of \$100 million on the LCDX (100 equally weighted reference entities). If credit events occur with respect to 12 reference entities, and each sustains a 40% loss, there will be no "incurred loss amount" on the 5-8% tranche, because the aggregate loss amount for all 12 settled reference entities will be \$4.8 million, less than the loss threshold amount of \$5 million. If a credit event occurs with respect to a 13th reference entity, which again sustains a 40% loss, the portion of the aggregate loss amount (\$5.2 million) that is in excess of the loss threshold amount of \$5 million, *i.e.*, \$200,000, will be the "incurred loss amount" on the 5-8% tranche, which the protection seller will pay to the protection buyer.

⁶ Continuing with the example described in footnote 5, if credit events occur with respect to seven additional reference entities, each of which sustains a loss of 40%, the protection seller will incur additional loss, in the aggregate amount of \$2.8 million, on all seven additional settled reference entities (numbers 14 through 20). If a 21st reference entity experiences a credit event and sustains a loss of 40%, none of that loss will be incurred by the 5-8% tranche, because the aggregate incurred loss amount (including the \$200,000 loss incurred by the 13th reference entity in footnote 5) has reached \$3 million after the 20th reference entity experiences the credit event, and the swap notional amount has been exhausted.

⁷ In the same example of a 5-8% tranche with an implicit portfolio size of \$100 million on the LCDX index, if credit events occur with respect to 92 reference entities and each sustains 0% loss (or 100% recovery), the aggregate recovery amount would be \$92 million, at the recovery threshold amount. If a credit event occurs with respect to a 93rd reference entity, and it sustains a 40% loss (or 60% recovery), the \$600,000 will be the "incurred recovery amount" on the 5-8% tranche and the swap notional amount will be reduced by \$600,000.

⁸ Contrasting with the scenario described in footnote 7, if credit events occur with respect to 95 reference entities, and each sustains 0% loss (or 100% recovery), the aggregate recovery amount would be \$95 million. The swap will terminate because even if credit events then occur on all of the five remaining reference entities and each sustains a 100% loss, the aggregate loss amount could not exceed the loss threshold amount of \$5 million, and protection seller would never incur any loss. This scenario of swap termination may be unlikely in the lower tranches of the LCDX, but it is less hypothetical in a customized basket with fewer reference entities.

seller can incur under the swap. The swap notional amount will be reduced by loss amounts that the protection seller incurs as well as the recovery amounts that the protection seller incurs.

If a reference entity is removed from the LCDX index as described under “LCDX” above (in connection with the withdrawal of a relevant secured list or a succession event), the reference entity is considered to be a settled reference entity with a recovery amount equal to 100% of the relevant notional amount.

Settlement of Tranched LCDX Transactions

Cash settlement applies to Tranched LCDX transactions upon a credit event relating to a reference entity, and final price, or the recovery rate, for the relevant reference obligation is determined pursuant to an auction. If there is an ISDA-sponsored auction on the relevant reference entity and designated priority, that auction will determine the final price for purposes of settlement. If an ISDA-sponsored auction fails or if no such auction is run, the calculation agent will run a “mini-auction” in accordance with the “isolated transaction settlement terms.” In both cases, the cash settlement amount owed by the protection seller to the protection buyer will be the incurred loss amount, if any.

Under the isolated transaction settlement terms, the calculation agent will solicit firm bids from at least five dealers (including protection seller) to enter, as a protection seller, into a physically-settled LCDS transaction (under which a credit event is deemed to have been triggered) relating to the relevant reference entity and designated priority on the same terms as an “isolated transaction.” The highest bid price will be the final price, which will serve as basis for calculation of loss amounts and recovery amounts for purposes of cash settlement of the Tranched LCDX transaction. The protection seller and the protection buyer of the Tranched LCDX transaction will be deemed to enter into an “isolated transaction,” under which either the protection buyer or the protection seller can require physical settlement.

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This memorandum has been prepared as a service to clients and other friends of RK&O to report on recent developments that may be of interest. It is not intended to be a full description of all material terms of the Tranched LCDX product. The information provided is therefore general, and should not be considered legal advice.

Should you have any questions with respect to the Tranched LCDX product, please do not hesitate to contact us:

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