

ISDA's Evolving Auction Methodology: Cash Settlement of Loan Credit Default Swaps

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The deterioration in the credit markets over the past year has caused investors to focus on the operational and counterparty risks embedded in the closely-related credit derivatives market. In particular, buyers of credit default protection increasingly worry about their ability to realize the "recovery value" of the assets underlying the derivative transaction from their counterparty promptly after a credit default.

Investors in the U.S. derivatives market recently have begun to purchase and sell protection against the default of leveraged loans using: (i) the single-name syndicated secured loan credit default swap (LCDS), (ii) the index form of LCDS (LCDX), or (iii) the tranching version of LCDX (Tranching LCDX). Investors in the LCDS/LCDX family of products may sleep more soundly than investors in other derivative transactions due to a key design feature hard-wired into the products: prompt cash settlement through a binding, market-wide auction capable of generating trusted recovery values.

The same auction technology is currently being adapted for use in Europe in connection with cash settlement of the European family of leveraged loan credit default swap and index products. Once finalized, the European loan credit default swap and index will be the first European derivative products to use a market-wide auction to set recovery values for cash settlement. This reflects the market's desire for a more efficient determination of recovery values, -- one that overcomes the difficulties in valuing the deliverable loans and physically settling multiple loan transactions.

This memorandum explains why traditional "physical settlement" of LCDS/LCDX presents intractable difficulties, and why cash settlement is the desired alternative for a majority of derivative counterparties. In addition, the memorandum outlines the complex methodology used for LCDS/LCDX auctions, referencing the actual procedures used in the recent auction held for Movie Gallery, Inc. first lien loans as an example.

Background

After a credit event occurs under a credit default swap, protection buyers traditionally receive the benefit of their credit protection through "physical settlement" of the swap. This means that a protection buyer delivers an eligible debt obligation to, and receives a par payment from, its protection seller. But physical settlement raises a number of issues, some of which are exacerbated by the complex nature of the underlying loans referenced in the LCDS/LCDX products.

First, physical delivery of a loan can be cumbersome and time-consuming. While the "Physical Settlement Rider" published by The Loan Syndications and Trading Association, Inc. attempts to ameliorate these problems by codifying standards and conventions used to physically settle LCDS and LCDX transactions, the process will still strain operational resources at institutions with a large number of LCDS/LCDX transactions. Second, since the aggregate notional amounts of LCDS/LCDX transactions will likely exceed the outstanding principal amounts of the underlying loans, a "short squeeze" in the loans may occur, when many

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Investors in the LCDS/LCDX family of products benefit from a key design feature hard-wired into the products: prompt cash settlement through a binding, market-wide auction capable of generating trusted recovery values.

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protection buyers have the simultaneous need to purchase the loan in the cash market in order to physically settle their swap transactions. A short squeeze produces artificial inflation and increased volatility of the price of the deliverable loan after a credit event, and may also prolong market-wide settlement timeframes in LCDS/LCDX transactions.

Cash settlement, on the other hand, enables derivative counterparties to settle LCDS/LCDX transactions without the delivery of a loan: instead, protection seller pays to protection buyer the difference between par and the market price, or “recovery value”, of the loan. The critical difficulty in cash settlement is finding a trusted market price in a potentially illiquid market. A bilateral price-discovery mechanism agreed on between two swap counterparties may be capable of generating a trusted price, but it still exposes the counterparties to “basis risk” if they are unable to settle offsetting trades with all other market participants at the same price. Therefore, the key to a successful cash settlement mechanism is the ability to find a trusted market price to clear all LCDS/LCDX trades.

Application of Cash Settlement to LCDS/LCDX

In May 2007, the LCDS standard terms supplement was amended by the International Swaps and Derivatives Association, Inc. to provide for cash settlement at an auction-generated price to the extent a successful auction occurs with respect to the relevant reference entity and its loans of the relevant lien.¹ In addition, the standard terms governing both the LCDX product and the Tranching LCDX product, published by ISDA in May and September 2007, respectively, contain the same cash settlement requirement for all component transactions in the index.

The auction mechanism devised for LCDS/LCDX is based squarely on the ISDA-sponsored CDS auction

mechanism, which was first used in June 2005 to cash settle outstanding CDS contracts after the bankruptcy of Collins & Aikman Products Co., and has been tested and refined in connection with its use following credit events in the CDS market involving Delta Air Lines, Inc., Northwest Airlines, Inc., Delphi Corporation, Calpine Corporation, Dana Corporation, Dura Operating Corp. and, most recently in February 2008, Quebecor World Inc. The Dura CDS auction methodology, published in November 2006, was modified to create a mechanism that could be used to determine the price of a secured loan, and the resulting LCDS/LCDX auction mechanism was published by ISDA in September 2007. The LCDS/LCDX auction mechanism was first used in October 2007 to cash settle LCDS and LCDX contracts referencing Movie Gallery first lien loans.

The remainder of this memorandum outlines the basic terms of LCDS/LCDX auction settlement terms, and explains how those terms were customized for the Movie Gallery auction.

LCDS/LCDX Auction Methodology

The goal of the auction methodology is three-fold: to (i) determine a “Final Price” of the underlying loan that can be used by the market to settle all LCDS/LCDX transactions covered by the auction, (ii) enable parties voluntarily to physically settle LCDS transactions through the auction at the Final Price, and (iii) dictate the terms of any such physical settlement.

After a credit event, at the request of two eligible LCDS/LCDX dealers, the auction administrator, Markit Group Limited, will poll all eligible dealers to determine whether an auction should be held with respect to the defaulted reference entity. If a majority of eligible dealers vote for an auction, Markit will promptly announce that an auction will be conducted. Markit will then convene dealers to determine (i) the specific terms of the auction, based on ISDA-approved

¹ Pre-May 2007 LCDS transactions may also be subject to the auction if parties adhere to the auction protocol on a voluntary basis after a credit event.

template auction documentation,² and (ii) the eligible deliverable obligations for that reference entity and lien priority.³

The Auction

The price-finding process is designed to create “price tension”, thereby enhance trust in the integrity of the outcome, by blending traditional Dutch auction bidding methodology with the ability to physically transact through the auction at the Final Price. The Auction occurs in two stages, as described below.

Morning: Markit determines the “inside market midpoint” and the “open interest”

On the morning of the auction date, each participating dealer submits (i) an inside market bid/offer pair, representing a bid and an offer price for the eligible deliverable obligations identified in the relevant auction terms, and (ii) physical settlement requests on its own behalf and on behalf of its customers, reflecting requests to physically transact through the auction. Each dealer’s inside market bid/offer pair must be in a specific lot size and cannot differ in price by more than a maximum spread, each as reflected in the relevant auction settlement terms.⁴

Markit sorts the inside market bids received from each dealer in descending order and the inside market offers in ascending order. Markit ignores bids and offers that cross or touch (i.e., “tradeable markets”), and identifies the “best half” of quotes received in the non-tradeable markets, meaning those with the smallest bid/offer spreads. The arithmetic mean of that best half of quotes is the “inside market midpoint”. This preliminary price will be announced

by Markit and will serve as an important reference point for purposes of determining the Final Price, as discussed below.⁵

Physical settlement requests submitted by a dealer are limited in size and direction by (i) the net market position of all of the dealer’s LCDS/LCDX transactions, or (ii) the net market position of the customer’s LCDS/LCDX transactions with the submitting dealer, as applicable. Physical settlement requests to buy will be matched against physical settlement requests to sell, resulting in a market-wide “open interest” that quantifies the unfilled physical settlement requests and indicates the direction of additional orders (to buy or to sell) that are needed to fill all unmatched physical settlement requests.⁶

Once the morning session has been completed, Markit will publish the “inside market midpoint” and the size and direction of the “open interest” on its website.

Afternoon: Markit determines the “Final Price” and the “open interest” is matched with limit orders

In the afternoon of the auction date, dealers submit limit orders on their own behalf and on behalf of their customers. Unlike physical settlement requests, limit orders are not limited by the net position of LCDS/LCDX transactions of the submitting dealer or customer. Limit orders must be in the direction opposite to the open interest, and will be matched against the open interest in the order of best price to worst price. If the limit orders do not satisfy the open interest, the inside market quotes submitted by dealers in the morning will be used to fill the open interest.⁷

² If the terms are not approved by the requisite number of dealers within ten business days after the announcement of the auction, the auction will be abandoned.

Requisite number of dealers in this context means 75% of the dealers that vote, provided that at least 75% of the dealers that voted for the auction participate in the vote.

³ The requisite number of dealers to approve the deliverable obligations is 75% of the dealers that vote, provided that at least five dealers participate in the vote.

⁴ In the Movie Gallery Auction, the minimum lot size, or inside market quotation amount, was \$3 million, and the maximum difference between the inside market bid and offer submitted by a dealer was two points.

⁵ In order to discourage dealers from submitting self-serving inside market bid/offer pairs, or otherwise attempting to influence the inside market midpoint, dealers that submit quotes which constitute the tradeable markets and are in the opposite direction of the open interest are required to pay an adjustment amount to ISDA, equal to the quotation amount multiplied by the difference between the inside market midpoint and such dealer’s quote, and can be used by ISDA to defray the administrative costs of the auction.

⁶ If open interest is zero, the market is matched, and the inside market midpoint is the Final Price.

⁷ The amount of such quotes will be the inside market quotation amount and the price of such quotes will be the quote price for the non-tradeable markets or the inside market midpoint for the tradeable markets.

Once all of the open interest has been matched, the last limit order or inside market quote that is used to match the open interest (i.e., the highest offer in the case of open interest to buy or the lowest bid in the case of open interest to sell) will be the Final Price, subject to a cap.⁸

Settlement After Auction

LCDS/LCDX transactions governed by the auction will be cash settled at the Final Price. The cash settlement date is prescribed in the auction settlement terms.⁹

Physical Settlement through the auction is governed by the auction settlement terms as well as the Physical Settlement Rider. Every matched physical settlement request pair, matched physical settlement request/limit order pair, and matched physical settlement request/inside market quote pair will form a matched trade. Parties to a matched trade will be deemed to have entered into an LCDS/LCDX transaction with hard-wired terms provided in the auction settlement terms, for which a Credit Event Notice and Notice of Publicly Available Information are deemed to have been delivered.¹⁰ Protection buyer in that transaction must deliver the notice of physical settlement (NOPS) by the second business day after the auction date. If it fails to do so, protection seller then has 15 days to deliver a NOPS and demand delivery of the loan. In lieu of par payment for the loan, protection seller will pay the Final Price to protection buyer.

Failed or Abandoned Auction

If an auction fails or is abandoned, the LCDS/LCDX transactions will be subject to physical settlement pursuant to their own terms, which include the Physical Settlement Rider.

Conclusion

The auction methodology that has evolved through eight CDS credit events and one LCDS/LCDX credit event has successfully generated reliable recovery values of assets underlying the CDS and LCDS/LCDX products in the U.S. Adapting the auction to the European loan credit default swap products will require modifications necessary to suit the underlying European loan market, in which investors face issues such as access to information concerning loans and credit events. The resolution of these issues and a successful auction will initially require unprecedented cooperation among dealers. When these issues are resolved to the market’s satisfaction, the European loan credit default swap and index products will benefit from a price discovery mechanism that enables prompt and efficient settlement of the derivatives transactions.

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If you have any questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

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⁸ The Final Price cannot be (i) higher than the inside market midpoint plus the cap amount if the open interest is to sell, or (ii) lower than the inside market midpoint minus the cap amount if the open interest is to buy. In the Movie Gallery auction, the cap amount was one point. If there is still open interest remaining after using all limit orders and inside market quotations, the Final Price will be zero if the open interest is to sell, or the higher of par and the limit offer cap if the open interest is to buy. The limit offer cap is the highest inside market offer that is part of the non-tradeable markets, and is a concept unique to LCDS/LCDX auction. This concept was added to the LCDS/LCDX auction due to the possibility that over-secured loans may have a value above par even in a default situation.

⁹ In the Movie Gallery auction, the cash settlement date was the tenth business day after the auction.

¹⁰ To the extent that customers submit physical settlement requests and limit orders through their dealers, dealers will be parties to the matched trades formed in the auction, and each dealer party will have an offsetting trade on the same terms with its customer who submitted the physical settlement request or limit order.

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