

FAQ

This FAQ document is intended as guidance only and does not purport to be and should not be considered a guide to or an explanation of all relevant issues for consideration in connection with credit derivatives auctions. In relation to any particular auction, parties should refer to the relevant Auction Settlement Terms published by ISDA and should consult with their legal advisers and any other adviser they deem appropriate.

Unless otherwise defined, capitalized terms used in this FAQ document have the meanings given to them in the 2003 ISDA Credit Derivatives Definitions, as amended and supplemented by the 2009 Credit Derivatives Determinations Committees, Auction Settlement and Restructuring Supplement.

Auction Settlement Terms and Timing

- Who decides the Auction terms and parameters? Are traders involved?

The relevant Determinations Committee (the “DC”) specifies all the terms and parameters of each Auction in the Auction Settlement Terms document for such Auction. This is based on the form of Auction Settlement Terms published by ISDA.

DC Members involve traders where appropriate in this process.

- When are the Auction terms and parameters made available?

Auction details as published in the Auction Settlement Terms are posted on www.isda.org/credit by the DC Secretary before an Auction. The DC may resolve to publish the key auction parameters in advance of the full auction terms.

- Why might it take longer than 30 days after the DC’s determination that a Credit Event has occurred to arrange for an Auction?

Following a determination that a Credit Event has occurred and that an Auction should be held, the DC determines the relevant Deliverable Obligations in respect of the Reference Entity and the Auction and publishes these in the “Final List” on the ISDA website.

In order to do so, documentation in respect of potential obligations submitted for consideration may need to be sourced and their terms reviewed (including giving opportunity for Eligible Market Participants to submit, and/or challenge the inclusion of, particular obligations). Although this will be relatively straightforward in some cases, there may be circumstances in which the terms of a particular obligation require detailed review and consideration by the DC.

Before the Auction

- What are the FX rates used for?

Certain FX rates are posted on www.creditfixings.com, two business days (or, in the case of the Americas DC, one business day) prior to the Auction. They are used to convert the amount of Deliverable Obligations denominated in a different currency to that of the quotation currency specified in the Auction Settlement Terms. This ensures a single FX rate is used by all market participants to calculate the amounts of Deliverable Obligations that are to be Delivered into the Auction.

In the case where a CDS is denominated in a currency other than the Auction currency, the Final Price determined pursuant to the Auction (which is expressed as a percentage) would be applied to the Floating Rate Payer Calculation Amount in the normal way, so as to result in an Auction Settlement Amount in the currency of the CDS. No FX rate is required in this process except for a party to calculate the maximum permissible size of its Physical Settlement Request (in the Auction currency) that a party may submit in relation to the CDS (as this is limited to such party’s “Market Position”, which, as defined in the Auction Settlement Terms, is determined by reference to a party’s

net CDS position). No rate is specified for this conversion and participants may therefore determine their Market Positions using a reasonably determined rate.

- **When should clients submit their Physical Settlement Request to Dealers?**

If customers want to submit a Physical Settlement Request to a Participating Bidder in an Auction, they should do so no later than the deadline specified in the Auction Settlement Terms, generally 5pm on the day prior to the Auction. A Participating Bidder is not obligated to accept Customer Physical Settlement Requests after that time (and is not obligated to accept them at any time if it does not have a trading relationship with the relevant customer).

Limits on the size of Customer Physical Settlement Requests are set out in the applicable Auction Settlement Terms.

Auction Submissions

- **If I am a net buyer of CDS protection, in which direction should my Physical Settlement Request be entered?**

A net protection buyer can enter a Physical Settlement "Sell" Request and a net protection seller can enter a Physical Settlement "Buy" Request.

In a standard physically-settled CDS contract, the CDS protection buyer delivers obligations to physically settle the transaction. In any trade pursuant to the Auction Settlement Terms, the CDS protection buyer will also deliver obligations and should therefore enter a Physical Settlement Sell Request (i.e. a firm commitment to enter as Buyer into a CDS contract on terms equivalent to the Representative Auction-Settled Transaction – as defined in the Auction Settlement Terms (the "RAST")).

In the converse situation, a net seller of CDS protection should therefore enter a Physical Settlement Buy Request (i.e. a firm commitment to enter as Seller into a CDS contract on terms equivalent to the RAST).

- **Should the price submissions include accrued interest?**

When the CDS arising in the Auction itself (on terms equivalent to the RAST) is settled after the Auction, **no additional amount is added to the Physical Settlement Amount to reflect accrued interest**, i.e. when a buyer of CDS protection sells a Deliverable Obligation into the Auction, it will receive the Final Price and nothing for accrued interest.

Accordingly, if a party believes accrued interest should be accounted for (e.g. if the Deliverable Obligations are continuing to pay current interest) the party should submit the dirty price, and otherwise the clean price. Participating Bidders and customers should factor in this consideration when considering what prices to submit.

- **Why can't each Participating Bidder submit Limit Orders for more than the amount of the Open Interest in the Subsequent Bidding Period?**

The Open Interest is the difference between (i) the sum of the Quotation Amounts in all valid Physical Settlement Buy Requests and (ii) the sum of the Quotation Amounts in the valid Physical Settlement Sell Requests, i.e. the amount of interest left to fill in the Auction. Limit Orders serve to allocate the Deliverable Obligations representing the Open Interest and cannot exceed it (since participants know that there would not be enough interest to sell or buy, as applicable, Deliverable Obligations to satisfy any larger order). There would therefore be no natural incentive for a party to limit the size of its order if it were to exceed the Open Interest.

Deliverable Obligations representing the Open Interest are matched with Limit Orders according to the offer or bid price, as applicable, of the Limit Orders. If in this process there are multiple Limit Orders that clear the remaining

Open Interest at the Final Price, such Limit Orders are filled against the remaining Open Interest pro rata with respect to the Quotation Amount which they specify.

The only benefit of placing an order larger than the Open Interest is therefore to maximize pro-rata allocation where more than one party's Limit Order clears the Open Interest at the Final Price. The cap at the Open Interest removes the incentive to submit artificially large submissions. For example, if there is JPY 5 BN of Open Interest, the sum of a participant's Limit Orders cannot be larger than JPY 5 BN.

- **Are recovery locks settled through the auctions?**

Recovery locks settle based on the Auction Final Price in accordance with the Definitions (as amended by the Supplement) through the auction. Fixed Recovery Transactions are cash settled, not auction settled, and so they do not use the Auction Final Price in settlement (the recovery is fixed).

- **When a party calculates its net CDS position ("Market Position"), what trades should be included? Should it be limited to transactions entered into with counterparties that have adhered to the ISDA Big Bang or Small Bang Protocol?**

The size of Physical Settlement Request that a party can enter in an auction is limited by reference to that party's net CDS position, defined in the Auction Settlement Terms as the "Market Position". This definition requires a party to calculate its Market Position by reference to its (1) Auction Covered Transactions and (2) Auction-Linked Cash Settled Transactions.

To qualify as an "Auction Covered Transaction", a Credit Derivative Transaction on the relevant Reference Entity must incorporate the March 2009 Supplement or the July 2009 Supplement and specify "Auction Settlement" as the applicable Settlement Method. The Big Bang and Small Bang Protocols apply the relevant supplement and Auction Settlement to a wide range of credit derivative transactions. For transactions where both parties have adhered to the Big Bang or Small Bang Protocol, this would include single-name CDS, constant maturity swap and recovery lock transactions, CDX and iTraxx transactions (including untranching, tranches and swaptions), first to default, Nth to default and bespoke portfolio transactions. The following types of transaction are examples of those that would NOT be Auction Covered Transactions: Reference Obligation Only, Preferred CDS, Fixed Recovery CDS.

Where one or both of the parties to the transaction have not adhered to the Big Bang or Small Bang Protocol, a party would need to confirm whether the supplement applies to a particular transaction to determine whether it is an Auction Covered Transaction (and therefore could be included in calculation of that party's Market Position). Parties may wish to note that a corporate or sovereign single-name CDS referencing the ISDA Credit Derivatives Physical Settlement Matrix dated April 8, 2009 or later will include one of the supplements identified above and will specify Auction Settlement as the Settlement Method.

For a transaction to qualify as an "Auction-Linked Cash Settled Transaction", it must reference the relevant Reference Entity and the parties must have specifically agreed that settlement will occur by payment of an amount calculated by reference to the Auction Final Price. However, the following types of Credit Derivative Transactions which satisfy this criteria will not constitute Auction-Linked Cash Settled Transactions and therefore cannot be counted as part of the Market Position: Reference Obligation Only Transactions; Loan Only Transactions; Preferred CDS Transactions; Fixed Recovery Transactions; and any other transaction that is an "Excluded Index Transaction" or an "Excluded Non-Index Transaction" as defined in the Auction Settlement Terms.

Adherence to the Big Bang or Small Bang Protocol is therefore not relevant to the question of whether a transaction is an Auction-Linked Cash Settled Transaction.

Trades and Final Price

- **Why is there a cap amount on the Final Price?**

During the first phase of the Auction, the Participating Bidders' Initial Market Submissions are used to determine the Initial Market Midpoint as described in the Auction Settlement Terms. This is then published, along with the details of

the Open Interest. The Open Interest indicates whether there is a net demand or a net supply of Deliverable Obligations.

The cap amount blocks the ability to manipulate the result by stopping the Auction Final Price from moving in the opposite direction suggested by the Open Interest. For example, if the Open Interest is to sell, it would be illogical for the Final Price to move higher than the Initial Market Midpoint.

- **What happens if a party cannot deliver the exact amount?**

Due to minimum denominations or transfer amounts, it may not be possible for the Buyer under a Representative Auction-Settled Transaction arising pursuant to the Auction to deliver Deliverable Obligations in an aggregate amount exactly equal to the Floating Rate Payer Calculation Amount, particularly if the Deliverable Obligations are denominated in a currency different from the Auction currency (in which latter currency the Floating Rate Payer Calculation Amount is denominated).

As in the case of a standard physically-settled CDS transaction, the Buyer may deliver Deliverable Obligations in an aggregate amount less than the Floating Rate Payer Calculation Amount, in which case the respective Seller would pay an equivalent proportion of the Physical Settlement Amount (but if the Buyer were to deliver more than the Floating Rate Payer Calculation Amount, it would not receive more than the Physical Settlement Amount).

It should also be noted that Physical Settlement Requests and Limit Orders must be an integral multiple of a specified minimum size (the "Quotation Amount Increment") and the specified "Rounding Convention" will apply to certain matched Physical Settlement Requests and Limit Orders, as described in the Auction Settlement Terms. These rules will mean that the notional size of any RAST transactions formed in the auction will be an integral multiple of an amount specified in the Auction Currency, and so due to FX conversions, parties may not be able to deliver a precise amount of Deliverable Obligations denominated in a different currency.

For example: Party A wishes to deliver USD 1 MM nominal value of Deliverable Obligations into an Auction denominated in JPY, and (i) the FX Rate is 85.55 JPY/USD, (ii) the minimum denomination for the relevant USD obligation is USD 1,000 and (iii) the Quotation Amount Increment and the Rounding Amount for the Auction are each JPY 100,000. Party A cannot enter a Physical Settlement Sell Request for JPY 85,550,000, because it is not an integral multiple of JPY 100,000. Party A can enter a Physical Settlement Request for JPY 85,500,000, and deliver the USD obligation with a nominal value of USD 999,000 (to reflect the minimum denomination of the obligation) against payment of JPY 85,464,450 multiplied by Final Price.

- **Can I specify which Deliverable Obligations I want to accept delivery of in respect of a physically settled transaction pursuant to the Auction Settlement Terms?**

No. Participating Bidders are notified of their counterparty/ies and trade size(s), but, as with standard CDS settlement, it is the Buyer under the Representative Auction-Settled Transaction (i.e. the party who submitted a Physical Settlement Sell Request or Limit Offer) who may determine, in the Notice of Physical Settlement, which of the Deliverable Obligations to deliver.

Physical Settlement Requests and Customer Physical Settlement Requests contain a representation that the submitting party is not subject to any requirement that would make it impossible or illegal for them to Deliver or accept Delivery of any of the Deliverable Obligations. Further, the terms of the Representative Auction-Settled Transaction provide (as further detailed in the Auction Settlement Terms) that a party may designate an Affiliate to Deliver or accept Delivery of Deliverable Obligations on its behalf and may so designate any third party to do so (with the consent of the other party) if it is illegal or impossible for it to Deliver or accept Delivery.

- **What is the relevance of any set-off rights in respect of loans on the Final List?**

Section 2.15(a)(ii) of the Credit Derivatives Definitions provides that, in order to constitute a Deliverable Obligation, an obligation must not be subject to any counterclaim, defense (other than a counterclaim or defense based on the factors set forth in Section 4.1 (a)-(d) of the Definitions) or right of set-off by or of the relevant Reference Entity or any applicable Underlying Obligor (together referred to here as "relevant set-off rights").

Under Japanese law, there is a statutory right for the borrower to set off its obligations owed to the lender under a loan against any obligations owed to the borrower by the lender. Further, on a transfer of a loan a borrower would, in principle, be able to exercise any relevant set-off rights that it could have exercised against the transferor (existing at the time of the transfer of the loan) against the transferee, even after the transfer becomes effective and perfected.

Consequently, in order for a loan on the Final List (a **Loan**) to constitute a Deliverable Obligation either (i) there must, as a matter of fact, be no relevant set-off rights or (ii) any relevant set-off rights must have been waived by Aiful.

In order to obviate the need for lenders to seek waivers independently and to thereby facilitate the Auction process, a form of waiver has been agreed with Aiful.

Pursuant to this form of waiver, Aiful waives any set-off rights that it has against a relevant transferor which exist at, or are capable of arising after, the time of any transfer under a RAST or the cash settlement fallback provisions contained in the Auction Settlement Terms.

A person taking delivery of a Loan under a RAST (a **RAST Recipient**) will therefore receive it free and clear of any relevant set-off rights. Further, a RAST Recipient will be able to sell the Loan (or deliver it pursuant to a credit derivative transaction, including other than a RAST) free and clear of any relevant set-off rights, provided that it can establish, as a matter of fact, that there are no set-off rights subsisting between it and the Reference Entity (Aiful), i.e. once waived pursuant to the Form of Waiver, set-off rights do not arise again for the purposes of future transfers.

We understand that a waiver on the terms described here has been given by Aiful in respect of certain of the Loans and is in the process of being obtained in respect of the remaining Loans.

Resources

www.isda.org/credit

www.creditfixings.com