

REVERSE inquiries
Workshop Series

Issuing Credit Linked Notes

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“Gambling on the failure of others”?

FINANCIAL TIMES

Vatican used charity funds to bet on Hertz credit derivatives

‘Gambling’ bets placed under watch of Cardinal Becciu, who was forced to resign last month

In 2018, Pope Francis said credit default swaps “encouraged the growth of a finance of chance and of gambling on the failure of others, which is unacceptable from the ethical point of view”. The instruments, he said, were “[a ticking time bomb](#)”.

But three years earlier, part of a €528m Vatican portfolio “derived from donations” bought structured notes containing CDS as part of a bet that Hertz would not default on its debts by April 2020, the documents show. The company [filed for bankruptcy](#) the following month, giving the Holy See a narrow escape on the investment, which paid out in full.

Agenda

- Introduction to Credit Linked Notes
 - Anatomy, Purpose and Key Concepts
- Bank programs and SPV programs
- Single name, basket and index CLNs
- Tranched and untranching structures
- Settlement methods (auction, cash and physical)
- Areas of basis risk with CDS and underlying assets
- Documentation
- US securities laws and regulatory and tax issues

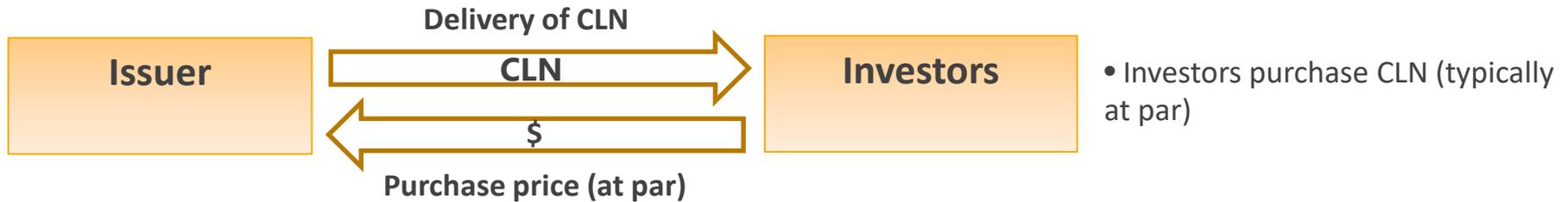


Anatomy of a Credit Linked Note

"A credit linked note (CLN) is a financial instrument designed to transfer the credit exposure in respect of one or more specified reference entities and/or obligations from the issuer to the investor. The issuer pays an enhanced coupon to the investor. In return, the investor's right to receive its principal in full at maturity is at risk if a credit event occurs in respect of the reference entity or obligation."

Anatomy of a Credit Linked Note

Issue Date:



No 'Credit Event':



'Credit Event':



Types of CLN based on hedge

- Credit Linked Notes typically **EITHER**:
 1. Repackage standardised single-name or index credit default swaps into a funded form ("**vanilla CLN**")
 - Hedged with vanilla CDS
 - Terms closely replicate those of CDS to minimise any basis risk
 - OR**
 2. Transfer the credit risk of specific underlying instrument ("**bespoke CLN**")
 - Typically a loan or bond, but occasionally an exposure under other instruments (letters of credit, ISDA Master Agreements etc.)
 - Hedged with underlying instrument
 - Terms are bespoke, designed to closely match risk of underlying
- Both forms of CLN generally utilise concepts terms and concepts developed by credit derivatives markets

Comparison with certain other credit products

Other products may achieve similar purposes and economic outcomes but may have advantages and disadvantages:

- Credit default swaps (CDS)
 - ✓ Not required to be pre-funded so allow leverage
 - ✗ Limited universe of investors
- Total return swaps
 - ✓ Can be tailored to bespoke nature of underlying
 - ✗ Require extensive negotiation
- Loan participations
 - ✓ True participation may remove of credit risk of grantor
 - ✗ Not easily tradeable
- CLOs/CDOs
 - ✓ Spread risk across broader portfolio of exposure
 - ✗ Limited opportunity to tailor terms to specific risk exposures

Purpose of Credit Linked Notes

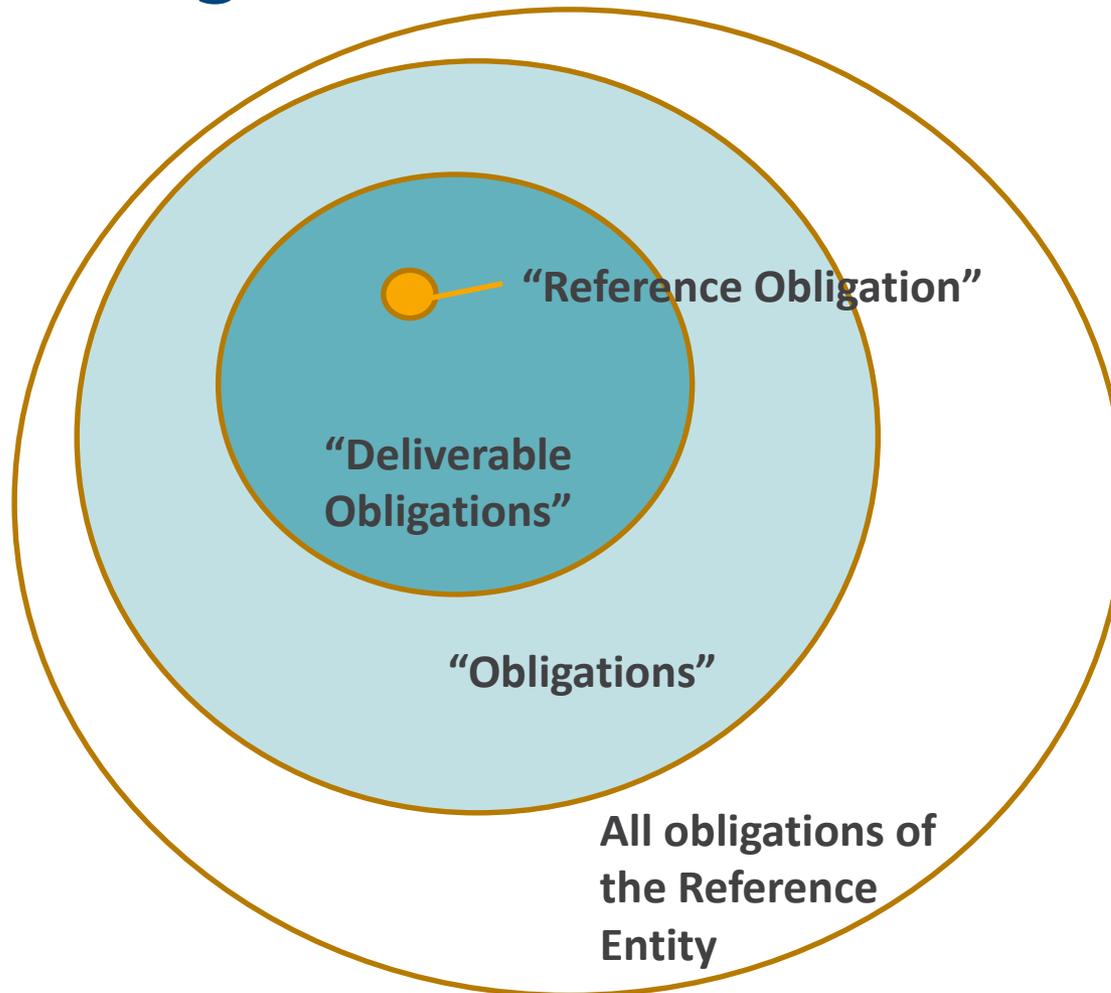
- For Issuer/Arranger:
 - Ability to transform CDS contracts into a funded form
 - Syndication of credit risk of underlying debt with transfer or other restrictions
 - Meeting treasury funding requirements
 - Streamlined documentation when issuance platform established
- For Investor:
 - Ability to access CDS markets/indices without ISDA relationship
 - Ability to tailor terms (maturity, Reference Entity) to specific requirements
 - Access to risk/return on products otherwise limited to bank lenders
 - Tradeable product with price discovery



Key Concepts I: The Basics

- Reference Entity/Reference Obligation
- Principal Amount
- Interest/Coupon Amounts
- Credit Events and 'Event Determination Date'
- Conditions to Settlement
- Settlement Method (Auction/Cash Settlement/Physical Settlement)

Key Concepts II: The Obligation Universe



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- Obligations
 - Used to determine whether a Credit Event (such as a Failure to Pay or Restructuring) has occurred
 - Include where Reference Entity is obligor or guarantor
 - Defined by:
 - Obligation Category: Payment, Borrowed Money, Bond or Loan, Bond, Loan, Reference Obligation Only
 - Obligation Characteristics: Not Subordinated, Specified Currency, Not Sovereign Lender, Not Domestic Currency, Not Domestic Law, Listed, Not Domestic Issuance
 - Non-EM CDS typically trades Borrowed Money with no Obligation Characteristics; EM more restrictive

Key Concepts II: The Obligation Universe

- Deliverable Obligations
 - Used to determine which obligations may be delivered in physical settlement (or valued in cash/auction settlement)
 - Include where Reference Entity is obligor or guarantor
 - Defined by Deliverable Obligation Categories (same as Obligation Categories) and Deliverable Obligation Characteristics (same as Obligation Characteristics plus:
 - Assignable Loan/Consent Required Loan/Direct Loan Participation
 - Transferable, Maximum Maturity, Accelerated or Matured, Not Bearer
 - Non-EM CDS typically trades Bond or Loan with some Deliverable Obligation Characteristics; EM more restrictive

Key Concepts II: The Obligation Universe

- Reference Obligation
 - Option to specify one or more obligations of the Reference Entity as the Reference Obligation:
 - To ensure at least one Obligation/Deliverable Obligation
 - Used as benchmark with Not Subordinated Obligation Characteristic to determine where senior/subordinated CLN
 - Used as valuation obligation in Cash Settlement
 - Used in bespoke Reference Obligation only CLNs
 - Substitute Reference Obligation provisions
 - Standardization of Reference Obligations across widely traded names

Key Concepts III: Credit Events

- Bankruptcy
- Failure to Pay
- Restructuring
- Obligation Acceleration
- Obligation Default
- Repudiation/Moratorium
- Governmental Intervention (Financials/Sovereigns)

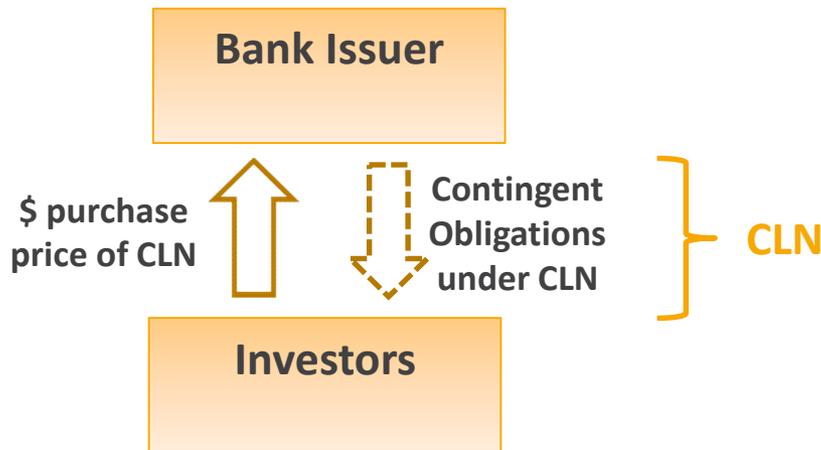
Key Concepts IV: Successors

- Provisions included to address possibility where debt obligations move to new entities
- Determined based on all outstanding Bond and Loans
- Thresholds

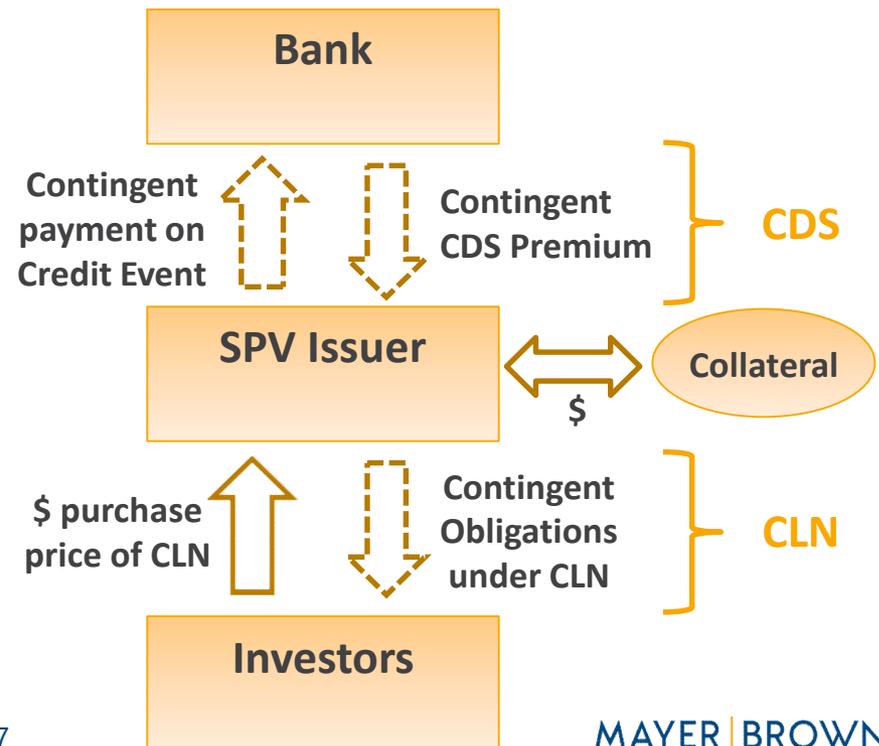
75%+	Sole Successor
25%-75%	Possible multiple Successors
<25%	No Successor (<i>unless RE ceases to exist</i>)

Bank programs and SPV programs

- Bank can use cash proceeds for any purposes
- Investor has full recourse to Bank for obligations under CLN
- Bank has complete discretion how to hedge its obligations (or whether to hedge at all)
- No nexus between investors and underlying hedging activities of bank (except possible break costs on early redemption)



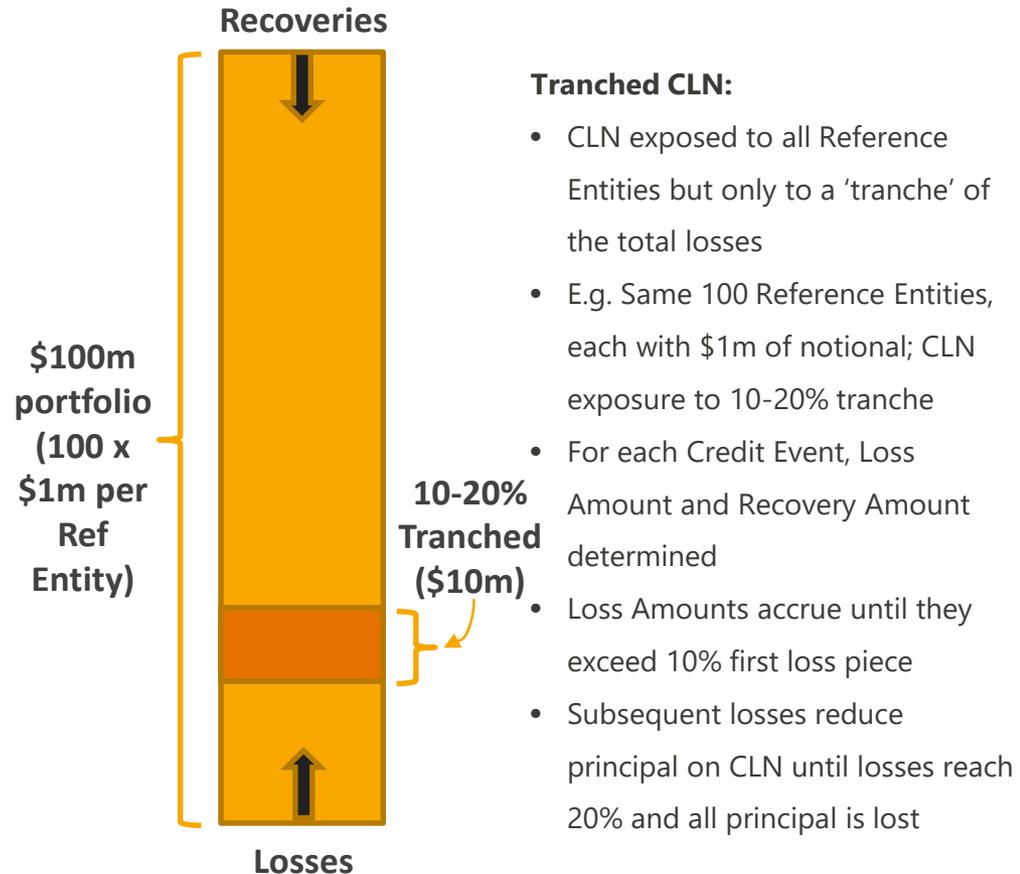
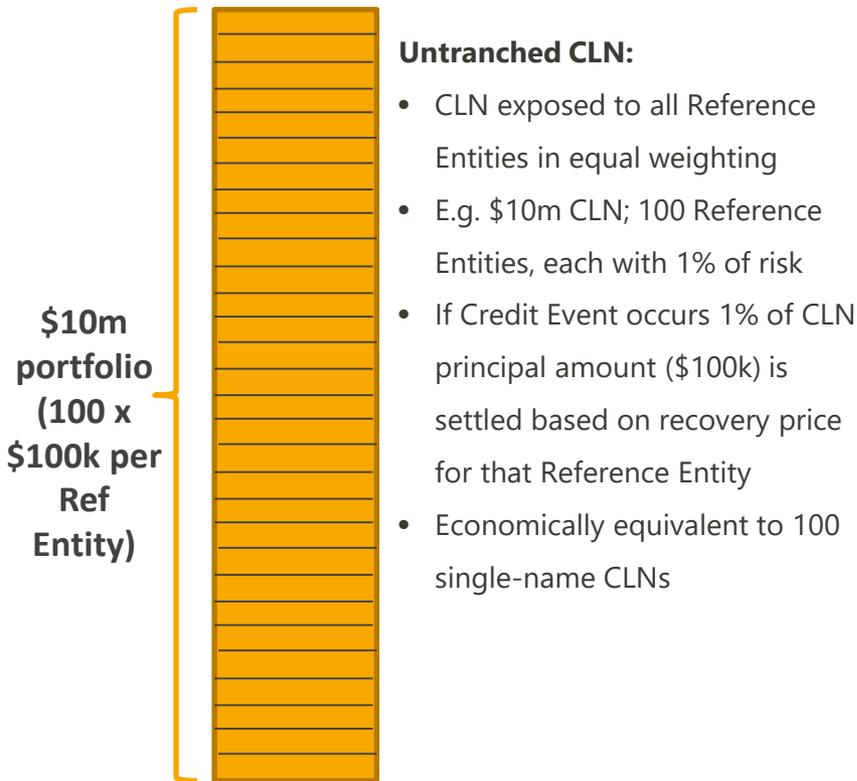
- SPV uses CLN proceeds to purchase high quality liquid collateral
- SPV enters into CDS with bank
- Collateral secures SPV's obligations to (1) bank under CDS, and (2) investors under CLN
- SPV's obligations to investors contingent on payments received under collateral and CDS



Single name, basket and index CLN

- Single name
 - Single Reference Entity
 - Upon Credit Event, CLN is cash settled by cash payment based on value of Reference Entity's obligations or physically settled by delivery of obligation of the Reference Entity
- Basket/Portfolio CLN
 - Multiple Reference Entities
 - Risk can be apportioned with partial settlement on each Credit Event or "first to default"
- Index CLN
 - Typically references CDS indices published by IHS Markit (iTraxx, CDX)
 - CLNs may be 'tranching' or 'untranching'

Untranching and Tranching index CLN



Settlement Methods

- Auction Settlement
 - CLNs are early redeemed at a price equal to the product of the par amount of CLN and the “Auction Final Price”
 - “Auction Final Price” determined by Market-wide auction administered by ISDA
 - May be separate auctions for senior and sub debt obligations
- Cash Settlement
 - “Final Price” determined by CLN Calculation Agent based on dealer poll for Reference Obligation or selected Valuation (Deliverable) Obligation
- Physical Settlement
 - CLN settled by a principal amount of Deliverable Obligations equal to CLN principal amount
 - Challenges of physical settlement

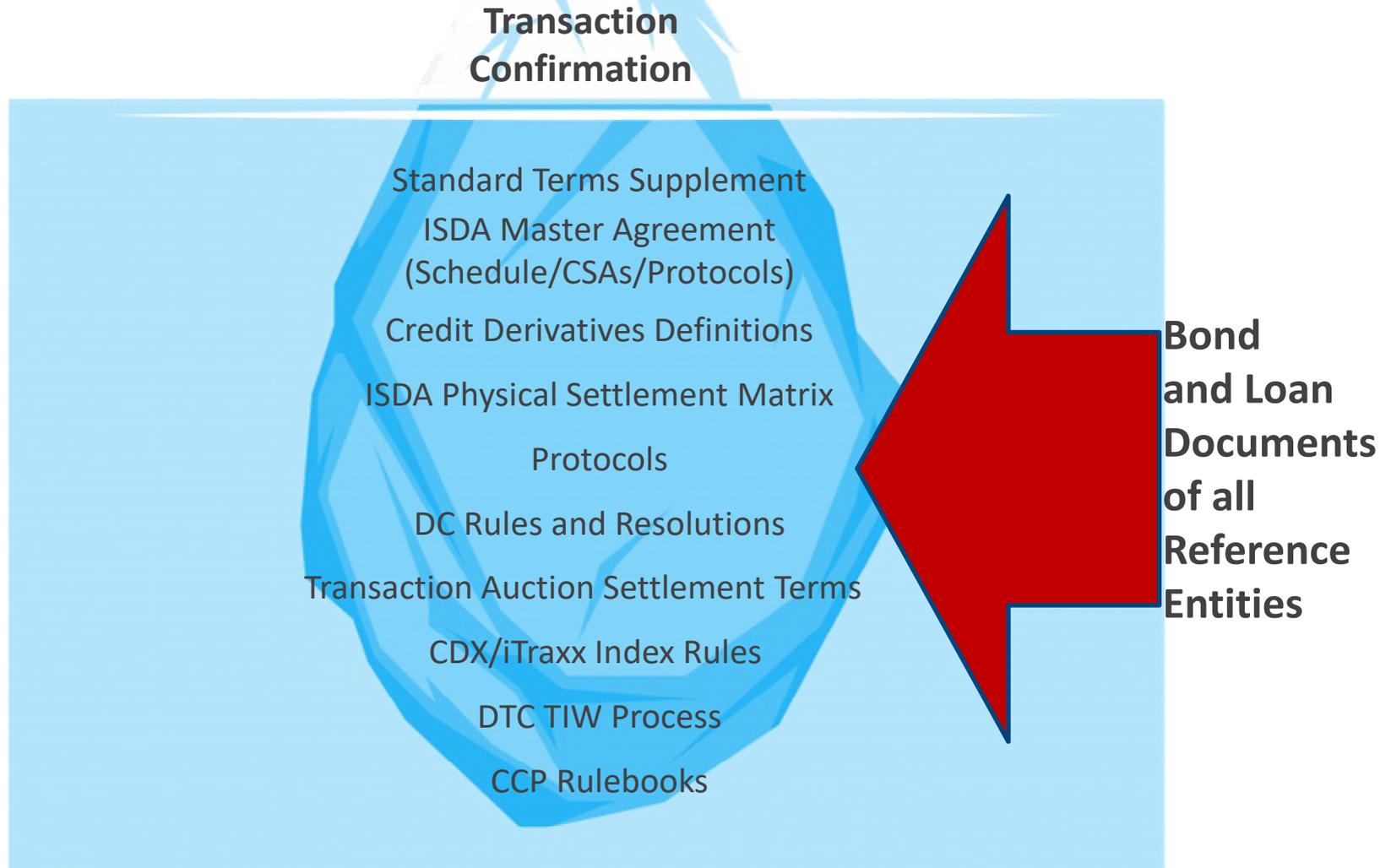
Areas of basis risk with CDS (vanilla CLN)

- Timing of Credit Events
 - **Problem:** CDS contracts can be extended beyond scheduled termination (e.g., 'Notice Delivery Period'; Potential Failure to Pay; Potential Repudiation; Determination Committees deliberation)
 - **Solutions:** Having longer term of CLN than CDS hedge and/or discretionary extension of maturity provisions in CLN
- Adoption of market-wide CDS protocols
 - **Problem:** CDS may be amended from time to time by adherence to protocols that do not cover CLNs (e.g., 2014 Credit Derivatives Definitions Protocol, 2019 Narrowly Tailored Credit Event Protocol)
 - **Solutions:** Terms allowing modification of credit provisions without investor consent (but amendments may still need to be documented)

Areas of basis risk with underlying (bespoke CLN)

- Publicly available information
 - **Problem**: Events surrounding occurrence of Credit Event may be non-public information (e.g., in private loan)
 - ***Solutions***: Provisions in underlying to permit disclosure; discretion in CLN terms to call event without evidence; use of 'verification agent'; 'wait and see' approach; file bankruptcy proceedings
- Settlement issues
 - **Problem**: Underlying may be difficult to value and/or subject to defences, counterclaims or risk of set off
 - ***Solutions***: Bespoke valuation provisions; noteholder last look; physical settlement; issuer representations on validity of claim

But beware of the CDS “Iceberg”...



US Documentation



- CLNs are normally issued under an existing program (either a medium-term note program or a designated structured note program)
- A CLN product supplement may be used where many CLN issuances are planned. CLN product supplement will typically include relevant provisions from the 2014 ISDA Credit Derivatives Definitions and relevant supplements with adjustments to reflect CLN structure:
 - Greater discretions of Issuer or Calculation Agent
 - Extended timeframes to reduce basis risk
 - Simplified determinations
- Pricing Supplement will contain commercial terms (maturity, coupon, credit events) and bespoke risk factors in relation to the relevant CLN terms and Reference Entity.
 - If a CLN product supplement is not used, the relevant ISDA Credit Derivatives Definitions will be included in the pricing supplement.

US-Specific Considerations

- Investor suitability
 - Not suitable for retail investors
 - Investor representation letter recommended
- Credit ratings
 - SEC Rule 17g-5 not applicable
 - Common hurdles
 - Extra turn-around time may be required, particularly where bespoke features or non-public triggers are involved.
- US tax considerations

Questions?



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