What You Need to Know NOW

by Rick Hyman & Amit Trehan

Credit default swaps, or "CDS" as they are commonly known, have emerged from virtual obscurity only five years ago to become a multitrillion dollar market today. Having arisen partly in response to the desire of bondholders to reduce credit risk without having to resort to more traditional forms of credit enhancement such as letters of credit, guarantees and financial guarantee insurance, CDS have evolved into a market of their own, trading freely, with possibly unfore-

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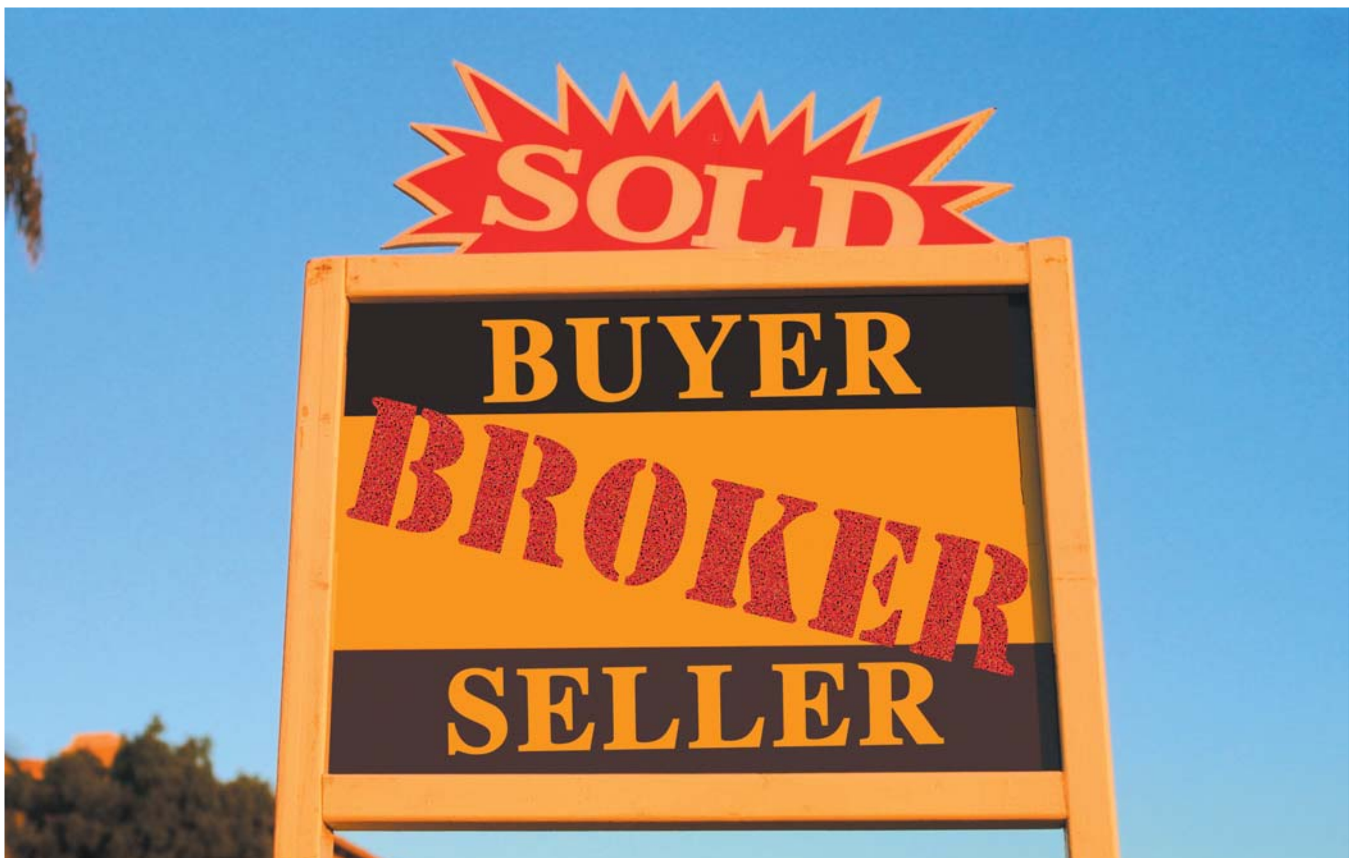

seen consequences for creditors of the underlying entities. More recently, the CDS market has expanded from bonds to cover commercial loans, so-called Loan-Only Credit Default Swaps or LCDS. This article describes the basic mechanics of CDS and LCDS, and explores a few of the ramifications of these critically important, but often misunderstood, financial products from the perspective of the lender, whether that lender is secured, unsecured, senior or subordinated.

The basic structure of a CDS or LCDS

All CDS and LCDS have the same four common elements: a reference entity, a reference obligation, a protection seller and a protection buyer. In its most basic form, a lender or bondholder seeking credit enhancement (the protection buyer) holds a note or a bond (the reference obligation) issued by a borrower or an issuer (the reference entity). In order to reduce its credit exposure to the borrower or issuer, the protection buyer enters into a swap agreement, via a broker, with an unrelated party (the protection seller), whose economic motivation is often to gain credit exposure to the reference entity and earn fees. Under the swap, the protection buyer agrees to make periodic payments of fees to the protection seller, and the protection seller agrees that, upon the first occurrence of one or more specified defaults by the reference entity (a credit event), to purchase the reference obligation from the protection buyer at par. Unlike traditional forms of credit enhancement, the reference entity, i.e., the underlying issuer or borrower, is not involved in the transaction and may be unaware that a CDS or LCDS is in place. From the perspective of a lender in a syndicated loan facility, this structure enables the protection buyer to avoid, at least prior to final settlement, having to procure the customarily required consents from the administrative agent and, in some instances, the borrower.

The players

The players in credit default swaps consist of buyers, sellers and the brokers that bring them together. In the relatively mature CDS marketplace, protection buyers are typically financial institutions that are seeking credit enhancement, either because of concern relating to the credit condition of a particular reference entity, or as part of an overall portfolio management tool. In the new LCDS marketplace, protection buyers are typically commercial banks, hedge funds, or any holder of commercial loan exposure seeking credit enhancement for the same reasons motivating CDS buyers. Moreover, the protection buyer may be a hedge fund or other financial institution that does not own the reference obligation, and may be purchasing a CDS or LCDS as a means of financial speculation, in effect "shorting" the underlying credit. Protection sellers in the current marketplace are often specialty insurers, hedge funds, or other types of funds seeking, in addition to fee income, "synthetic" or "derivative" exposure to credit markets in which they are not otherwise participants. Buyers and sellers purchase and sell their respective swap obligations at the counters of one or more of about a dozen financial institutions that make markets in credit default swaps.

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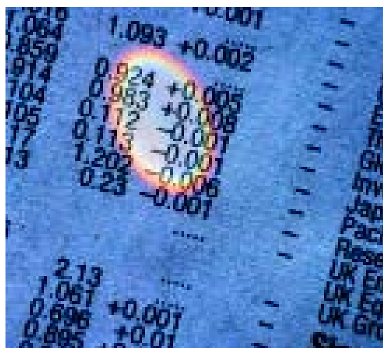
Term
The customary contractual coverage period, or term, of a typical CDS or LCDS is five years, but swaps are increasingly available for shorter or longer terms. As discussed in detail below, the event that triggers the settlement obligation of the protection seller must occur on or before the stated termination date. If no triggering event has occurred by the end of the term, the swap ends with the protection seller having earned its fees without even having had to make payment in return.

Pricing
CDS and LCDS fees are quoted in terms of a percentage, expressed in basis points, of the "notional amount" of protection being purchased. By way of example, suppose a corporation issues a bond with a face value of $10 million. A protection buyer with respect to that bond may enter into a five-year CDS contract with a protection seller quoted through a broker as being priced at 230 bps. Under this hypothetical contract, the protection buyer will pay the protection seller $230,000 per year (typically in four equal, quarterly installments) for the right to receive the par value of such bond ($10 million) upon the occurrence of a specified credit event during the term. As with most financial instruments, the price quoted by brokers for a particular swap (i.e., with respect to a particular reference entity and a particular reference obligation of that reference entity) fluctuates, sometimes dramatically, depending on the market's perceived risk associated with any given credit. Obviously, as "word on the street" about a particular reference entity's credit condition suggests deterioration, or worse yet, looming bankruptcy, the price quoted for swaps with respect to that reference entity goes up. Indeed, credit analysts increasingly focus their attention on price movements in an issuer/borrower's CDS/LCDS as a highly reliable indicator of the credit condition of that issuer/borrower.



Documentation
As with most derivatives, CDS and LCDS are documented using forms promulgated by the International Swaps and Derivatives Association, Inc. or "ISDA." Most lenders are familiar with ISDA forms in connection with interest swaps and other interest rate protection products. CDS and LCDS start with the same ISDA "Master Agreement" as would an interest rate protection product. The Master Agreement is then supplemented with ISDA Form Schedules and Confirmations that have been specifically developed for CDS and LCDS transactions. Uniform documentation reduces negotiation time and expense related to, and facilitates secondary trading in, CDS and LCDS.

Credit (triggering) events
The occurrence of a "credit event" during the term of the swap triggers the right of the protection buyer, and the obligation of the protection seller, to "settle" the contract in accordance with a specific set of notice procedures and timelines. While the roster of credit events can be negotiated, in basic CDS and LCDS transactions the triggers typically include a bankruptcy filing by or with respect to the reference entity and a failure to pay "borrowed money obligations" of the reference entity. For obvious reasons, it is critical that the credit event triggers be drafted clearly and unambiguously so as to reduce the likelihood for dispute as to whether or not a credit event has occurred. For example, it is easy to determine and prove whether the reference entity is the subject of a bankruptcy proceeding, but far less easy to determine and prove that the reference entity is "insolvent." The last thing a protection buyer wants, having dutifully paid its swap fees, is to get into a disagreement with its swap counterparty as to whether or not a triggering event has occurred. Payment default by the reference entity typically triggers settlement rights and duties if, after the expiration of any applicable grace period, the reference entity fails to make required payments when due under the reference obligation.

One credit-event trigger available for selection under the ISDA forms is the occurrence of a "restructuring" with respect to the reference entity regarding one or more of its obligations. The term "restructuring" invites ambiguity, and has led in the past to disputes over whether a credit event has, in fact, occurred. Generally, in the world of credit default swaps, a "restructuring" is the occurrence of any one of the following events that binds all holders of the reference obligation: reduction in the rate or amount of interest payable or accruable; reductions in principal or premium; postponement or other deferral of a date or dates for either the payment or accrual of interest, or the payment of principal or premium; or a subordination of the reference obligation. It is important to note that the restructuring must bind all holders of the reference obligation and the restructuring event must be something that is not expressly provided for under the terms of the documents evidencing the reference obligation. Adding a layer of complexity to this already relatively subjective concept are vague restructuring credit event exceptions, such as the occurrence of a restructuring event which does not directly or indirectly result from a deterioration in the creditworthiness or financing condition of the reference

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entity, or restructurings due to administrative adjustment, tax adjustment, or other technical adjustment occurrence in the ordinary course of business. It should be easy to see how sincerely held differences of view as to whether, for example, a restructuring of an obligation has occurred "in the ordinary course of business" can occur. As a result, use of "restructuring" as a credit event trigger has waned. Generally, with respect to U.S.-based LCDS, "restructuring" is *not* available in the market as a credit-event trigger. It remains available, however, in European-based LCDS transactions.

Settling up

As originally conceived, credit default swaps called for a "physical delivery" of the reference obligation, upon the occurrence of a credit-event trigger, as a condition of the protection seller's obligation to pay the notional amount (typically, but not necessarily, the face amount) of the bond. If, for any reason, the protection buyer was unable to physically deliver the actual instruments evidencing the reference obligation, then the protection seller had no duty to pay. As a preliminary step to the physical settlement process, the protection buyer would be required timely to

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deliver certain notices to the protection seller, together with a "notice of publicly available information," usually a news release or court filing, but can include a signed statement of the protection buyer, to "prove" that the credit-event trigger really occurred. Upon physical settlement, the deliverable obligation is tendered, together with any assignments and endorsements necessary to make the protection seller the legal holder of the obligation. Unless extended, physical settlement typically occurs within 30 calendar days of the protection buyer's required notices to the swap seller. On the established date, upon the protection buyer's proper tender of the reference obligation, the protection seller delivers the par value of the reference obligation to the protection buyer and the swap transaction is concluded.

There have been multiple settlements of CDS over the past few years, including a handful that have led to litigation as a result of ambiguities in the documentation. Although, as this article is being written, a credit event has not yet occurred in the young LCDS market, one is likely to occur in the very near future. Capitalizing on experiences in the CDS marketplace, market participants have been significantly revising LCDS settlement mechanics. Future LCDS will utilize closing mechanics and procedures developed in conjunction with the Loan Syndications Trading Association (LSTA), an organization well known to lenders. These mechanics are being developed to ensure the efficient and expeditious settlement demanded by

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participants in the LCDS market. As part of this process, LSTA has developed the "market standard indemnity" which seeks to make the transfer agreement covering the physical settlement of LCDS a *non-negotiable* document by providing that the protection seller will be indemnified by the protection buyer for anything in the assignment documentation that is not consistent with like documentation regarding the applicable deliverable obligation. The intent is to effect a quick settlement by avoiding disputes regarding the language of the assignment documentation.

With the exponential growth in the notional amounts of CDS and LCDS now outstanding, the markets have witnessed a strong push to move from physical settlement to "cash settlement." Cash settlement involves the payment by the protection seller of a "net" amount equal to the par value of the reference obligation less the "market price" of such obligation at the time of settlement. In the past, protection sellers were reluctant to opt for cash settlement to avoid the risk of a "bad price." To reduce this perceived risk, the markets have begun conducting auctions for reference obligations as a means to set the market price for use in cash settlements.

Among the first experiences with the auction process were certain of the CDS entered into with respect to bonds issued by Delphi Corporation and its affiliates. At the time of Delphi's bankruptcy filing in October 2005, the notional amount of CDS written on Delphi bonds exceeded the actual principal amount of such bonds by nearly ten to one. The excess protection was caused by a large number of investors interested in shorting the Delphi bonds. As mentioned earlier, a protection buyer does not have to own the reference obligation to purchase a credit default swap relating to it. In the case of Delphi, many market participants purchased CDS with the expectation that, upon the occurrence of a credit event, they would

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purchase the reference obligation in the secondary market in advance of settlement. The bankruptcy filing by Delphi, an indisputable credit event, resulted in nothing short of a mad scramble by those protection buyers that did not then own Delphi's bonds, with the resulting demand driving the price of these bonds up significantly. Given these somewhat unexpected results and recognizing that the spike in price could distort the economics of the original derivatives trades, numerous market participants agreed to forgo physical settlement and be bound by an auction that set a market price for cash settlement. Since the Delphi experience, ISDA has developed protocols that allow protection buyers and protection sellers to convert their existing contracts from physical settlement to cash settlement, with the final price for the applicable obligations determined by an auction conducted with the integrity of the markets. We will soon see what choices the market intends to make in this regard.

Implications of CDS/LCDS for the next economic downturn

As mentioned, there has yet to be a credit event in the LCDS market (although they are certainly inevitable, even in the absence of a widely predicted softening of the credit markets). Even with the CDS that have settled in the past few years, there are few published legal decisions related to the many issues that may arise when settling CDS and LCDS transactions. Accordingly, the next economic downturn may precipitate an environment of considerable legal uncertainty, specifically with regard to the impact of outstanding CDS and LCDS transactions. Indeed some have suggested that the next downturn will, in part, be caused, or amplified, by the presence of CDS and LCDS. For example, the ease with which bondholders and lenders can access the derivatives markets to hedge and diversify their risk could, conceivably, lead to reductions in the efforts traditionally expended by lenders in monitoring their credits. Lenders in syndicates leaving the credit work to an agent that has swapped out its credit risk may be in for some surprises in the next downturn. Morever, it is difficult, if not impossible, to know if the agent, or a co-lender is, or is not, protected under a swap agreement. Further, this newfound ease with which financial institutions are able to swap out credit risk may, at the structuring stage, lead to a greater willingness to provide new financings in amounts, or on terms, that otherwise do not comport with standard lending models.

The growth in CDS, and particularly LCDS, may also make out-of-court reorganizations and restructurings considerably more difficult to consummate. When faced with pending defaults, it should be expected that lenders and bondholders that have swapped out their risk will be much less willing to grant a troubled borrower concessions that might otherwise provide an opportunity to navigate a short-term crisis. In such a case, it may be in the best interests of such lenders or bondholders to await the occurrence of a credit event, thereby allowing them (as protection buyers) to trigger a settlement on the swap and recover par on their investment. The incentives against granting concessions would be even stronger where the underlying obligation is trading at discounted levels. Morever, such behavior would be magnified to the extent that lenders or bondholders are protection buyers holding swaps with notional amounts in excess of their physical reference positions. With some lenders in a syndicate holding LCDS while others are not, consensus-reaching (a difficult task under optimal conditions) will be harder than ever. The likely result is that in the coming downturn, a significant number of borrowers and issuers that may previously have been able to avoid a bankruptcy with an out-of-court reorganization or restructuring, will find themselves in bankruptcy court as a result of action in the derivatives markets.

The commencement of a bankruptcy case requires quick action on the part of creditor groups and senior lenders. Decisions must be made almost immediately on issues relating to debtor-in-possession financing, the use of cash collateral, the sale of assets and intercreditor disputes, many of which require the input of lenders and bondholders having, hopefully, at least a partially shared

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agenda. The inherent delay in the settlement of CDS and LCDS transactions, particular those calling for physical settlement, may cause havoc in instances where, as is so often the case, agent and lender consents are required on a timely basis.

As mentioned above, many hedge funds and other players have entered the CDS and LCDS market over the last few years as protection sellers in order to get additional "synthetic" exposure to certain credits. Protection sellers during this period have generated huge profits, collecting premiums from protection buyers while being confronted with few credit events triggering settlement obligations. While many CDS and LCDS are cash-collateralized, the impact of massive settlements of these swaps could prove highly disruptive to certain funds. Will we see some hedge fund failures as a result of being on the wrong side of too many credit default swaps? The answer should come in the next downturn.

Conclusion

As awareness of CDS and LCDS continues to build, and as the markets increase their operating efficiency, it is reasonable to expect that the current interest in the derivatives markets, and the CDS and LCDS markets in particular, will lead to the expansion of coverage to more, and smaller, credits. Accordingly, we believe that these issues, and many others that have not been anticipated, will present themselves in credits of all sizes and types. In order to successfully navigate the next credit cycle, it will be essential to understand the workings of the derivatives markets and to be attuned to the implications that they may have on behavior of the various parties. ▲

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