**COVER STORY: CDS**

# Changing settlement mechanics of credit default swaps

***By Rick Hyman and Amit Trehan, Mayer Brown LLP***

In recent years, the credit default swap market has grown dramatically. According to the International Swaps and Derivatives Association, in the first six months of 2007 alone, the notional amount of outstanding CDS contracts grew from $26 trillion to $45.5 trillion, a 75 percent year-on-year increase. Though there is little dispute that the stakes are high, the potential impact on bankruptcy cases remains to be determined.

This article discusses the basics of CDS and explores some of the repercussions of their increased prevalence. In particular, the article discusses the reasons for and the effects of the progression toward cash settlement of CDS.

At the root of most CDS is an agreement pursuant to which a "protection buyer" agrees to make periodic payments of fees to a "protection seller," and the protection seller agrees that, upon the first occurrence of one or more specified "credit events," it will purchase from the protection buyer a "reference obligation" issued by a "reference entity" at par. The reference obligation in a CDS was historically an unsecured bond, easily transferable upon the occurrence of a credit event (i.e., a payment default or a bankruptcy of the reference entity) without the need for much, if any, underlying documentation between the parties.

The growth in the market is due in large part to a shift in the underlying business strategy of the swap parties — while initially protection buyers were often banks and bondholders seeking to limit their credit risk with respect to debt or bonds that they held, more recently, a protection buyer will purchase a CDS to gain synthetic short exposure on a reference obligation as part of an overall arbitrage strategy. As the interest in CDS has continued to expand over the last few years, and as hedge funds and others have sought to move up in the capital structure, the CDS market has evolved to create a product tailored to secured loans, "loan-only credit default swaps," or LCDS.

### About the authors


Rick Hyman is a partner and Amit Trehan is an associate at the New York office of Mayer Brown LLP. They concentrate their practice on the financial restructuring and bankruptcy proceedings of business organizations of all sizes and types, on behalf of a broad range of lender clients.

Hyman can be reached at *fhyman@mayerbrown.com;* Trehan can be reached at *atrehan@mayerbrown.com.* ■


### Settlement mechanisms

Given the growth in the CDS and LCDS markets, significant attention has been paid lately to the creation of an efficient settlement mechanism. There are generally two settlement regimes, physical settlement and cash settlement. With physical settlement, the bond or loan is legally transferred from the protection buyer to the protection seller, and the protection seller pays face value to the protection buyer. To the extent the protection buyer does not own the bond or loan at the time of the credit event, it must acquire the instrument before completing settlement. Voting rights are transferred to the protection seller only upon completion of the transfer. With cash settlements, the protection seller will make a payment to the protection buyer in an amount equal to the difference between the *face value* of the subject loan or bond and the *market value* of the relevant instrument. No physical transfer is required. The backbone of any cash settlement mechanism is the establishment of a market value that the various market participants can agree is legitimate.

### Delphi illustrates problem, solution

Physical settlement has had its share of problems. The case of Delphi Corp. is perhaps the best example of this. At the time of Delphi's bankruptcy filing in 2005, it had approximately $2 billion in bonds outstanding. At the same time, the notional amount of CDS written on Delphi's bonds was over $25 billion, evidencing considerable synthetic exposure. The triggering of the credit event set off a short-squeeze — as protection buyers scrambled to acquire the Delphi bonds necessary to settle their CDS contracts, the price of the bonds spiked. When it became clear that physical settlement would not be possible given the large notional amount of outstanding CDS, numerous market participants subsequently agreed to amend their CDS contracts to provide for cash settlement rather than physical delivery.

Using protocols developed by ISDA, Creditex and Markit conducted an auction to set the market value for Delphi's bonds for purposes of cash settlement.


© 2007 LRP Publications - Reproduction Prohibited
0098-7336/07/$7.50 + $4.25