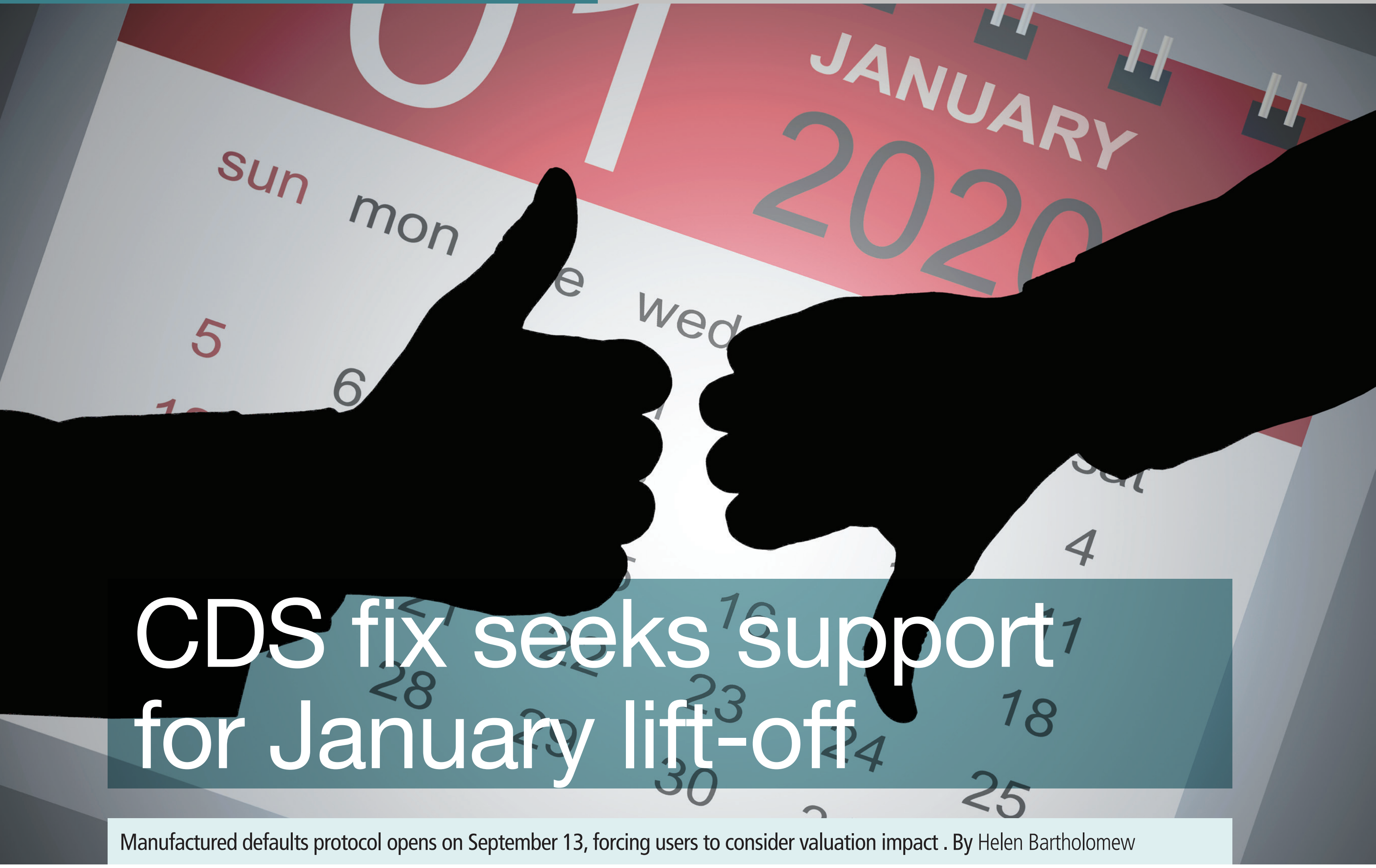

CDS fix seeks support for January lift-off

Manufactured defaults protocol opens on September 13, forcing users to consider valuation impact . By Helen Bartholomew

Traders of credit default swaps (CDS) are being asked to sign up to amended rules underpinning their contracts from September 16, as part of a plan to stamp out manufactured defaults – or narrowly tailored credit events (NTCEs) – which threaten to undermine the product's credibility.

The industry-wide protocol, run by the International Swaps and Derivatives Association, will automatically switch adhering parties' legacy contracts onto the updated standard on January 13, 2020, when the terms will become standard for new contracts. The protocol will remain open until October 14, an Isda spokesperson confirmed.

Some participants have reservations over whether the relatively narrow fix is enough to stamp out ever-more inventive ways in which savvy traders have gamed the market. Even so, take-up is expected to be high, since global regulators ramped up the attack on so-called 'opportunistic CDS strategies' following a wave of shady financing deals built around derivatives outcomes.

"The changes have generally been relatively well received by the market, as a lot of people use the product in a neutral way rather than an opportunistic way. Many were worried that these situations could have a negative impact on their trades and CDS market liquidity more generally. But now it's time to test those changes," says Fabien Carruzzo, a partner at law firm Kramer Levin.

> "While a lot of people think it's a good idea, they haven't yet given much thought to direct implications on their portfolios"
> Fabien Carruzzo, Kramer Levin

This means a more detailed consideration of any potential value transfer stemming from changes, which ultimately raise the bar for credit protection to pay out.

"While a lot of people think it's a good idea, they haven't yet given much thought to direct implications on their portfolios. People are going to have to look at their trades and start thinking about what these changes mean in practice," Carruzzo adds.

The switch has already attracted early support from some of the largest credit trading houses, including Bank of America Merrill Lynch, Citigroup and JP Morgan.

Valuation shift

As a yardstick, more than 340 firms signed up to Isda's last CDS protocol launched in February, which switched protection on senior German bank debt to the senior non-preferred level. This change mirrored a reclassification in cash markets to more closely align the country's approach to bail-in rules with other European Union jurisdictions.

While the German protocol was viewed as little more than a relabelling exercise for CDS players, amendments intended to stamp out NTCEs could translate into a clear valuation shift on directional portfolios.

CDS buyers, for example, could see value erosion from amendments that reduce the likelihood of contracts paying out. This is because greater discretion is afforded to the credit determinations committee – the group of 15 sell-side and buy-side firms tasked with ruling whether an issuer is in default and ultimately whether CDSs pay out. Under amended wording, first proposed by Isda in March, a failure-to-pay credit event – once a clear-cut test – would only be called and lead to CDS protection being paid out if it is accompanied by an observable deterioration in creditworthiness.

"For market participants who are buying CDS, maybe the switch is going to have a negative impact, but the question is whether they would get stuck in a smaller liquidity pool by not amending their contracts. If that's the case, it could be harder for them to get out of their contract, or novate their trades," says Carruzzo.

A causation test, whose definition is left purposefully vague, is intended to ward off some of the most egregious manufactured default situations, for which US homebuilder Hovnanian remains the posterchild.

In 2017, the firm reached a financing agreement with Blackstone's GSO unit that would see the builder default on a small amount of debt, triggering payouts on CDSs – of which GSO was a holder. This followed a blueprint set by earlier trigger-to-finance deals from iHeart Communications earlier the same year and Spanish gaming company Codere in 2013. But the Hovnanian debacle plunged to new depths in the murky CDS world when a second restructuring proposal included the issue of deeply discounted debt, intended to maximise the payout on CDSs.

> "The continued pursuit of various opportunistic strategies in the credit derivatives markets ... may adversely affect the integrity, confidence and reputation of the credit derivatives markets"
>
> Regulators' statement

Halting opportunism

Regulators have since called for the market to clean up its act. In June, the US Securities and Exchange Commission, US Commodity Futures Trading Commission (CFTC) and the UK's Financial Conduct Authority issued a joint statement confirming their collaborative efforts to halt so-called "opportunistic strategies" in the credit derivatives market, including manufactured credit events.

"The continued pursuit of various opportunistic strategies in the credit derivatives markets, including but not limited to those that have been referred to as 'manufactured credit events,' may adversely affect the integrity, confidence and reputation of the credit derivatives markets, as well as markets more generally. These opportunistic strategies raise various issues under securities, derivatives, conduct and antifraud laws, as well as public policy concerns," they said.

In July, the CFTC followed up with a webcast on the issue, where it noted 14 separate incidences of opportunistic strategies in the CDS market since the start of 2017.

While some view the uptick in regulatory scrutiny as criticism of the narrow scope of proposed amendments – for example, the Codere debacle may not have been caught by the updated definitions – others warn there can never be a catch-all for all eventualities of wrong-doing.

"There are lots of shades of grey in the market, and regulators recognise this update fixes one end of the spectrum," says London-based lawyer familiar with the changes. "The Hovnanian case would not be possible under the new terms, but when you get into things like orphaning there's still a debate to be had about whether that behaviour should be stopped and how to do it."

Orphaning can see CDSs rendered worthless if reference obligations are moved to an alternative entity, leaving no debt to determine payouts following a credit event.

This caused a stir earlier in the year, when CDSs written on Dutch telco Ziggo became orphaned after obligations were transferred to a new entity in March 2018.

Protection holders missed a 90-day window to transfer to the new entity, leaving sellers to pocket a premium on protection they knew could never pay out.

Buyers realised their error months later, when the company was acquired by Vodafone. After lengthy deliberations, the DC ruled in favour of protection holders, transferring CDSs to the new entity, using a little-known loophole to overrule the 90-day transfer window – much to the chagrin of hedge fund sellers, which had spied a free lunch.

Amending contracts is also time-consuming – the latest update will take effect almost two years after initial talks began. Drafting a fix for every example of unsavoury behaviour in the CDS market may not be realistic or even possible, but the lawyer warns participants not to rule out the possibility of further updates as the dialogue between regulators and the market gathers pace.

"There may be further changes, but it may be a problem that's not fixed in the drafting but fixed in the regulation. Most types of financial instrument are capable of being misused by people and that's why we have financial regulation. If we can stop it happening through drafting that's a clear way to do it but it's not the only way and there are some things that are impossible to fix in drafting."

Changes mulled for Muni CDSs

Similar amendments are now being considered for CDSs on municipal bonds – a narrowly traded market governed by a separate set of Isda definitions. Muni contracts are not part of the latest update, but demand for similar action is increasing alongside a recent controversy in that market.

In August, hedge fund Warlander Asset Management and the Illinois Policy Institute, a local think tank, attempted to invalidate more than $14 billion of debt issued by the state of Illinois. In a court filing, they argued the issuer had sold bonds to finance a deficit – a prohibited practice under the state constitution.

Two bond funds – Nuveen Asset Management and Alliance Bernstein – questioned the hedge fund's motives for litigation given that Warlander owned CDSs on the issuer, which would pay out following a default on debt payments. The court ruled there was not enough evidence for the case against the plaintiffs to proceed, though an appeal is expected.

"The muni CDS market is small compared to the corporate market, and at an earlier stage of development, but this makes it easier to make changes to the contract. That's why we think there might be some appetite to do something similar now rather than waiting until the market becomes larger," says Carruzzo.

He compares recent commotion in the muni market to the controversy around communications firm Windstream. In February, the firm was pushed into bankruptcy after a court sided with hedge fund investor Aurelius Capital Management, ruling that a spin-off of the company's cable activities into a separate unit breached certain bond covenants, forcing a payout to bondholders. ■