Credit Derivatives: Risk Management, Control Rights and the Implications for Insolvency Workout Proceedings

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Introduction

- Traditional notion of debt involves fixed return, control rights, default rights, reviewable transactions or preferences

- On insolvency, creditors can exercise those control rights based on their economic interest – debtor needs their support for restructuring

- Creditors can hedge their economic risk through credit derivatives [generic term for over-the-counter financial instruments that allow parties to transfer or assume credit risk]

- Unlike insurance, amount of compensation that can be claimed under a credit derivative is not related to actual losses suffered by protection buyer

- Global market for credit derivatives estimated to be US$30 to 50 trillion

Risk Management

- Most common form of credit derivatives are credit default swaps (CDSs), many written on well-known corporate and sovereign names
- CDS a risk management tool for financial institutions
- In basic single-name CDS, protection buyer buys from protection seller, protection against the credit risk associated with a principal amount (notional amount) of a debt or guarantee obligation (reference obligation) of a debtor (reference entity) for a specified period (tenor).
- CDS allows party to transfer its credit risk of reference asset, that it may or may not own, to another party; for example, bondholder hedges "spread risk" and/or "default risk"
- Protection seller's obligation to pay arises on occurrence of credit event, e.g. bankruptcy, failure to pay, obligation default, restructuring

Risk Management

- Participants include commercial banks, investment banks, hedge funds, pension funds and insurance companies, as both risk sellers or risk takers

- While credit derivatives provide for the transfer of credit risk, they are complex products with short history of experience

- Also an active trading market for CDS

- Use of credit derivatives grew in popularity in a relatively benign economic environment, now with current financial crisis, challenges

Credit Default Swaps

- Protection buyers use CDSs to manage particular market exposures in order to diversify own investment portfolios

- Key elements of a CDS contract: identification of the reference entity, description of reference obligation, selection of credit events, and specification of mechanisms of settlement

- Conceptually, terms subject to negotiation; however, in practice, CDs are commodity products with industry wide standards by International Swaps and Derivatives Association (ISDA)

- Many credit derivative transactions, including most credit default swaps, are not funded, but may be subject to margin and collateral arrangements depending on the counterparty

- Shortage of available protection sellers for banks seeking to free up their regulatory capital contributed to development of collateralized debt obligations (CDOs)

- Typically, bank transfers bundle of credits to special investment vehicles (SIV), which sells multiple tranches to investors, higher risk, higher yield
  - Where structure not remove credit risk while being flexible to accommodate fluctuating loans at customer level, led to development of "synthetic" CDO capital structures - needed investors searching for enhanced yields with little regard for increased risk

- Management of risk, but separation of creditor's economic interest in the debtor from formal rights

Risks were evident before the current crisis
Sarra, Creber and Murphy study 2006

Global Credit Derivatives Exposures by Ratings Sold

	2002	2006
AAA	22%	11%
AA	14%	6%
A	29%	23%
BBB	28%	29%
Below investment grade:	8%	31%

- Hedge funds major driver of change in market ; as a seller, market share doubled 2004 to 2006 to a 32% market share

- Reasons for move down the credit curve included tight spreads; as margins squeezed at upper end of credit curve, to maintain returns, investors shifted to more speculative investment grades and unrated exposures

Sarra, Creber and Murphy, continued

- Top 20 bought reference entities in 2005, gross sold and bought protection by volume, included Bear Sterns, AIG, Fannie Mae

- Among U.S. banks, 77% of credit derivative volume in 2006 was carried out by Citibank, Bank of America, Wachovia, HSBC USA, JP Morgan Chase

- With an unfunded credit derivative, protection buyer exchanges credit risk on reference entity for counterparty risk of protection seller; top 25 counterparties globally included Bear Sterns, Lehman Brothers, AIG, Merrill Lynch

- Concluded (in 2006) that adequacy of any collateral requirements has not been tested during period of real credit stress or market dislocation

Two years later….

- Lehman Brothers, Bear Stearns, Merrill Lynch, Fannie Mae, AIG
- Jurisdictions disagree on how to address, degree of intervention- deposit guarantees, troubled asset recovery programs, liquidity injections, US dispute over US$ 700 billion bailout
- Given that financial institutions may be fully or partially hedged through CDS, a key consideration at point of filing insolvency proceeding is whether debtor corporation or affiliates are reference entities in the credit derivative market

Legal and operational risks may impair restructuring process

- Paper considers how CDs may affect behaviour and motivations of various stakeholders of distressed entity during restructuring
- Can cause greater complexity and uncertainty in restructuring, as real economic interests of stakeholders not transparent
- Uncertainty re reference entity, protection period, reference obligation, deliverable obligation, credit event
- Asymmetry of knowledge of the risk as between an originating lender transferring credit risk to investors, who are often primarily investors
- Negotiation of debt compromise more difficult due to uncertainty as to the identity and actual economic interests of the parties

Implications for Restructuring - Physical Settlement

- New parties during proceeding
  - Time re demand can exceed 60 days; protection seller now becomes the party at the restructuring bargaining table; could be issue if urgency and/or if protection seller has different objectives
- Single institution from which debtor borrowed now multiplicity of intermediaries, counterparties, insurers
- Cascading swaps means multiple rapid changes to who holds the claim, making it difficult for debtors to establish who has the economic risk and hence interest in a workout
- If the original creditor only partially hedged under CD, then with physical settlement, now two parties with financial exposure
- Due to the trading volumes, potential to cause revolving door effect, hard to build consensus on plan, garner requisite support of creditors

Implications for Restructuring - Cash Settlement

- With cash settlement, the protection buyer continues to be the party with the legal claim although at a reduced or eliminated financial exposure. The debtor and other creditors may have no, or limited, notice or knowledge of the reduced exposure
- Fully hedged creditor less concerned with success or failure of debtor or with optimal realization on collateral if the debt is secured
- Creditor may actually have over-coverage and thus negative economic interest; could materially benefit if restructuring fails
- Financial institution may be less interested in advancing further credit in form of post commencement or exit financing if it has limited or no ongoing financial interest in the debtor

Additional Implications

- Restructuring process needs to accommodate the means by which reference obligations of debtor may be valued for purpose of settling outstanding CDs

- If direct relationship between debt and payment obligation under the swap, the derivative contract itself represents the economic interest; however, many outstanding derivative contracts may aggregate 5-10 times amount of creditor claims; Delphi - US$25 billion in CDs on US$2 billion of Delphi bonds

- Many restructurings are substantially negotiated before any formal proceedings are taken; creditors who may be obliged to assign their claims to protection seller may not be able to participate effectively in the negotiations or to bind their claims to an agreed restructuring

Active market in creditor claims after default

- Claims trader creditor may be seen as having a new, speculative and short term interest in debtor
  - Having acquired its position when debtor already in difficulty, it often hedging against the speculative outcome of restructuring process.
  - Such a creditor, perhaps holding a deciding vote, little interest in long term viability and little in common other stakeholders

- In a deteriorating credit market
  - Rapid trading and change of parties
  - CDS counterparties may challenge claims made under CDSs by financial institutions who, with hindsight, can be alleged to have had prior knowledge of deterioration of the credit or were in early stages of restructuring negotiation in which financial institution would itself have had a material ability to influence the occurrence of a credit event

Moral hazard

- Classic paradigm is that stakeholders with economic interest in the debtor corporation are parties with greatest interest and influence in restructuring- existence of credit derivatives may complicate this basic premise by potentially affecting the composition and motivations of various stakeholders

- A creditor who also has material holdings of credit derivatives may have economic interests that encourages it to cause a default to occur so that there will be a credit event

- Possible presence of parties holding large CDS positions who may acquire other claims in order to position selves to cause a credit event to occur

Public Policy Considerations

- Existence of credit default swap cover on a debtor may affect the interests and behaviour of stakeholders during workout negotiations and the structure and terms of a proposed restructuring plan- but law aimed at encouraging restructuring

- Interests of parties with a CDS position will differ depending on amount and duration of cover, definition of credit events, type of settlement

- Consider insolvency law goals of:
  - Transparency
  - Certainty
  - Predictability

- Broader public policy questions re ISDA, e.g. exclusion from stay