



INSOL INTERNATIONAL

**CREDIT DERIVATIVES IN
RESTRUCTURINGS**

A GUIDANCE BOOKLET



INSOL INTERNATIONAL

International Association of Restructuring, Insolvency & Bankruptcy Professionals

Credit Derivatives in Restructurings

A Guidance Booklet

Copies of this report are available from:

INSOL International

2-3 Philpot Lane, London, EC3M 8AQ, UK
Tel: +44 (0)20 7929 6679 Fax: +44 (0)20 7929 6678

Email: heather@insol.ision.co.uk
www.insol.org

Price £50.00 plus postage & packing

Copyright © No part of this document may be reproduced or transmitted in any form or by any means without the prior permission of INSOL International. The publishers and authors accept no responsibility for any loss occasioned to any person acting or refraining from acting as a result of any view expressed herein.

Published September 2006



INSOL INTERNATIONAL

International Association of Restructuring, Insolvency & Bankruptcy Professionals

It is my sincere pleasure to introduce this excellent report on “Credit Derivatives in Restructurings”.

Lenders, particularly banks that are involved in sophisticated portfolio management techniques, are increasingly using credit default derivatives. Consequently, there is ongoing debate on a number of key credit derivative issues in the market. One area that is emerging as having the potential to cause difficulties is these derivatives' impact on restructuring work, especially in out-of-court or informal rescue situations.

The efforts of lender groups to achieve consensual restructuring are becoming difficult for many reasons, not least of which is the presence of so many different parties with different agendas at the table, such as bondholders, distressed funds, and debt traders. The fact that some of these parties will have their positions protected by the effective “insurance” of credit default derivatives adds another dimension, and is already beginning to produce interesting, but at times difficult, behavioural dynamics.

The INSOL Lenders Group therefore recommended that we produce this publication on this relatively new development, which is essentially educational as well as awareness-raising. These guidance notes are extremely well researched and are presented in an easy to read style. The working group of this project worked tirelessly with leading market players to ensure that this report achieved its objective and I would proudly say that without a doubt it has.

A handwritten signature in black ink, consisting of several loops and a final vertical stroke.

Sijmen de Ranitz
President
INSOL International



INSOL International

GROUP THIRTY-SIX

Addleshaw Goddard
Allen & Overy LLP
Alvarez & Marsal
Baker Tilly
BBK
Begbies Traynor
Bingham McCutchen LLP
Chadbourne & Parke LLP
Cleary Gottlieb Steen & Hamilton LLP
Davis Polk & Wardwell
Deacons
De Brauw Blackstone Westbroek
Ernst & Young
Ferrier Hodgson
Freshfields Bruckhaus Deringer
Goodmans LLP
Grant Thornton
Greenberg Traurig LLP
Huron Consulting Group
Jones Day
Kaye Scholer LLP
Kirkland & Ellis LLP
KPMG
Kroll
Linklaters
Lovells
Norton Rose
Pepper Hamilton LLP
PPB
PricewaterhouseCoopers
RSM Corporate Advisory Services
Skadden, Arps, Slate, Meagher & Flom LLP
Shearman & Sterling LLP
Vantis
Weil, Gotshal & Manges LLP
White & Case LLP



INSOL INTERNATIONAL

International Association of Restructuring, Insolvency & Bankruptcy Professionals

INSOL Lenders Group

The idea of producing a booklet on the potential impact of credit derivatives on restructuring work had been under consideration for some time. The market for credit derivatives was expanding at an extremely rapid rate – as it continues to do – and it was becoming clear not only that they were present in some corporate cases that were the subject of restructuring, but also that such instances would be likely to become increasingly common.

What was not known was just what the effect of these products might be upon the behaviour of participants around the restructuring table, and indeed upon the outcome of individual restructurings, though evidence had begun to emerge that there could be – and indeed had been – some impact. Views differed, with some thinking that the consequences would be minimal, and others that there could be significant consequences. With the restructuring scene relatively quiet at the time of writing, the reality remains to be seen – perhaps when there is an economic downturn and the number of restructurings rises accordingly.

Given these uncertainties and the related potential issues, together with what proved to be widespread support for a publication, the INSOL Lenders Group took a decision to go ahead, leading to the formation of a working group. The acknowledgements indicate the significant amount of work that was involved and the wide discussion and consultation that were undertaken in producing this booklet. The INSOL Lenders Group and the working group would like to thank all those who assisted with the project.

The booklet does not seek to establish any principles or rules, but is intended to help develop an understanding of the issues that may be encountered. With credit derivatives likely to appear more and more often in restructuring work, we believe that the booklet will be of use to those involved and hope that it will prove to be a useful source of guidance to which they can turn.

Robert Graham
*Chairman of the INSOL
Lenders Group*

Terry Bond
*Ex-Vice-chairman of the
INSOL Lenders Group and
Chairman of the working group*

Acknowledgements

This project was initiated by the INSOL Lenders Group (“ILG”) and it was coordinated and run by a working group of the ILG together with other representatives from the Group of 36 firms of INSOL International (“INSOL”).

The working group, chaired by Terry Bond, consultant to INSOL and RSM Corporate Advisory Services, comprised the following persons (listed with their respective institutions).

Robert Graham	Standard Chartered Bank and Chairman, ILG
Renée Toft	Now with Cairn Financial Products Limited
Peter Stevens	Credit Suisse
Donald Bernstein	Davis Polk & Wardwell
Nick Segal	Davis Polk & Wardwell
Izumi Fukushima	Davis Polk & Wardwell
Maggie Mills	Ernst & Young
Peter Bloxham	Freshfields Bruckhaus Deringer
Simon Brodie	Freshfields Bruckhaus Deringer
Patrick Daniello	JPMorgan Chase Bank
Parisa Suvarnatemee	JPMorgan Chase Bank
Charles Maunder	Michelmores
Steven Pearson	PricewaterhouseCoopers
Lee Watson	PricewaterhouseCoopers

Acknowledgements

The project was initiated over a year ago, and since then a considerable amount of market research, discussion, meeting and other work was carried out to produce this publication.

In a fast-changing financial marketplace, and with a relatively new, rapidly developing subject matter, this project not only involved the members of the working group but also benefited greatly from consultation and discussion with representatives of some 100 institutions around the world. These are representatives from many of the largest banking institutions and regulatory and other authorities, together with insolvency professionals and other participants in the restructuring market. This publication is the result of the valuable contributions made by all these people.

Naturally, it is not possible to thank each of these contributors individually but a special mention should be made of Simon Brodie and Terry Bond who both invested a huge amount of their own time and effort in this publication. INSOL are especially grateful to both of them. Additionally, INSOL would like to thank all those who assisted at the various stages of the project.

The working group dedicated significant time and effort to the development of this publication and everyone in the group made major contributions in numerous ways. INSOL would like to express its gratitude to all the members of this group for their effort and appreciate the time they spent on this project away from their busy work schedules.

In particular, INSOL would like to express its special thanks to the teams at Freshfields Bruckhaus Deringer in London and Davis Polk & Wardwell in New York, who worked assiduously on drafting and redrafting the text to seek to ensure not only that its content was right, but also that it was expressed such that potentially difficult concepts came through in the most straightforward and readable way.

Contents

Introduction	1
Executive Summary	2
Credit Derivatives: The Market	3
Basic elements of credit default swaps	7
Settlement following a credit event	9
Comparison with other types of credit products and techniques	11
Practice Points	13
Conclusions	31
Appendix A: Selected types of credit derivatives and other credit-linked products	34
Appendix B: ISDA Publications often used in credit derivatives documentation	37
Appendix C: The Restructuring credit event	39
Appendix D: Credit events since 1 January 1999	41
Appendix E: Sources of further information	42

CREDIT DERIVATIVES IN RESTRUCTURINGS

A GUIDANCE BOOKLET

1. INTRODUCTION

1.1 The pace of change in the financial world never slackens, with new products and systems always appearing and legal or regulatory developments always taking place. In due course, these changes generally impact on the world of restructuring, where those involved need to adapt and evolve in response.

1.2 Credit derivatives are a relatively new development, but the growth of the credit derivatives market has been explosive and they are now an accepted part of the risk management and trading scene.

1.3 As an inevitable consequence, they have begun to appear in restructurings, adding a further potential level of complexity with which those involved have to deal. However, their significance for restructurings will vary across jurisdictions, and – with their use still evolving – remains to be established fully. The true impact may become clearer in less benign economic times.

1.4 Some concerns have been expressed that the presence of credit derivatives will make restructurings more difficult, and there have been reports that problems have already arisen from time to time, but it has not been established how often they have arisen. As credit derivative cover is likely not to be disclosed, though, it may not be possible to establish what, if any, link there may be between the presence of credit derivatives and dynamics or difficulties in any particular restructuring.

1.5 The purpose of this booklet is to raise awareness of the potential impact of credit derivatives – in particular credit default swaps – on restructurings (including possible changes in behavioural dynamics resulting from positions in credit derivatives of participants around the restructuring table) and to provide a point of reference for those involved in restructurings facing situations where participants may hold such a position.

1.6 The booklet is written from a corporate restructuring perspective, and focuses on single-name credit default swaps – an integral part of the growing and changing credit derivatives market – as these are the credit derivatives

considered most likely to affect the dynamics of restructurings. References in sections 5 to 7 to credit default swaps are to single-name credit default swaps (except where otherwise stated) and sections 2 and 8 should be read accordingly. Different issues may arise where other types of credit default swaps (such as credit default swaps on asset-backed securities) are present.

1.7 It is important to note that this booklet is intended only to provide an overview of some of the key issues that are likely to arise in a restructuring where the debtor is the subject of credit derivatives (and in particular credit default swaps). It does not establish a set of principles or offer specific advice. It is always necessary to take account of (and obtain professional advice on) the facts of individual cases and of the laws, regulations, rules and practices of the particular jurisdiction concerned. Further, the booklet refers to the impact of securities laws and regulatory requirements. It should be noted that these vary from country to country and require careful and detailed consideration in each case.

1.8 The date of writing of this booklet is 11 August 2006.

2. EXECUTIVE SUMMARY

2.1 Credit derivatives enable participants in financial markets to acquire or dispose of credit risk separately from other risks such as interest risk and currency risk. They may be tailored to a participant's particular requirements. Credit default swaps are the most commonly used credit derivatives, and the mechanics of a basic credit default swap are explained in paragraph 4.1 below.

2.2 Creditors such as financial institutions use credit default swaps as a tool to manage exposure to particular borrowers or sectors. Credit default swap protection may, among other things, allow institutions to increase credit lines and transfer credit risk to players in sectors that do not have direct credit origination capabilities. Financial institutions also deal in credit default swaps with a view to obtaining income both from trading in them and as part of their general financial services business. Further, credit default swap cover may assist financial institutions in managing compliance with regulatory capital requirements.

2.3 To date, credit default swaps have been written mostly on well-known corporate and sovereign names. They have not been present in all restructurings, and they have been seen to affect a relatively limited number of those in which they have been present. However, there have not been a large number of major restructurings in recent times, and – given the increasing size

Credit Derivatives in Restructurings

and reach of the market for credit default swaps – they are likely to become an increasingly significant part of the restructuring environment.

2.4 The existence of credit default swap cover on a debtor may affect the interests and behaviour of stakeholders during restructuring negotiations, and the structure and terms of restructuring plans that are proposed.

2.5 The interests of individual parties with a credit default swap position may also differ. Such interests will turn on (among other things) the amount and duration of the cover, the events that may trigger it, and the ways in which it may be settled.

2.6 A party's credit default swap cover may be invisible to other parties involved in a restructuring; holders of protection are likely to consider that it is not in their best interests to disclose such cover, and a party would be unlikely to be legally required to disclose a credit default swap position to parties around the restructuring table generally.

2.7 It is therefore important for all parties involved in a restructuring to have some knowledge of credit derivatives, and be aware of their potential impact on the restructuring being dealt with.

2.8 Credit derivatives such as credit default swaps bear a number of similarities to other products and techniques used to manage and invest or trade in credit risk. Although the presence of credit derivatives may increase the complexity of restructurings, issues may be mitigated in practice by certain factors such as adoption by relevant parties of a cash settlement mechanism, and it appears that credit market participants have seen no evidence to date that the presence of credit default swaps has caused an otherwise viable restructuring to fail. However, there have been instances where problems have been encountered. Where problems arise, their resolution will be assisted by awareness of the potential risks, efforts (particularly by the debtor) to identify important players and understand their positions, and careful planning.

3. CREDIT DERIVATIVES: THE MARKET

3.1 *Credit derivative* is the generic term used to refer to any of several types of financial product, the risks and returns on which are linked to the credit of one or more entities.

3.2 The simplest and most commonly used credit derivative product is the credit default swap (CDS). Single-name CDSs continue to be the most popular

credit derivative product, having accounted for 51 per cent of the global market in 2003.¹ Industry-wide acceptance of standardised CDS documentation has enabled dealers to make markets in CDSs written on an increasing number of corporate debtors,² and has meant that CDSs have become increasingly tradable.

3.3 Credit derivatives may be used for active portfolio and asset management, management of individual credit lines, trading and market-making, or other purposes. Trading opportunities may exist, for example, if the credit risk of a corporate debtor is expected to increase or decrease in the future such that the price of credit protection on the debtor is expected to rise or fall (as the case may be). A party may also seek to arbitrage, for example by selling protection at the prevailing market price to benefit from having purchased existing protection at a lower price. Many types of organisation are active players in the credit derivatives market,³ each with potentially differing drivers of behaviour.

3.4 A party may simultaneously hold several different positions in credit derivatives written on the same debtor. In a large financial institution, for example, portfolio management and trading functions will likely be handled by different units, so a portfolio management unit may have purchased credit protection while a trading desk has sold equivalent protection.

3.5 The global market for CDSs was estimated to be USD⁴ 17.1 trillion in notional size as at the end of 2005, representing annual growth of over 100

¹ *BBA Credit Derivatives Report 2003/2004*, British Bankers' Association (BBA), 2004 (which uses a definition of "credit derivative" expressed by the BBA). At the date of writing, this is the most recent such report. The next such report is due to be published in September 2006.

² To date, CDSs have been written mostly on well-known corporate and sovereign names, and CDSs on such names are actively traded in CDS markets in London and New York. Market-making is said to be less common in general in CDSs on lesser-known corporate names than in CDSs on well-known corporate names, but trading volumes of CDSs on emerging-market names are said to be growing quickly.

³ Banks accounted for 51 per cent of the buyers of credit protection globally at the end of 2003, but were expected to account for only 43 per cent of the market by 2006. Hedge funds were the joint-second largest players on the buy side, together with securities houses, at the end of 2003, and were expected to overtake securities houses by 2006. Insurance companies were found to have a falling share of the sell side of the market. Hedge funds' sell-side market share trebled from five per cent in 2001 to 15 per cent in 2003, and this growth was expected to continue into 2006, by which time their market share was predicted to have overtaken that of securities houses. Source: *BBA Credit Derivatives Report 2003/2004*, BBA, 2004.

⁴ United States (U.S.) dollars.

Credit Derivatives in Restructurings

percent from USD 8.4 trillion as at the end of 2004.⁵ The global market for credit derivatives had previously been predicted to reach USD 8.2 trillion by 2006, representing a 45-fold increase in the nine years from 1997 to 2006.⁶ Market participants have attributed this growth to:

- (a) increasing liquidity in the market;
- (b) a widening of the product base attracting more participants;
- (c) improving standardisation of the terms of credit derivatives; and
- (d) a growing client understanding of credit derivatives.⁷

3.6 Participants are also believed to have found the credit derivatives market attractive primarily for the following reasons:

- (a) the tailored nature of investments and hedges;
- (b) the ability to disaggregate credit risk from certain risks inherent in other credit products and techniques, and have it transferred to other parties (who may not have direct credit origination capabilities);
- (c) the ability to short sell credit efficiently;⁸
- (d) the confidentiality of transactions; and
- (e) liquidity especially in times of general credit market turbulence.

3.7 At the date of writing, some of the developing trends in the credit derivatives market are the following:

⁵ 2005 Year-End Market Survey, International Swaps and Derivatives Association, Inc. (ISDA), 2006 (using a specific definition of "CDS" expressed by ISDA). Notional size here refers to outstanding *notional amounts* (see paragraph 4.1 below).

⁶ BBA Credit Derivatives Report 2003/2004, BBA, 2004.

⁷ BBA Credit Derivatives Report 2003/2004, BBA, 2004.

⁸ The term *short selling* (also known as *shorting*) is used in this booklet to mean selling an interest that the seller does not hold.

- (a) Greatly increasing single-name CDS volume, and some migration of single-name CDSs towards the lower end of the corporate credit spectrum. The market for CDSs relating to loans (*LCDSs*) is in the early stages of development and is expected to begin to grow strongly.
- (b) A move to make the process of settlement of CDSs more efficient with the appropriate application of cash settlement mechanisms.⁹
- (c) Increasing efficiency of middle and back-office processing of credit derivative transactions.
- (d) Increasing volumes of products referring to CDS indices (*CDS index products*) with updated baskets of underlying reference names launched periodically.

3.8 Further, credit derivatives that satisfy certain conditions may be taken into account by certain financial institutions in assessing compliance with regulatory capital requirements applicable to exposure to credit risk of the underlying names. The implementation of *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (known as *Basel II*) may affect the usage (and terms) of CDSs used to hedge exposures.¹⁰

3.9 Appendix A contains further technical information on credit derivatives and other credit-linked products.

⁹ See further paragraph 5.7 below.

¹⁰ Basel II constitutes a new framework for the calculation of regulatory capital requirements, available at www.bis.org. A supervisory framework reflecting Basel II in the European Union is embodied in the recast Banking Consolidation Directive (Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast)) and extended to investment firms in the recast Capital Adequacy Directive (Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast)). See further the commentary in footnote 69 below.

Credit Derivatives in Restructurings

4. BASIC ELEMENTS OF CREDIT DEFAULT SWAPS

A Basic Single-Name Credit Default Swap

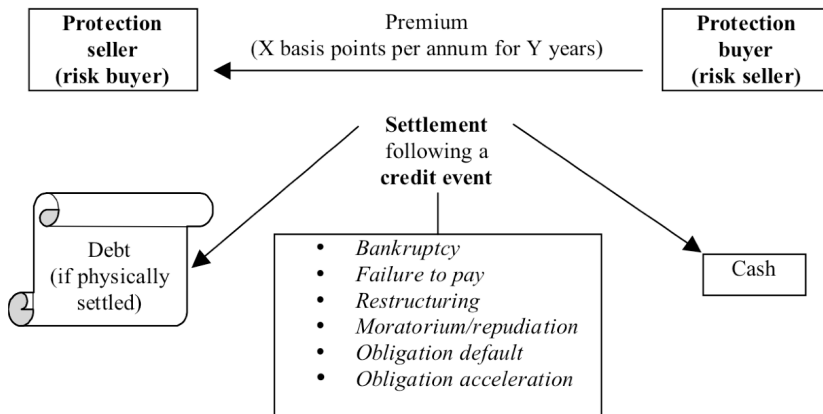


Figure 1

4.1 In a basic single-name CDS, illustrated in Figure 1 above, one party (the *protection buyer*) buys from the other party (the *protection seller*) protection in respect of a principal amount (the *notional amount*), against the credit risk of a single entity (the *reference entity*)¹¹ with regard to a specified obligation or class of obligations¹² during a specified period (the *tenor*). The protection buyer pays a *premium* to the protection seller in exchange for the credit protection provided under the contract. The premium is usually a fixed rate per annum accruing on the notional amount, payable quarterly in arrear during the tenor of the contract (though in a short-term contract it may be prepaid). The tenor may be different from the term of the relevant obligation or obligations. Closeout (*settlement*)

¹¹ Single-name CDSs also usually include provisions for identifying what may constitute a *successor* to a reference entity upon the occurrence of an event such as a merger or spin-off affecting the reference entity, and for cover to continue in respect of such a succeeding entity.

¹² Such obligations may be debt obligations or guarantee obligations. References in this booklet to cover on debtors and to "underlying debt" (in the context of single-name CDSs) should be read as including references to cover on guarantors and to "underlying guarantees" respectively.

entails the delivery of, or reference to, certain obligations of the debtor after the occurrence of a specified event (see section 5 below).

4.2 CDSs are usually documented using a standard form agreement developed by ISDA.¹³ The basic contractual relationship between the protection buyer and protection seller is defined in a standard ISDA Master Agreement, which (among other things) sets out the respective obligations of the protection buyer and protection seller to make payments or deliveries.

4.3 The Master Agreement contemplates that the parties will supplement or modify certain of its provisions by reference to a *schedule* containing additional terms. The schedule may include elections by the parties relating to one or more alternative provisions set forth in the Master Agreement, and administrative details.

4.4 The key economic terms of a CDS are documented in a *confirmation*, which incorporates *Definitions*. At the date of writing, the current market standard Definitions for substantially all new single-name CDSs are the 2003 ISDA Credit Derivatives Definitions. The confirmation for a single-name CDS specifies (among other things):

- (a) the notional amount;
- (b) the reference entity;
- (c) the scope of the protection (in terms of obligations of the reference entity);
- (d) the tenor;
- (e) the premium; and
- (f) the settlement method, which may include criteria for what obligations may be delivered upon physical settlement (for a description of which, see paragraph 5.5 below) and details of a *reference obligation* for the

¹³ The BBA found that “the vast majority” of CDSs were based on ISDA standard documentation: *BBA Credit Derivatives Report 2003/2004*, BBA, 2004. This section and the remainder of the booklet deal with CDSs and other credit derivatives based substantially on such documentation.

Credit Derivatives in Restructurings

purposes both of such criteria and also of price calculation for cash settlement (for a description of which, see paragraph 5.7 below).

4.5 Appendix B contains an inexhaustive list of ISDA forms, user's guides and other resources that are frequently used in the credit derivatives market.

5. SETTLEMENT FOLLOWING A CREDIT EVENT

5.1 Each CDS contract specifies certain events (*credit events*) relating to the reference entity. The selection of credit events will be influenced by local market practice and the credit quality of the CDS's reference entity. The specified credit events may include some or all of the following:

- (a) *bankruptcy* of the reference entity or commencement of an insolvency procedure;
- (b) the reference entity's *failure to pay* in accordance with any obligation that falls within a specified category (for example, regarding borrowed money of the reference entity);
- (c) *restructuring* of any obligation of the reference entity falling within a specified category that results in a material change to its terms;¹⁴
- (d) *moratorium* or *repudiation*;
- (e) occurrence of a *default* under any obligation of the reference entity that falls within a specified category, being other than a failure to pay; and
- (f) *acceleration* of any obligation of the reference entity that falls within a specified category.

5.2 In practice, in the CDS market on corporate entities it is very common for CDSs to specify the same three credit events alone: *bankruptcy*, *failure to pay* and *restructuring*. Matters relating to the taking place of a credit event in the context of a restructuring are explored in detail in paragraphs 7.45 to 7.47 below.

¹⁴ See further Appendix C.

5.3 The occurrence of a credit event in itself is not sufficient to trigger the protection buyer's rights under a CDS. Either the protection buyer or the protection seller would have to deliver a *credit event notice*, containing a description in reasonable detail of the facts asserted as constituting a credit event. The terms of the CDS confirmation determine whether the protection buyer, the protection seller or either of them may deliver a credit event notice.¹⁵ A further condition to settlement, requiring delivery of a *notice of publicly available information*, is generally included. Such a notice would be required to cite information reasonably confirming facts relating to the occurrence of a credit event set out in a specified number of internationally recognised public sources.¹⁶

5.4 If a credit event occurs during the term of the contract, one of the parties to the CDS elects that settlement should take place, and the applicable conditions are met (including delivery of such notices as may be required), the transaction may be settled by the making of one or more *protection payments*, via *physical settlement* or *cash settlement*. As at the date of writing, the latest market information indicated that 86 per cent of credit derivatives were physically settled.¹⁷

5.5 In the case of physical settlement, the CDS provides for the protection seller to be required to pay to the protection buyer the notional amount in cash, and the protection buyer to be required to deliver to the protection seller a debt obligation (a *deliverable obligation*) of the reference entity in a principal amount equal to the notional amount. The deliverable obligation would have to satisfy certain criteria agreed by the parties, as set forth in the contract. For example, the deliverable obligation may be required to be one or more of the following:

- (a) a bond or loan;
- (b) unsubordinated to a reference obligation in right of payment;
- (c) denominated in an agreed currency;

¹⁵ See Appendix D for a list of certain major reference entities in respect of which credit events have been called since 1 January 1999.

¹⁶ A public source would be as specified in the CDS confirmation itself or one of the public sources listed in the applicable Definitions. The publicly available information may also consist of information received from official sources, such as court orders, from the reference entity, or from a "trustee, fiscal agent, administrative agent, clearing agent or paying agent".

¹⁷ *BBA Credit Derivatives Report 2003/2004*, BBA, 2004.

Credit Derivatives in Restructurings

- (d) an assignable or transferable obligation; and
- (e) of a stated term to maturity that is not longer than an agreed period.¹⁸

5.6 The obligation delivered would generally, as a matter of practice, be the cheapest deliverable obligation available.

5.7 In the case of cash settlement, the CDS provides for the protection seller to be required to pay to the protection buyer an amount in cash equal to the notional amount minus the market value of a reference obligation. Market value would be determined by obtaining dealer price quotes for the obligation during a specified period following the occurrence of the credit event.¹⁹ However, processes for cash settlement in the credit derivatives market have been evolving.²⁰ At the date of writing, new mechanisms for cash settlement of CDSs are under consideration.

5.8 Matters relating to settlement in the context of a restructuring are explored in detail in paragraphs 7.48 to 7.54 below.

6. COMPARISON WITH OTHER TYPES OF CREDIT PRODUCTS AND TECHNIQUES

6.1 Purchasing CDS cover on a debt instrument can be seen as establishing a similar risk profile to that arising upon a short sale of the reference entity's debt. However, a CDS enables parties to isolate credit risk as a distinct

¹⁸ The type of credit event relied upon by the triggering party determines the criteria for obligations to be deliverable. Following a *restructuring* credit event, a number of different approaches exist with respect to deliverability of obligations upon physical settlement: see Appendix C.

¹⁹ Alternatively, parties to a cash-settled CDS may stipulate in advance the price (expressed as a percentage of the notional amount) to be paid to the protection buyer upon the occurrence of a credit event. However, such *fixed amount* settlements are usually only used in the case of CDSs on debtors in respect of which there is an established market, and as to which the parties may agree on a price based on historical default and recovery rates. In any event, such a contract will often provide for additional "true-up" payments to be made after the initial fixed payment, upon determination of the market value of a certain reference obligation.

²⁰ See for instance (in relation to CDS index products) the *2005 CDS Index Protocol* (relating to Collins & Aikman Products Co., a U.S. supplier of automotive parts), the *2005 Delta & Northwest CDS Index Protocol* (relating to Delta Air Lines, Inc. and Northwest Airlines, Inc., two U.S. airline companies), the *2006 Calpine CDS Protocol* (relating to Calpine Corporation, a U.S. power company) and the *2006 Dana CDS Index Protocol* (relating to Dana Corporation, a U.S. supplier of automotive parts). Each of these is available at www.isda.org.

tradable interest separate from ownership of, or any other interest or risk²¹ associated with, a debt obligation (subject to any exposure by the protection buyer to *counterparty risk* (the risk of default of the protection seller under the CDS)).²²

6.2 Credit derivatives such as CDSs are similar in a number of ways to other products and techniques used to manage and invest or trade in credit risk. However, CDSs have certain additional characteristics that distinguish them from other such products and techniques. Key distinctions are outlined in the tables below.

Credit insurance	CDS
A party must have an insurable interest to be protected by a credit insurance policy, and must show an actual loss to receive insurance payments	A protection buyer does not need to own any obligation, under a CDS, and needs simply to show the occurrence of a credit event (without necessarily incurring any loss) in order to be paid by the protection seller

Loan assignment	CDS
A lender who seeks to transfer credit risk by assignment of a loan must comply (among other things) with transfer restrictions affecting the loan (which may include a requirement for involvement by the debtor)	A lender may transfer credit risk on a loan held by it without regard to transfer restrictions governing the loan (and without any involvement by the debtor) by entering into a CDS under which the lender is the protection buyer in respect of the reference entity

²¹ Such as interest risk or currency risk.

²² A protection buyer under a CDS will generally be exposed to counterparty risk, though such risk may be mitigated by the use of posted collateral (see footnote 67 below).

Credit Derivatives in Restructurings

Sub-participation ²³	CDS
A sub-participant may have negotiated to obtain an influence over the exercise of voting rights attached to sub-participated debt	A protection seller under a CDS usually has no influence over voting rights attached to the debtor's obligations, unless and until any of such obligations are delivered upon physical settlement ²⁴

7. PRACTICE POINTS

Introduction

7.1 In any restructuring,²⁵ the debtor (as well as creditors and other stakeholders) should aim to understand the position and goals of the other parties involved in order to be able to formulate a negotiating strategy and restructuring plans. Everything that affects the exposure and the financial position of each party involved is relevant for these purposes. However, it is rarely possible to see the full picture, and the potential existence of CDS cover may add to the complexity of the picture.

7.2 As a result of the growing size and reach of the market for CDSs,²⁶ they are likely to appear with increasing frequency in restructurings and become an

²³ The term *sub-participation* is used in this booklet to refer to an instance where a creditor remains the creditor of record, but enters into a bilateral contract (short of an assignment) with a *sub-participant* under which the latter obtains certain rights relating to the debt, and acquires no contractual rights against the debtor.

²⁴ In some markets, CDSs are used by parties who wish to extend credit to borrowers or sectors to which they would not have access as lenders of record because of local regulatory constraints. In such cases, the protection sellers are often granted the power to control decisions relating to the underlying debt (though restrictions in the terms of the debt may have an impact on the effectiveness of such an approach).

²⁵ Including any informal workout, and any bankruptcy proceeding that potentially involves a plan of reorganisation, scheme of arrangement or the otherwise active participation of creditors and stakeholders. The booklet having been written from a corporate restructuring perspective, different issues from those discussed may arise upon the restructuring of a financial institution or sovereign entity.

²⁶ At present, the use of CDSs is increasing particularly – though not exclusively (see footnote 2 above) – in relation to large corporates with rated debt obligations that are traded in mature markets.

increasingly significant part of the restructuring environment. An understanding of their potential impact on the restructuring process is particularly important, always bearing in mind the changing nature of the CDS market. A key question for participants in the early stages of a restructuring is whether the debtor (or any of its affiliates) is a reference entity in the CDS market.²⁷

7.3 However, CDSs are simply one kind of risk management and trading tool currently in use. In the restructuring context, they should be viewed in a similar way to other credit protection techniques with which restructuring participants may be more familiar.

7.4 In this context, it should never be assumed that a creditor's economic interest in a restructuring depends solely on the size of its apparent debt exposure. The creditor's exposure may be subject to a sub-participation or credit insurance, or otherwise affected by relationships not involving the debtor.²⁸ Such arrangements are ubiquitous and often invisible to all or some participants in the restructuring process. A creditor with protection will generally not wish to disclose its existence or terms to the debtor or other parties.²⁹

7.5 In particular, a party is likely to consider that it is not in its best interests to disclose CDS cover, as such disclosure may damage that party's relationship with the debtor in question, and may in effect also involve revealing its portfolio and risk management techniques. Further, it would be unlikely for a party to be legally required to disclose, to parties around the restructuring table generally, whether it has purchased or sold CDS cover, the terms of any such cover, or any dealings in credit protection. The position will likely be no different where the party is a member of a steering committee.

7.6 Where information concerning the existence of a party's protection arrangements is available, this should be factored into analyses of the relative

²⁷ The booklet does not specifically address situations where a debtor in a restructuring process itself has a credit derivative position (which it may do on another obligor for treasury, corporate finance or other reasons).

²⁸ Various different matters may determine a creditor's level of exposure, potentially affecting its strategy at the restructuring table, such as its foreign exchange position.

²⁹ Confidentiality restrictions under the general law or as a matter of contract may also restrict the disclosure of certain information. On the other hand, a party holding CDS protection may decide to make limited disclosure of the existence and terms of such protection if it wishes to seek to negotiate special terms in a restructuring plan to accommodate its CDS position (for the reason described in paragraph 7.17(d)(i) below, for instance).

Credit Derivatives in Restructurings

positions of the parties, negotiating strategies, and proposals for restructuring plans. Where such information is unavailable, as is often the case, it is necessary to be aware that protection arrangements may exist and may affect the dynamics of a restructuring and the structure and terms of restructuring plans that are put forward (recognising, for example, that the existence of such arrangements may account for otherwise inexplicable behaviour by a party to restructuring negotiations).

7.7 The terms of CDSs (even those written on an identical reference entity) are not necessarily uniform, and may differ significantly as a result of negotiation and customisation.³⁰ In addition, no two parties would approach any particular situation in exactly the same way. The impact (if any) of CDS protection will therefore vary from case to case, and it is not possible to set out in advance the principles that will apply in every case. However, certain key factors are likely to be taken into account by participants, and it is therefore possible to make some high-level generalisations about the likely issues and the actions parties may be expected to take.

7.8 This booklet addresses the types of issues that may arise and their potential impact on the dynamics of restructurings. The following paragraphs provide general commentary on the potential impact of CDSs on restructurings, and illustrate the kinds of situation with which participants in restructurings may be confronted and how issues may arise. The examples in particular outline the relative positions of, and incentives that may affect, lenders (fully covered, partially covered, uncovered or involved in multiple capacities), protection sellers and debtors. In light of the factors set out in paragraph 7.7 above, though, the examples and associated comments are not intended to be viewed as a comprehensive statement of the likely position of any of the parties.³¹

General issues

7.9 There are concerns that the widespread use of CDSs by members of the creditor community could complicate, and on occasions undermine, a

³⁰ In particular as regards credit events and deliverability of obligations upon physical settlement: see paragraph 5.1 above and Appendix C.

³¹ Appendix E contains a list of sources of further information that may prove of some use in this regard.

restructuring process.³² Concerns have in particular arisen on the following grounds:

- (a) Unknown and invisible positions of creditors (which may involve interests conflicting with those of other creditors) where creditors holding protection may seek to cause the occurrence of a credit event. A default under applicable credit documentation, or a bankruptcy proceeding, may for instance amount to a credit event. In such a case, some creditors (unknown to other participants) may be in a position where they would maximise their overall recovery were a default or a bankruptcy to occur, even if such a situation would be damaging for the debtor and the prospects of an effective restructuring.
- (b) Disruption to the restructuring process (and in certain cases process paralysis) during a key point in the process of consensus-building among stakeholders, owing to the occurrence of a credit event that may lead to delivery of obligations upon physical settlement of CDSs that are written on the debtor. Such settlement may give rise to substantial changes to the participants around the restructuring table, and fragmentation of the creditor community.

7.10 The presence of CDSs may give rise to an additional level of complexity in the behavioural dynamics of a restructuring, but there are likely to be reasons that problems may in practice be limited in extent.³³ To date, CDSs have not been present in all restructurings, they have been seen to affect a relatively limited number of those in which they have been present, and it appears credit market participants have seen no evidence that CDSs have caused an otherwise viable restructuring to fail. However, problems have already been encountered – even though in recent times the credit markets have been relatively benign and there have not been a large number of major restructurings. The position in the event of a local or broader market downturn or

³² See, for example, *Towards Greater Financial Stability: A Private Sector Perspective – The Report of the Counterparty Risk Management Policy Group II* (July 2005) (available at www.crmpolicygroup.org), at pages B-18 to B-19: “While the major creditors in workouts in the past were typically banks, new types of creditors ... have emerged ... as ... participants in the CDS market. ... It is impossible to foresee exactly how well the vitally important credit workout process will function in the future. Yet, it seems prudent to assume that with changing players and changing motives, the [restructuring] process will be more difficult.”

³³ A number of these are described in the discussion of the examples in paragraphs 7.16 to 7.44 below.

Credit Derivatives in Restructurings

crisis may be somewhat different from that which has been generally evident to date.

Securities laws and regulatory requirements

7.11 In many financial institutions, any of a number of different business units may have purchased or sold protection, for business purposes such as trading or portfolio management.³⁴ However, securities laws and regulatory requirements applicable to financial institutions (such as laws or regulations relating to insider dealing, insider trading or market abuse) may restrict the flow of non-public information between units within the same financial institution.³⁵

7.12 A financial institution's policies, driven in part by the need to observe the requirements of securities laws and regulatory requirements, will generally limit certain information flows within the institution. Many institutions clearly separate their *private side* corporate lending and associated portfolio management functions from their *public side* CDS trading desk, with restrictions on the transfer of information between the two sides. The relationship or distressed debt unit at a particular institution may therefore have no (or limited) information about any CDS position of other units within the institution. Each institution will have its own approach to determining the relationship and the acceptable level of contact between its different units.

7.13 Particularly in light of the comments above, it is important to take into account that the unit of an institution represented at the restructuring table may be unaware whether the institution has CDS cover, or of the terms of any such cover. The dynamics of the restructuring may be influenced if and to the extent parties around the table do have such awareness.

³⁴ A large proportion of credit derivative transactions are "trading" in nature, i.e. not intended as hedging of any holdings by the relevant institution of the reference entity's debt. This booklet does not seek to deal in depth with the implications of the holding of credit derivative trading positions in a restructuring. Trading purchasers or sellers of credit protection that are not holders of record of debt of the debtor in question will not be involved in any restructuring discussions in these capacities, unless and until physical settlement occurs (and then only to the extent such traders seek to be involved in such discussions). However, their position could be affected by a restructuring, and this may have an impact at the restructuring table (see the commentary in paragraph 7.39 below).

³⁵ Relevant securities laws and regulatory requirements may have an impact not only on the transmission of information between units within financial institutions, but also on other aspects of entry into and settlement of CDS transactions. It is important that financial institutions take appropriate legal advice in all relevant jurisdictions on applicable securities laws and regulatory requirements, breach of which may have very serious consequences.

7.14 The likely constraints on communication arising from securities laws and regulatory requirements should particularly be taken into account in analysing the likely behaviour of the parties at the table. These may prevent the unit of an institution at a restructuring table from becoming aware of any cover held within another unit of the institution, or the terms of any such cover. On the other hand, where a unit of an institution legitimately makes a unit of the same institution represented at a restructuring table aware of cover (or the terms of cover) during the course of a restructuring, this may lead to a change in the behaviour of the latter.

7.15 Entities affected by a supervisory framework reflecting Basel II may also give consideration to the impact of CDSs on their regulatory capital requirements within such a framework. This may in turn have an impact on their usage of CDSs and their approach to the exercise of rights under CDSs (including in the context of a restructuring).

Examples

The fully covered lender, the protection seller and the debtor

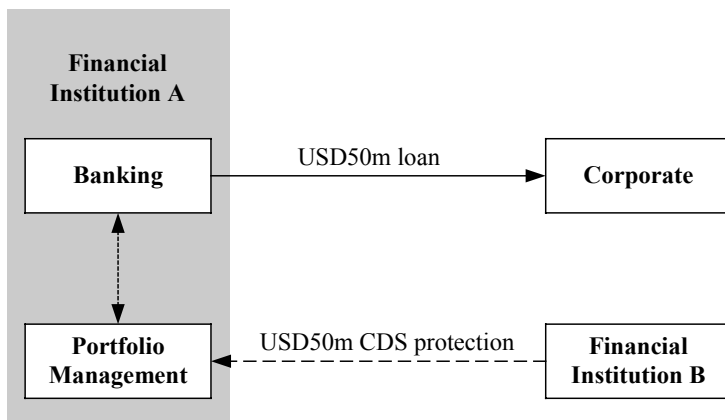


Figure 2

The fully covered lender (protection buyer): Financial Institution A

7.16 In Figure 2 above, Financial Institution A has a USD 50 million exposure to a corporate as part of a USD 500 million syndicated facility. Financial Institution A also holds USD 50 million of protection under a CDS.

Credit Derivatives in Restructurings

Management responsibility for each position resides within the part of the lender that originated the deal, i.e. the Banking book holds the loan and the Portfolio Management book holds the CDS. The corporate is distressed and a steering committee is in the process of being formed.

7.17 One important factor to consider is the level of protection a “fully covered” lender such as Financial Institution A actually has, in order to ascertain how any potential restructuring would or should be treated under relevant CDSs. The key questions are whether the protection purchased is effective cover on the underlying debt, and whether the lender may be able to “trigger and deliver”. Key points to be considered include:

- (a) To what entity or entities the lender is exposed.
- (b) Whether the lender's CDSs are traded on obligations of a reference entity within the debtor's group.³⁶
- (c) Whether the lender's CDS positions would or may be cash settled.
- (d) In the case of CDSs that may be physically settled, what debt instruments are deliverable obligations; in particular, whether the lender is likely to be able to deliver its loan.³⁷
 - (i) The lender may wish to seek modifications to the terms of its loan to the debtor (such as the removal of restrictions on transferability) in order to permit its deliverability, or may seek to purchase other obligations to deliver.³⁸

³⁶ The lender may reject any restructuring proposal that contemplates obligations of a reference entity under the lender's CDS cover being rolled into obligations of a newly restructured entity that is not a *successor* for the purposes of the cover (see footnote 11 above).

³⁷ Deliverability was in question after the filing for bankruptcy of Calpine Corporation on 20 December 2005. The ranking in the debt structure of certain of the group's convertible bonds was not clear, with resultant doubts in the CDS market as to their deliverability.

³⁸ TXU Europe Limited and TXU Europe Group plc, companies in the European part of the TXU energy group, entered administration on 19 November 2002. Most CDSs written on entities in the European part of the group were written on TXU Europe Group plc. The entry into administration of the two companies amounted to a credit event under most or all of these CDSs. However, there were no actively-traded deliverable obligations of TXU Europe Group plc. As a solution to this problem, the administrators of TXU Europe Group plc were asked to facilitate the sale of

- (ii) The lender may reject any restructuring proposal that envisages changing the terms of an obligation – for instance its maturity date – such that that obligation is no longer deliverable.
- (e) The credit events specified in the lender's CDSs, and the likelihood and likely timing of such events occurring during the restructuring.³⁹

7.18 The tenor of outstanding credit protection should also be considered. The key questions here are when scheduled termination of the CDS cover may occur, and how this fits with expectations concerning the likely timeline for completing the restructuring. Any proposal that envisages restructured facilities having a term extending beyond that of the original facilities and the tenor of associated CDS cover would in effect be expecting a party with such protection being prepared to move to a position of reduced cover (except in certain cases where the proposal in itself includes circumstances amounting to a credit event⁴⁰). This could be financially disadvantageous from that party's point of view, especially as replacement cover may be unavailable in the market, and the price of any replacement cover that is available will be likely to have increased (perhaps significantly).

7.19 A fully covered lender may not wish to serve on a steering committee formed for the purpose of assisting the negotiation of restructuring plans. The existence of cover on credit risk of the debtor may result in such a lender being reluctant to join a steering committee, in particular given the time commitment that serving on a committee may entail (and restrictions on the ability of the lender to trade in public markets that may result from the receipt of confidential information by steering committee members). However, major banks and other major financial institutions may still wish to serve on a steering committee and participate actively in the restructuring process for reputational or other reasons.

7.20 A fully covered lender may be unwilling to sign up to a standstill arrangement or informal moratorium, as such an arrangement could preclude a credit event from taking place or otherwise jeopardise such a lender's ability to exercise protection rights. However, it is possible that a standstill or forbearance

intercompany loans owed by TXU Europe Group plc, with a view to their meeting the criteria for deliverable obligations under outstanding CDSs.

³⁹ See especially the commentary in paragraphs 7.45, 7.47(b), 7.47(c), 7.47(d) and 7.47(f) below.

⁴⁰ For commentary on such a proposal, see paragraphs 7.46 and 7.47 below.

Credit Derivatives in Restructurings

arrangement involving simply an agreement to defer the exercise of remedies during the standstill period may not interfere with the rights of a creditor holding protection.

7.21 Where a fully covered lender is asked to agree to a waiver of defaults, its approach may turn on whether such a waiver may reduce the likelihood of the occurrence of any particular credit events in respect of which it has cover.

7.22 A fully covered lender may find it advantageous to seek to have a clear credit event occur, such as a bankruptcy filing or formal restructuring of an obligation of the debtor. More generally, a party that has bought credit protection may be expected to act in relation to restructuring or other proposals in line with its own interests, taking such protection into account in devising and implementing a negotiating strategy. If its potential loss in the event of (say) bankruptcy of the troubled entity is fully hedged, this will be a major factor that party may take into account when deciding how to act. Its behaviour in this respect may be influenced by the nature and availability of deliverable obligations (see paragraph 7.17(d) above).

7.23 However, although bankruptcy of the debtor may (upon the satisfaction of certain conditions) permit a creditor that is a protection buyer under a CDS to call for settlement, other credit events may equally do so, and a creditor may determine that its interests are best served by not insisting on a bankruptcy proceeding.⁴¹ Covered lenders may also represent an insignificant minority that can be outvoted pursuant to applicable majority voting provisions.

7.24 Depending on the way in which the relevant CDS is settled, a protection buyer may retain its rights under the underlying debt after settlement, even if it has full protection. If cash settlement may take place, or physical settlement may take place and the protection buyer is able to deliver obligations other than the underlying debt, the protection buyer may in such an instance retain its claims in respect of the debt and therefore have an economic interest in achieving an outcome of a restructuring that maximises the value of the debt.⁴²

⁴¹ A creditor may reach such a conclusion particularly where there is uncertainty as to the particular bankruptcy proceeding the debtor would be required to undergo under its local jurisdiction for a credit event to be triggered.

⁴² On the other hand, a lender that has claimed the benefit of CDS cover over part of the debt held by it may choose to sell any remaining debt held by it.

The financial institution (protection seller): Financial Institution B

7.25 Before settlement, a protection seller such as Financial Institution B would not be at the table in its capacity as protection seller. Upon physical settlement, which may be some time after a credit event (called either by the protection buyer or by the protection seller depending on the terms of the CDS in question), it may treat its resulting ownership of a delivered obligation as a trading exposure and not take an active position in the underlying debt and the restructuring.⁴³ The protection seller may simply sell in the market the underlying debt as quickly as possible. In these circumstances, it would not be the protection seller who ends up holding the underlying debt but some other party (who may also wish only to trade the debt and not play an active role in the restructuring). Particular investment funds may also look to acquire debt of the distressed entity by making purchases of such debt from protection sellers after physical settlement has taken place.

7.26 On the other hand, there may be situations in which a protection seller may wish to become involved in a restructuring, where for example it has sold protection with a view to acquiring more debt and bargaining power in the restructuring. A CDS may be a cost-effective route into a restructuring, though as the protection buyer rather than the protection seller would elect what obligation to deliver upon physical settlement of a CDS, such a strategy may be difficult to effect.⁴⁴

7.27 Any uncertainties regarding the operation of CDSs⁴⁵ or the timing of a transfer of an important debt (being important either because it is held by a key supporter of a restructuring or because votes in respect of it are sought in support of a majority voting position) could result in delays in a restructuring process. However, the risk of disputes between creditors generally exists in any case, and its impact may be mitigated by early discussions with the parties concerned.

7.28 A protection seller is also usually unable, under the terms of a CDS, to direct a protection buyer during a restructuring as to how to exercise its rights in

⁴³ A protection seller may also itself have laid off part of the credit risk of the debtor via the purchase of CDS protection, which may in turn be physically settled.

⁴⁴ For further commentary on physical settlement, see paragraphs 7.51 to 7.54 below.

⁴⁵ Resulting, for example, from doubts as to whether a credit event has occurred (see paragraph 7.45 below).

Credit Derivatives in Restructurings

respect of any obligation of the debtor (before any physical settlement takes place). The position is different in respect of those sub-participations under which sub-participants have negotiated rights to direct how votes in respect of debt should be exercised (including during a restructuring).⁴⁶

The debtor

7.29 A debtor may frequently require a committed level of support for its proposals before launching – for instance – a court-led restructuring process. Such a requirement would be driven by the operational business impact, potential costs and reputational implications of a failed process.

7.30 It will be advisable for the debtor to investigate whether it is used as a reference entity in the CDS market.

7.31 Where CDS protection is potentially in play in a restructuring, its possible implications mean a debtor should scrutinise carefully the potential positions of key creditors to seek to ascertain the issues that affect them (which may affect their behaviour and the appropriate or likely structure and terms of restructuring plans) and to be aware of the potential impact on the restructuring process of the exercise of CDS cover.

7.32 The debtor should be particularly aware of potential changes to the parties around the table upon physical settlement,⁴⁷ and take CDS-related issues into account in its negotiating and communications strategies.

⁴⁶ Unless and until physical settlement takes place under a CDS, the protection buyer under the CDS is generally entitled to vote the deliverable debt (see also section 6 above for commentary on voting rights).

⁴⁷ See paragraphs 7.25 and 7.26 above.

The partially covered lender and the lender with multiple capacities

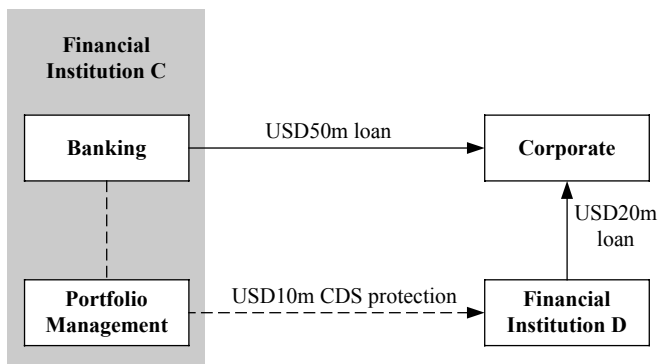


Figure 3

7.33 In Figure 3 above, Financial Institution C has a USD 50 million exposure to a corporate as part of a USD 500 million syndicated facility. Through its CDS trading desk, Financial Institution C has sold USD 10 million of CDS credit protection on the corporate to Financial Institution D, another financial institution in the syndicate. Financial Institution C is not part of a steering committee that has been established.

7.34 Figure 3 illustrates two further aspects of the situation that may develop when CDSs are in play.

The partially covered lender (protection buyer): Financial Institution D

7.35 First, in Figure 3 Financial Institution D has only partial rather than full protection. Its exposure to the corporate is USD 20 million but it only has protection in respect of USD 10 million of that amount.

7.36 In practice, it is rare for a lender to purchase protection in order to cover 100 per cent of the value of its debt, so it is likely that a creditor will often be only partly hedged and still have a significant interest as a creditor in the outcome of a restructuring of the debtor. This is especially likely to be the case in more complex multi-facility restructurings, where it may be that one tranche of an institution's debt is hedged and another tranche is not.

Credit Derivatives in Restructurings

7.37 Many of the same issues will apply in respect of a partially covered lender as in respect of a fully covered lender (for example, the need to review the potential level of protection actually provided by a CDS given the likely terms of the protection and the likely course of the restructuring).

7.38 The approach of a partially covered lender may, however, be affected by the fact that it will retain a residual claim against the debtor and therefore have a greater relative economic interest in maximising recovery from the debtor than if it had been fully covered.

The lender with multiple capacities: Financial Institution C

7.39 Secondly, Figure 3 illustrates how parties may find themselves involved in a restructuring in multiple capacities. Financial Institution C is both a lender and a protection seller, so the exercise of rights under the CDS may result in the institution having an increased exposure to the corporate as a result of the receipt of deliverable obligations of the debtor in settlement of the CDS. Events during the restructuring, and the outcome of the restructuring, may also have an effect on the institution's position as protection seller.⁴⁸ Such an impact, whether actual or potential, may influence the behaviour of the institution at the restructuring table.

7.40 However, in the circumstances illustrated in Figure 3, the unit of Financial Institution C with responsibility for managing the USD 50 million loan at the restructuring table may not be aware of the existence of the protection sold through the lender's CDS trading desk to Financial Institution D. Strategic decisions regarding the loan in the restructuring may be taken independently of factors relating to the position of Financial Institution C as a protection seller.⁴⁹

⁴⁸ This may be as a result of their direct impact on its CDS position, or indirectly as a result of changes in market prices of the corporate's debt instruments (for instance in the circumstances referred to in paragraph 7.47(f) below).

⁴⁹ See paragraph 7.13 above. Alternatively, debt acquired upon settlement of the CDS may come under the control of the unit responsible for managing the USD 50 million loan, which may then acquire a more significant and influential role in the restructuring because of the increased exposure (though in its capacity as protection seller Financial Institution C could come to the table only upon physical settlement). Whether positions would be combined in this way in practice will depend on both the particular institution in question and the prevailing circumstances.

7.41 Financial institutions are frequently stakeholders in multiple parts of a capital structure in any case, and multiplicity of economic interests of a party at a restructuring table should therefore not be seen as a new phenomenon.

The uncovered lender

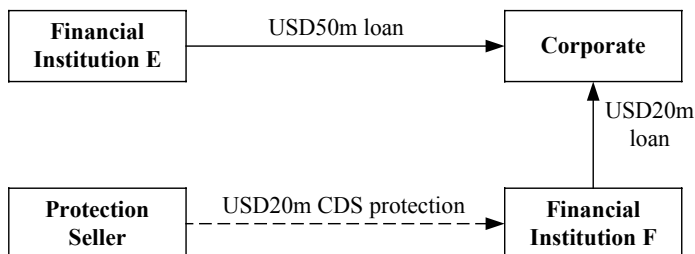


Figure 4

The uncovered lender: Financial Institution E

7.42 In Figure 4 above, Financial Institution E has a 10 per cent participation in a USD 500 million syndicated facility. Here, it has no protection but suspects that CDSs may be in play elsewhere in the restructuring. It is a member of a steering committee that has been established. Financial Institution F has a USD 20 million participation in the facility, covered by a CDS for its full exposure.

7.43 In this situation, Financial Institution E as an uncovered lender should consider the potential impact on the restructuring negotiations of the existence of credit protection. In the first place, it should be aware that there may be little information available as to the protection bought by Financial Institution F. If the cover remains undisclosed to parties around the restructuring table generally, as is likely, there will be an inequality of information at the table, which may lead to practical difficulties in negotiating an agreement as to how the corporate is to be restructured. However, in this particular respect the situation is no different from that where sub-participations exist.

7.44 The relative exposures of creditors are commonly used as a basis for decisions on voting, risk apportionment and distribution of proceeds. There may be delay in resolution of these issues if a creditor's actual lack of (or reduced) exposure is not recognised until late in the negotiation process. This may give rise to increased time pressure in achieving a successful restructuring, if the

Credit Derivatives in Restructurings

debtor is due to experience a “squeeze” in liquidity or is subject to the risk of creditor action.⁵⁰

Occurrence of a credit event

7.45 A potentially important practical issue may be whether a credit event has occurred at all.⁵¹ In such a scenario, the identity of those who may ultimately bear the credit risk of the debtor will be unclear. Indeed, as parties at the table will almost certainly not have access to the relevant CDS documentation, it will in all likelihood be difficult for them (or protection sellers) to take a view as to whether a credit event has occurred.

7.46 If CDS cover is thought to be in play in a restructuring, the parties negotiating the restructuring may want to bring to the table those with the “real” economic interests. They may consider this to be achievable by means of a restructuring plan that deliberately facilitates a credit event, potentially leading to the settlement of outstanding CDSs. If a credit event does take place, this may give rise to additional clarity as to the appropriate parties with which negotiations should be taking place, and result in a greater understanding of each party’s true interests by other parties.

7.47 However, the factors listed below apply in the context of a credit event, and parties may in this light consider that restructuring plans should *not* be designed so as to facilitate a credit event deliberately. A party, before seeking to facilitate a credit event, may find it appropriate to consider the potential impact of such a credit event on the debtor and the prospects of a successful restructuring.

- (a) It may not be advantageous to seek to facilitate a particular type of credit event such as *bankruptcy* (see paragraph 7.23 above).

⁵⁰ Particular time pressure may arise if CDS cover is acknowledged and it is not clear what instruments are deliverable to achieve physical settlement (see the commentary in footnote 37 above).

⁵¹ This was at issue during the restructuring in 2001 and 2002 of Marconi Corporation plc, a United Kingdom telecommunications company, during which schemes of arrangement were proposed. There were differing views in the market as to whether a credit event had occurred at any point in the restructuring. This caused some uncertainty as to the likely outcome of voting on the proposed schemes until very shortly before the necessary creditor scheme meetings.

- (b) Whether CDSs are in play, and the terms of any such CDSs, will probably not be widely known. Information may be available in relation to market-traded CDSs, but the terms of such CDSs may differ from the terms of any CDSs that may be present in the restructuring.⁵² It may be difficult for parties to establish what circumstances would facilitate a credit event, if they do not have access to the relevant CDS documentation.⁵³
- (c) The terms of the underlying debt may affect the likelihood of a particular type of credit event being able to be facilitated.
- (d) A protection buyer may prefer to call a credit event as soon as possible, in order to close out its exposure at a lower cost than may be incurred subsequently. However, a protection buyer may decide not to call (or to defer calling) a credit event, perhaps in order to maintain ongoing CDS protection against potentially greater value-deteriorating events occurring within the tenor of the cover. There may also be a delay in a protection buyer's exit and a protection seller's arrival at the table, if physical settlement takes place some time after a credit event. Some form of process paralysis may take place pending the exit of protection buyers after a credit event, as they may have little interest in maintaining the momentum of restructuring negotiations; in an extreme case, a restructuring process may come to a halt.
- (e) It may be particularly difficult to clarify the appropriate parties with which negotiations should in due course take place, where a protection seller has itself laid off part of the credit risk of the debtor via the purchase of its own CDS protection.⁵⁴
- (f) Discussions around the potential occurrence of a credit event may give rise to movements and volatility in market prices of the distressed entity's debt instruments. Market prices of its debt instruments may increase ahead of a potential credit event (and indeed after a credit event) where they are actually or potentially deliverable upon physical settlement, and

⁵² In particular, the specified credit events may differ (see paragraph 5.1 above and Appendix C).

⁵³ Even if a credit event is facilitated, the additional clarity described may be unlikely where protection has been purchased in the form of a portfolio CDS (for a description of which, see Appendix A), given that in such a case the protection buyer may be reliant on multiple credit events for settlement to be able to take place.

⁵⁴ Such a party's further CDS protection may continue notwithstanding the occurrence of the credit event in question, and be on different terms from the CDS under which it is the protection seller.

Credit Derivatives in Restructurings

for which there may therefore be an actual or potential increase in demand.⁵⁵ This in turn may have an impact upon the approach, regarding the particular debtor, of players both around the table and in the credit markets more generally.

- (g) The public availability of information relating to the occurrence of a credit event would generally be required for settlement to be able to take place.⁵⁶
- (h) Physical settlement following a credit event may entail particular instability around the restructuring table.⁵⁷ In the absence of access to the relevant CDS documentation, it will not necessarily be clear that cash settlement would take place instead.
- (i) Under the terms of any outstanding physically settled CDSs, there will be limits on what debt obligations would be deliverable (see paragraph 5.5 above); it may also be unclear what debt obligations would be deliverable.⁵⁸

Settlement

7.48 In circumstances where a credit event has occurred and settlement has been called for, practical differences may arise from whether the protection seller's obligation is to make a payment reflecting the deterioration of the credit (cash settlement) or to take and pay for a transfer of the underlying debt (physical settlement).

⁵⁵ Delphi Corporation, a U.S. supplier of automotive parts, filed for bankruptcy on 8 October 2005. The notional amount of credit derivatives referencing Delphi Corporation was said to be more than 10 times the approximately USD 2 billion of outstanding bonds issued by the company. Bond prices rose from 58 cents on the dollar following the bankruptcy filing, to 72 cents on the dollar, before falling as it became clearer that there was support for a cash settlement auction process of outstanding CDS index products (effected in due course with the use of the *Revised 2005 Delphi CDS Index Protocol*, available at www.isda.org). A similar phenomenon was evident around the filing for bankruptcy of Dana Corporation. On the other hand, inherent credit risk of a distressed entity may (as ever) exert downward pressure on market prices of its debt instruments.

⁵⁶ See paragraph 5.3 above.

⁵⁷ See paragraphs 7.51 to 7.54 below.

⁵⁸ See the commentary in footnote 37 above.

Cash settlement

7.49 Upon cash settlement, the protection buyer remains as the holder of the debt, though its interests may remain different from those of parties with different CDS positions.

7.50 However, new mechanisms for cash settlement⁵⁹ may affect the impact of cash settlement on restructurings.

Physical settlement

7.51 Physical settlement of CDSs may give rise to a particular instability around the restructuring table. It is common during a restructuring process for the identity of creditors to change, as underlying debts change hands. However, additional shifts in the dynamics of negotiations may arise if physical settlement takes place following a credit event, and a substantial number of players around the table change as a result.

7.52 These shifts may be greater in those instances where multiple parties arrive at the restructuring table where previously there had been only one party. This may occur in particular where:

- (a) protection had been purchased from more than one protection seller;
- (b) protection had been purchased from a protection seller that in turn had purchased physically settled CDS protection on the debtor from more than one counterparty; or
- (c) a protection seller takes delivery of underlying debt and sells it in the market to a number of parties.

7.53 It may be particularly difficult before a credit event to predict the number and respective participations of parties arriving at the table after physical settlement, as:

⁵⁹ See paragraph 5.7 above.

Credit Derivatives in Restructurings

- (a) any one of the situations described in paragraph 7.52 above may pertain without being generally evident ahead of the relevant parties arriving at the table; and
- (b) counterparties to CDSs may enter into arrangements that net their respective CDS positions, leading to a lower number of separate claims, and possibly thereby a lower number of parties arriving at the table, as compared with the situation that would have existed in the absence of such arrangements.

7.54 A substantial amount of debt may change hands upon physical settlement, and may be transferred to entities without specialised distressed debt units or expertise in restructurings.⁶⁰ It is unclear how often debt is transferred upon physical settlement under CDSs to parties who want to play an active role in a restructuring. However, active trading of debt at all levels of the capital structure is now a common feature of restructurings and the impact of such activity is usually dealt with satisfactorily within restructurings. On occasions, the transfer of debt upon the settlement of CDSs will have little or no impact on a restructuring process, in particular if physical settlement takes place after important binding creditor votes have been taken.

8. CONCLUSIONS

8.1 The development of the credit derivatives market has had a major impact upon the way in which entities such as financial institutions manage and trade in risk.

8.2 Growth in this market has been explosive. The market is likely to continue to grow both in size and reach.

8.3 Credit derivatives such as CDSs are likely to appear increasingly often in restructurings.

⁶⁰ See *Towards Greater Financial Stability: A Private Sector Perspective – The Report of the Counterparty Risk Management Policy Group II* (July 2005) (available at www.crmpolicygroup.org), at page B-18: “Some sophisticated investors may be opting to use new credit transfer instruments to sell problem credits ... rather than go through the prolonged and time-consuming workout process in circumstances in which the newer holders of such credit risk may have little experience or interest in participating in complex workouts.”

8.4 Not all parties involved in restructurings will be buyers or sellers of CDS cover. A party at the restructuring table that *does* have a CDS position may have different interests from other players at the table. Such a party's position may, for instance, entail a potential benefit (at least to the extent of the party's cover) in the occurrence of a credit event.

8.5 Even among a number of parties with a CDS position, interests may differ depending on:

- (a) the reference entities of the protection;
- (b) the extent to which the amount and duration of the protection cover the parties' underlying debt positions;
- (c) the credit events specified;
- (d) whether the positions may be cash or physically settled; and
- (e) the likely nature and availability of deliverable obligations.

8.6 It is unlikely that it would be in the interests of any parties holding CDS protection to reveal this, and they are unlikely to be subject to any obligation to disclose this to parties around the restructuring table generally. In the absence of disclosure of CDS protection to such parties generally, there will be an inequality of information at the table.

8.7 The different and potentially invisible interests of the players around the table in such a situation may affect behavioural dynamics at the table and give rise to an additional level of complexity both of negotiations and of solutions.

8.8 Nevertheless, reputational as well as economic factors are (as ever) guides for parties' behaviour.

8.9 Securities laws and regulatory requirements are also relevant and should be carefully considered.

8.10 When a restructuring is contemplated, debtors and their advisors are encouraged to consider the potential presence of CDSs and all its possible consequences.

Credit Derivatives in Restructurings

8.11 CDSs are now an established part of the risk management and trading landscape, and are likely to appear increasingly in restructuring work. Their existence may increase the challenges for those engaged in a restructuring. However, it appears that credit market participants have seen no evidence to date that the presence of CDS protection has caused an otherwise viable restructuring to fail, though there have been instances where problems have been encountered.

8.12 This is another development in the complex world of restructurings to which participants will need to adapt.

APPENDIX A: SELECTED TYPES OF CREDIT DERIVATIVES AND OTHER CREDIT-LINKED PRODUCTS

Portfolio credit default swap.⁶¹ CDSs may be written on a portfolio of reference entities. The calling of a credit event with respect to any entity in the portfolio will require one or more protection payments to be made by the protection buyer to the protection seller (though in some portfolio CDSs, the aggregate amount of such payments as would otherwise be required must reach an agreed threshold before payment is actually made). During the term of the CDS, the aggregate notional amount of the CDS is reduced from time to time by the notional amount that relates to each reference entity that experiences a credit event.

Collateralised debt obligation (CDO). Collateralised debt obligations are secured credit-linked securities, usually issued by a special purpose vehicle that is sponsored by a financial institution. Among other things, CDO transactions are used by financial institutions often to comply with internal risk controls or regulatory capital requirements.

In a simple CDO transaction, the financial institution initially enters into a contract with the vehicle, under which the financial institution transfers to the vehicle exposures to a portfolio of debt obligations. The transfer may be accomplished:

- (a) by a direct sale of such obligations from the financial institution to the vehicle for cash (in which case the transfer of credit risk and the resulting CDO transaction are referred to as a *cash* transfer and a *cash* CDO transaction, respectively); or
- (b) by entering into a portfolio CDS under which the financial institution buys protection from the vehicle in respect of the credit risk of such obligations (in which case the transfer of credit risk and the resulting CDO transaction are referred to as a *synthetic* transfer and a *synthetic* CDO transaction respectively).

The vehicle then issues CDO debt securities to third parties, such securities being secured by (and recourse under which being limited to) the available collateral, i.e. payments to be received by the vehicle under the obligations in

⁶¹ The terminology used in respect of portfolio CDSs is analogous to that used in respect of single-name CDSs (for a description of which, see sections 4 and 5 above).

Credit Derivatives in Restructurings

the portfolio (in the case of a cash transaction) or under the portfolio CDS (in the case of a synthetic transaction).

The proceeds of the sale of securities are applied by the vehicle to pay the purchase price of the portfolio (in a cash transaction), or to cover protection payments to be made under the portfolio CDS (in a synthetic transaction).

A payment default under an obligation in the portfolio or the calling of a credit event in respect of an obligation covered by the portfolio CDS (as the case may be) would result in a corresponding reduction in payments to the holders of the CDO securities, subject to any protection provided by over-collateralisation of the securities.⁶²

Credit-linked note. A credit-linked note is a debt instrument, the issuer's payment under which is contractually linked (and the purchaser's recourse under which is limited) to the credit and performance of another debt obligation or a portfolio of other debt obligations. Among other things, a credit-linked note allows its issuer to transfer the credit exposure associated with such an obligation or obligations to the purchaser of the note. The economic relationship between the issuer and purchaser of a credit-linked note is thus similar to that between the protection buyer and protection seller, respectively, under a portfolio CDS.

In a simple credit-linked note structure, an entity with credit exposure to a portfolio of debt obligations issues credit-linked notes in an aggregate principal amount up to the aggregate principal amount of the obligations in the portfolio,⁶³ and with a term to maturity that is not longer than the longest term to maturity of any obligation in the portfolio. The terms of the notes also provide, among other things, that recourse by the holders of the notes is limited to the amounts paid from time to time by the obligors under the portfolio. Interest on the notes is paid from a combination of investment returns on proceeds of the sale of such notes and interest payments made under the obligations in the portfolio.

⁶² In most CDO transactions, the principal amount of obligations in the collateral portfolio is larger than the principal amount of CDO securities secured by it. In addition, the vehicle may issue to the sponsoring financial institution subordinated debt securities or preferred shares to absorb initial loss amounts (if any) incurred under the portfolio before additional loss amounts are passed on to the purchasers of more "senior" CDO securities.

⁶³ To provide a measure of protection to note purchasers, the principal amounts of credit-linked notes in most transactions are smaller than the principal amounts of obligations in the related portfolios.

A payment default under an obligation in the portfolio would result in a corresponding reduction in the payments made to the holders of the credit-linked notes.⁶⁴

⁶⁴ Such a reduction would be subject to the protection provided to the noteholders by the excess (if any) of the aggregate principal amount of obligations in the portfolio over the principal amount of the related credit-linked notes.

Credit Derivatives in Restructurings

APPENDIX B: ISDA PUBLICATIONS OFTEN USED IN CREDIT DERIVATIVES DOCUMENTATION

The following ISDA publications are often used in credit derivatives documentation. They are all available at www.isda.org.

Master Agreements⁶⁵

- 1992 ISDA Master Agreements (Multicurrency – Cross Border form, or Local Currency – Single Jurisdiction form)
- 2002 ISDA Master Agreement

Definitions

- 1999 ISDA Credit Derivatives Definitions
- 2003 ISDA Credit Derivatives Definitions
- 2000 ISDA Definitions

Supplements

- 2005 Matrix Supplement (contemplating incorporation of terms set out in the Credit Derivatives Physical Settlement Matrix)⁶⁶

Forms of Confirmation

- Form of Confirmation for use with the 1999 ISDA Credit Derivatives Definitions (Exhibit to the 1999 ISDA Credit Derivatives Definitions)
- Form of Confirmation for use with the 2003 ISDA Credit Derivatives Definitions (Exhibit A to the 2003 ISDA Credit Derivatives Definitions)

⁶⁵ The Master Agreements include forms of schedules and confirmations.

⁶⁶ This is an optional supplement to the 2003 ISDA Credit Derivatives Definitions, applicable to a transaction if the parties so specify in the relevant confirmation. The matrix contains commonly used elections that apply to physically settled CDSs written on certain types of reference entities.

- Confirmation for use with the Credit Derivatives Physical Settlement Matrix

Credit Support Annex⁶⁷

- 1994 ISDA Credit Support Annex (New York law form or English law form)

ISDA also publishes guides to its standard documents, including the following:

- User's Guides to the 1992 Master Agreements
- User's Guides to the 2002 Master Agreement
- User's Guide to the 1994 ISDA Credit Support Annex

⁶⁷ The Credit Support Annex is an optional security agreement that may be entered into between parties to a derivative transaction documented by a Master Agreement. It is structured so as to mitigate counterparty risk by requiring one or both parties to post collateral to the other from time to time in an agreed amount. The amount is often specified as an agreed percentage of the amount that the posting party would be required to pay to the other party if the transaction were terminated at the relevant time.

Credit Derivatives in Restructurings

APPENDIX C: THE RESTRUCTURING CREDIT EVENT

The *restructuring* credit event involves a material change to the terms of a debt obligation of a reference entity, such as reduction in the amount of principal or interest, deferral of payment or maturity, or subordination of the obligation that, in each case, is made under distressed circumstances. In recent years, its applicability has been tested in various situations.⁶⁸

The “Without Restructuring” approach altogether eliminates *restructuring* as a credit event.

Where *restructuring* is included as a credit event, the “Multiple Holder Obligation” restricts such a credit event to one affecting an obligation held by more than three unrelated holders, and with respect to which the consent of at least 66⅔ per cent (determined by the terms of the obligation) is required for the event in question.

Several different approaches to physical settlement following a *restructuring* have developed in the industry and been documented by ISDA.⁶⁹

⁶⁸ Notably, in those circumstances where a *restructuring* credit event has been caused by an amendment to the terms of a relevant debt obligation of a reference entity that (though technically falling within the definition of a *restructuring*) broadly improved the reference entity's short-term financial outlook. Such a credit event may, at least temporarily, boost the price of the restructured obligation to a level higher than it was before the credit event (and may also result in higher trading prices of other obligations of the reference entity with maturities comparable to or shorter than the restructured obligation). Long-dated obligations of the reference entity, on the other hand, may trade at the same or significantly lower prices after the credit event, reflecting the market's view of the reference entity's long-term prospects. The prices of the obligations of Consecro Inc., a U.S. provider of insurance products, displayed this phenomenon in the context of its restructuring of 2000.

⁶⁹ The *restructuring* approaches discussed here have been simplified for ease of illustration and comparison, and should not be relied upon as a complete description of the terms of any such approach. See the 2003 ISDA Credit Derivatives Definitions (in particular sections 2.32 and 2.33) for the terms of each approach to the *restructuring* credit event. At least in the case of banks operating under the “Standardised Approach”, *restructuring* is not required as a credit event in order for a CDS to be an effective hedge for the purposes of Basel II but the regulatory capital benefits of a CDS are lower under Basel II in the absence of protection afforded by inclusion of *restructuring* as a credit event (Basel II, paragraph 192).

Modified Restructuring. This approach allows *restructuring* as a credit event, but requires (among other things) that if the protection buyer gives notice of the occurrence of a *restructuring* credit event, the deliverable obligation:

- (a) have a stated maturity that is not later than the earlier of:
 - (i) 30 months after the effective date of the restructuring; and
 - (ii) the latest final maturity of any restructured bond or loan; and
- (b) be transferable to the protection seller without any requirement for consent.

Modified Modified Restructuring. This approach allows *restructuring* as a credit event and requires (among other things) that the deliverable obligation:

- (a) have a stated maturity that is not later than the later of:
 - (i) the termination date of the CDS; and
 - (ii) 60 months after the effective date of the restructuring (in the case of a restructured bond or loan), or 30 months after the effective date of the restructuring (in the case of all other deliverable obligations); and
- (b) be transferable to the protection seller without any requirement for consent (except any consents of the obligor under a relevant loan agreement, not to be unreasonably withheld).

“Full” Restructuring. This approach allows *restructuring* as a credit event and does not impose any limitations on the maturity or transferability of obligations in order for them to be deliverable.

Credit Derivatives in Restructurings

APPENDIX D: CREDIT EVENTS SINCE 1 JANUARY 1999

The following is an illustrative list of some of the major reference entities in respect of which credit events under credit derivatives have been called since 1 January 1999.⁷⁰

Adelphia	NRG Energy
Air Canada	Owens Corning
Armstrong	Pacific Gas & Electric
AT&T Canada	Parmalat
British Energy	Railtrack
Calpine	Republic of Argentina
Comdisco	Russia – sovereign debt
Collins & Aikman	Solutia
Conseco	Southern California Edison
Delphi	Swissair
Delta Airlines	Telecom Argentina
Ecuador – sovereign debt	Teleglobe
Enron	TXU
Finova	TXU Europe
Global Crossing	United Airlines
Indonesia – sovereign debt	Warnaco Group
K-Mart	Worldcom
Marconi	Xerox
Northwest Airlines	

Sources: BBA, Fitch Ratings.

⁷⁰ This is not intended to be an exhaustive list of reference entities in respect of which credit events have been called since that date.

APPENDIX E: SOURCES OF FURTHER INFORMATION

(Sources listed in chronological order)

Marconi reveals shortcomings of credit swap documents, International Financial Law Review (October 2002)

Demystifying Restructuring Credit Events, Credit Suisse First Boston (February 2003)

The ABC of CDS: The credit guide to credit default swaps, Risk Waters Group (April 2003)

Global Credit Derivatives: A Qualified Success, Fitch Ratings (September 2003)

Lessons from the Marconi restructuring, Nicholas Frome and Claude Brown, International Financial Law Review (September 2003)

Derivatives must deal with restructuring quandary, Martin Hughes, International Financial Law Review (December 2003)

BBA Credit Derivatives Report 2003/2004, BBA (September 2004)

Credit Derivatives: A Primer, JPMorgan (January 2005)

Towards Greater Financial Stability: A Private Sector Perspective – The Report of the Counterparty Risk Management Policy Group II (July 2005) (available at www.crmpolicygroup.org)

The Next Wave: Why You Should Care About Credit Default Swaps, R. Michael Farquhar, American Bankruptcy Institute Journal, Vol. XXIV, No. 7 (September 2005)

Delphi, Credit Derivatives, and Bond Trading Behavior After a Bankruptcy Filing, Fitch Ratings (November 2005)

International Swaps and Derivatives Association, Inc. – www.isda.org



INSOL INTERNATIONAL

2-3 Philpot Lane, London EC3M 8AQ, UK

Tel: +44 (0)20 7929 6679

Fax: +44 (0)20 7929 6678

www.insol.org