WHAT'S A DEFAULT?

MOST CREDIT DERIVATIVES DEALERS THOUGHT THEY KNEW THE ANSWER—UNTIL A FEW HIGH-PROFILE EVENTS THREW THE MARKET INTO QUESTION.

By Barclay T. Leib

Credit derivatives only came into existence in the latter half of the 1990s, and the documentation behind the product has been lightly tested. But on September 22 last fall, some credit derivatives traders got a rude wake-up call. That was the day Bank of America and Chase announced the extension of $2.8 billion in loans to the troubled Conseco Corp. While this helped Conseco avoid an immediate bankruptcy declaration and sent the company's bonds modestly higher, the loan extension was technically deemed a restructuring. As such, it was also deemed a credit event—which allowed some fast-footed dealers to deliver long-dated Conseco securities against credit default swap agreements. Bonds that had previously been trading at a 60 handle could suddenly be tendered at par.

Since credit default events had been rare to that point—Rite Aid, Armstrong Corp. and school-bus manufacturer Laidlaw being the only three high-profile examples—several banks were caught completely off-guard by the Conseco situation. "I think there was a gentleman's perception that this loan restructuring should not have caused a default trigger, even though the nitty-gritty of the [International Swaps and Derivatives Association] document clearly allowed it to be such," notes a credit derivatives broker. "Even fewer dealers thought it was an appropriate response to get delivered longer-dated paper when it was a short-term loan that got extended."

Ever since, the usefulness of credit default swaps has been called into question, and the market has been abuzz with proposed language changes to the ISDA derivatives document. For all the deal flow these days, it's suddenly become apparent that many people aren't entirely sure what it is they've been trading: Is this a product that is supposed to pay off on credit impairment, or is it a product intended to protect capital in case of a cataclysmic inability to recover one's principal? Most people believe it should be the latter, but the Conseco event suddenly raised disparate interests and views that previously had been shoved under the rug.

Tailor-made contracts with specific restructuring provisions—either included or not—can always be designed and traded, but suddenly no one knows what the *standard* documentation for the interdealer market should be—and that has regulators and industry groups scrambling for answers. In a research report called "Restructuring: A Defining Event for Synthetic CDOs," dated December 22, the rating agency Fitch even stated that recent developments may eventually necessitate changes in its rating criteria for credit derivatives and the collateralized debt obligations into which they are sometimes packaged. According to Roger Merritt, managing director in Fitch's global loan products group, "a narrower definition as to what constitutes a credit event, or the complete elimination of restructuring, should, in fact, correspond with a lower incidence of credit protection payments for synthetic CDOs and credit derivatives."

Important insurance

Credit default swaps stipulate that in one of several possible events—the declaration of a bankruptcy, the failure to pay interest on a loan or bond, or the restructuring, repudiation or acceleration of a loan that lowers the overall creditworthiness of a counterparty—the buyer of the swap may deliver to the seller any loan or bond extending out to a predefined maturity, and receive back par value in return. In a market where it can be difficult and time-intensive for bank portfolio managers to resell an actual loan, this is an important and attractive product for lenders. Although delivery is typically based on physical settlement of loans or bonds at their par value, contracts are sometimes written for cash settlement of par value minus any recovery from the sale of the asset.

Because of the product, loan portfolio managers on both sides of the Atlantic have morphed in recent years into active traders, while insurance company and hedge fund managers gained a new way to position themselves.

Within the credit default swap contract, restructuring is clearly a trigger event important to many commercial banks. "There are increasing pressures on banks to mark loans to market, and when a loan is restructured, it is clearly a loss of value—often a step taken just to avoid an immediate default," explains Hetty Harlan, a managing director in charge of credit derivatives trading for BofA's portfolio management group. Harlan thus considers restructurings "de facto" or "prepackaged" defaults and a legitimate credit event under standard ISDA document.

"Such loans become expensive to hang onto in terms of loan loss reserves or charge-offs," she explains, "so we need to have some relief at that point to help mitigate the risk of doing so. Nobody wants to throw a company into bankruptcy if there's a glimmer of hope that a company may turn around with time. Banks shouldn't be in a position where they have to push for default because restructuring does not qualify for relief. That is in nobody's best interest."

Not everyone in the credit market thinks this issue is quite that simple and straightforward, however. According to sources close to the Conseco situation, Bank of America was actually the first institution to start delivering Conseco paper against long credit default swaps it had previously purchased. Harlan claims the bank only delivered the restructured loans, but other sources say BofA delivered the cheapest bonds it could get its hands on. Merrill Lynch quickly followed. But since Bank of America also had a hand in the loan extension, some cried foul at the potential conflict of interest.

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contract, BofA certainly could have considered it a repaid loan, and then extended a new loan if it had wanted to couch it in such terms," says one dealer. "That path would have avoided the technical default. In lieu of that, however, Bank of America termed the extension a restructuring, and quickly delivered Conseco paper to get it off its books."

"At the end of the day, calling the Conseco loan a restructuring was probably the commercially normal thing for BofA to have done," ventures another senior dealer. "It knew the implications of its actions, and coincidentally was happy to benefit. This is a financial market, not a social club. You have to have compelling big-picture incentives for people not to do short-term things in their economic best interest."

Nonetheless, these events highlight a moral hazard issue, and more than a few fund and insurance sellers of credit derivatives protection felt burned. After all, how can a bank extend a loan, collect big fees for doing so, then come crying to the market that they need added compensation under their credit default swaps? Many think there's something fundamentally wrong here. Moreover, they argue, if Bank of America had been short credit default swaps instead of long, might it have potentially followed a different path that would have once again benefited its own book but potentially left those actually betting on a Conseco default with less satisfaction?

Slow down, don't move too fast

As a result of this debate, many U.S.-based dealers last October petitioned for the complete removal of restructuring as a trigger event in credit derivatives documentation. Not long after, these dealers started quoting standard credit derivative contracts with the restructuring language removed. The broker market became a two-tier market of credit default swaps "with restructuring" and "without restructuring."

But many again cried foul. "I was very taken aback," says BofA's Harlan, "A credit default swap without a trigger for restructuring is a much less valuable instrument to us. By proposing such a change, dealers were just trying to simplify and provide a quick fix to the problem issue. But this quick fix would truly eat away at the contract's very usefulness to many buyers—particularly banks." Since then, Harlan has continued to insist that restructuring be included in all new contracts she enters into.

European credit derivative participants also balked at the new direction decided upon by their American counterparts. The European capital markets contain a much higher percentage of bank loans vs. bond debt, and few bankers want to lose the protection of a loan restructuring clause as a trigger for credit default swaps. After all, isn't a loan restructuring just one step removed from outright bankruptcy? And if people don't recognize it as such, what's the point of buying credit protection in the first place?

The result to date of this Continental drift: all credit derivatives transacted between U.S. and European counterparties continue to include restructuring in the documentation. But many contracts negotiated solely between U.S. counterparties do not. The credit derivatives market has effectively bifurcated itself into two distinctly different products, and although it hasn't yet reached a critical stage, participants are concerned that this bifurcation may start to hurt overall market liquidity.

Regulatory warnings

If the rancor from European bankers was not already loud enough, the global regulatory community also posted a strong stop sign in front of the "without restructuring" contracts. At the Chase-Derivatives Strategy Credit Derivatives Conference in mid-November, Federal Reserve Board official Thomas Boemio threw down the proverbial gauntlet. "If restructuring is taken out of ISDA documentation," he

said, "the Fed will ignore credit derivatives for purposes of capital relief." There were loud oohs and aahs from the bankers and dealers in the audience at Boemio's pronouncement. After all, credit derivatives were born very much to help banks satisfy Fed-mandated regulatory capital requirements. Take that regulatory relief away, and core demand for the product would certainly be reduced.

Since that conference, dealers have met many more times to try to hash things out. ISDA executive director and CEO Bob Pickel traveled to London in early December to try to smooth the ruffled feathers of European bankers. At the first of those meetings, held in the stately Fleet Street offices of Goldman Sachs, several European bankers explained that French regulatory officials had joined the Fed's Boemio in reiterating that credit derivatives documentation needs to retain loan restructuring default clauses in order to be deemed "good offset" to a loan or bond position. Such news caused further groans from dealing participants across the Atlantic.

"I don't think the Fed or the Commission Banquaire [the French regulator] have truly thought out their position on this," says one senior credit derivatives dealer at a major New York investment bank. "Since all bank loans can only be restructured with the 100-percent approval of those holding these loans, where's the harm in allowing capital relief at least until such a restructuring transpires?" In other words, if a bank has a two-year loan covered by a two-year credit default swap, that bank would naturally agree to a loan extension only on terms attractive to it. If not offered such terms, it would simply demand repayment of the loan, even if such demands forced the company into bankruptcy.

For its part, the Fed seems to have larger issues of fairness and security in mind. It doesn't want banks to appear to have capital protection after buying credit default swaps, only to be forced to effectively abandon such protection by a corporate counterpart playing hardball in a loan renegotiation process. For example, would a bank give up its collection rights on a $20 million credit default swap if it had $1 billion in total loans that could be thrown into the nonperforming category by a bankruptcy declaration? Without a hard and fast rule that a loan restructuring is a credit event, it might feel obliged to do so.

A pendulum

Over its short history, credit derivatives documentation has swung from being overly vague to potentially too specific. ISDA's initial credit derivative definitions, drafted in 1995 as an addendum to the ISDA master derivatives document, stipulated that in order to trigger a credit event, the change in the terms of any loan or bond obligation had to result in terms that were "materially less favorable to any holders of the obligation." Many deemed this language too vague and subjective; it tended to encourage litigation rather than avoid it.

After the 1998 turmoil surrounding Russian paper—which many viewed as a default, but some called a period of acute market stress—there was general agreement in 1999 to try to tighten up the documentation language. Very specific definitions of a credit event were introduced. Even then, some participants were not fully confident of the new verbiage, but after much discussion, exhaustion ruled. "People grew so sick of the debate on restructuring that in the end, it was just easiest to go with the new definitions and come back to the issue at a later date," says Richard Kennaugh, co-head of credit derivatives trading at Chase Securities. "At the time, the 1999 definitions were thought to at least be better than what was used before."

The 1999 definitions lasted all of 18 months before hit-

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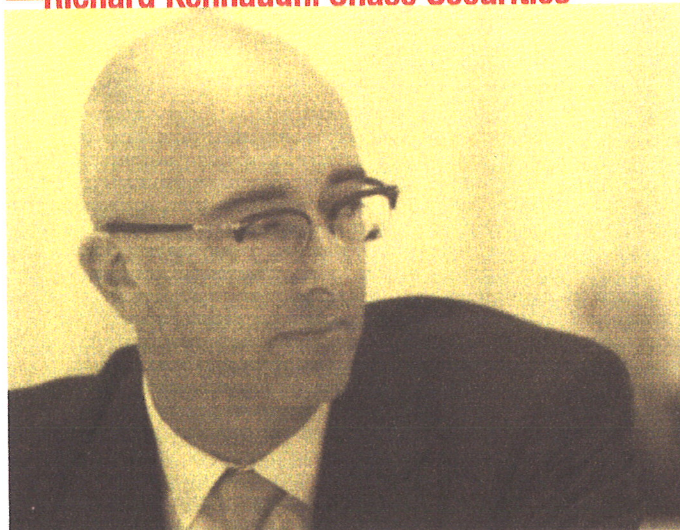

ting their first stumbling block. Now, participants complain that the definition of a credit default actually became far too precise back in 1999. The Conseco situation showed how a technical default could trigger a credit derivatives exercise, but without the debt of the underlying company being truly hurt. At the center of the snafu is the presumption that, when a bank loan is restructured, all other corporate debt becomes harmed and thus due and payable. Events have clearly proven otherwise: not only has Conseco not fallen into bankruptcy, but its various tranches of debt and bonds continue to trade at markedly different valuations in the market.

"Almost every major institution wants some change to the restructuring language now," says Kennaugh. "The status quo is not an acceptable option. We have to establish a better standard for interdealer business, or risk less liquidity and a great deal of added basis risk within dealer books." Although achieving consensus will not be easy, Kennaugh's hope is that some standard acceptable to investors, hedgers and dealers alike can be established. Then anything different from that standard will continue to be available in the market at a premium or discounted price depending upon the specific language used.

ISDA EXECUTIVE DIRECTOR AND CEO BOB PICKEL TRAVELED TO LONDON IN EARLY DECEMBER TO TRY TO SMOOTH THE RUFFLED FEATHERS OF EUROPEAN BANKERS.

The million-dollar question

So what should ISDA do to set the credit derivatives market back on course?

There are two basic paths—with numerous permutations buried within—the trade group could take. First, it could try to narrow the definition of restructuring and limit the deliverability under a restructuring to the actual loans or bonds in question, or to paper with a shorter tenor than the restructuring period. The language to accomplish this might require some tricky drafting, but the goal would be to give sellers of credit derivatives more solace that they could not be blindsided on a loan restructuring with the delivery of longer-dated paper, while the buyers of credit default swaps would still maintain the regulatory ability to tender restructured paper.

This compromise, however, could create a "two-step delivery option." On the occasion of a loan restructuring, the holder of a credit default swap might be able to either tender the actual loan affected or a similar short-term piece of debt, or hold onto the credit derivative for the possibility of an actual bankruptcy event at a later date. If bankruptcy eventually transpired, then any paper out to a predefined maturity would be tenderable. In other words, there could be one central contract, but with a new delivery twist within it.

"That might be a possible outcome," says BofA's Harlan. "But banks are so conservative, I think almost everyone would exercise the credit derivative on the first go-round. The pressure just to get troubled debt off one's books would dominate the potential reward of gleaning even greater value from the default swap later on."

Others aren't so sure this solution would work. "It might introduce too much uncertainty into the delivery process. People want to know what they are going to get, and when," says Hilmar Schaumann, head of credit derivatives trading for Swiss Re New Markets in New York

At the moment, credit default swaps can be triggered by either the buyer or seller of the swap, in order not to leave the seller hanging with a contingent liability. If a narrowed restructuring delivery option is introduced, it is likely that only the buyer of the default swap would have the power to decide whether to deliver a specific restructured loan.

Some also argue that, to be completely fair, the party long the credit default swap and tendering the loan should be forced to hand over any added fees collected from the restructuring. This is not currently standard practice.

The inclusion of a "materiality clause" is another possible permutation of the restructuring language being bandied about. Such a clause could stipulate that a restructuring only be considered a default event if the credit rating of the underlying corporate entity subsequently deteriorates beyond a stated level. Given the large range of potential underlying credits, however, the specific drafting required here might be even more difficult for participants to agree on in advance.

The other major alternative would be to continue allowing the two contracts—one with restructuring and the other without—to simply develop of their own accord, with Darwinian forces of supply and demand deciding which is more useful and popular as a core product. Restructuring would just become another check-box among many on the ISDA document that people could either use or ignore. Such an approach might result in more documentation mismatches and basis risk on dealer books, but it might also keep diverse end-user participants more satisfied.

"ISDA cannot unilaterally tell the market what it should use," says Jeremy Barnum, head credit derivatives trader at J.P. Morgan. "People will trade what contracts they want to trade, and we may have to wait to see which contract that will be. There is a perception that without regulatory capital relief, the market just dies, but that is patently wrong. Banks are increasingly a small percentage of the market. If banks still want relief with restructuring included, that price exists today and will continue to exist. It just may not be the standard contract anymore."

It is possible, of course, that the market will end up with a refined restructuring definition *and* a check-box approach to whether restructuring is included in a deal or not. Barnum, for one, thinks it is unrealistic to expect a single contract that unifies bank loan people and bond investors—two groups with fundamentally different needs and desires. "But ISDA had the foresight to structure its document in a menu framework where you can check off prepackaged definitions," he says, "so we're likely just headed to another check-box solution, maybe with some improved definitions within."

Whatever ISDA decides, it must do so quickly, before other credit derivative problems pop up. A year ago, for example, Xerox credit default swaps were trading at just 30 basis points per annum. Now they are 1,000 basis points bid, with no offer. Overall Xerox has $17 billion in outstanding debt and is quickly approaching full usage of its bank lines of credit. Separately, many of its interest rate and equity swap agreements have embedded credit clauses that will force it to liquidate these contracts should it be downgraded below a certain credit rating. It's easy to imagine yet another situation where Xerox may technically fall into default on certain obligations, but continue to pay interest on other paper.

It is also noteworthy that Conseco credit default swaps involved only a few hundred million dollars in notional obligations, while the outstanding amount of credit derivatives written on Xerox is quite a bit greater. Lawsuits haven't sprung from the Conseco situation, but they could for Xerox since there is more money on the table.

"We're just starting to see the world of distressed securities realize that some of these clauses that many thought didn't matter actually matter a great deal," says Leslie Rahl, president of Capital Market Risk Advisors. "Xerox in particular may be a good example of documentation language that was intended to protect counterparties in a downgrade situation, but now may have unintended negative consequences if these clauses actually get triggered."

Rahl acknowledges that credit trigger levels need to be precise, but she also worries that they introduce a certain amount of systemic risk. "Given the proclivity of rating agencies to downgrade whole industry sectors at the same time," she says, " credit triggers are the one thing in my mind that could cause systemic risk and bring on required knee-jerk reactions."

While ISDA is at it, some also think that language revolving around "successor corporations" should be examined. ISDA documentation provides that after a merger, spin-off or other corporate restructuring, a credit derivative will apply to the surviving corporation that inherits the majority of the original debt. But what happens to a credit derivative contract if, say, AT&T gets split into four equal parts with equal debt loads? Perhaps the credit derivative should really be split into pieces as well, particularly given the massive debt load to be transferred. Unfortunately, ISDA must work in a world in which financial nuances wreak havoc on derivatives contracts originally designed to be relatively simple and fungible.

"Have you every tried to cash in an insurance policy?" asks Rahl. "If you haven't read the fine print, it's not always as easy as it should be," she says. "This is what the credit derivatives market is currently grappling with." In other words, credit derivatives documentation may have worked reasonably well in good times, but what happens in bad?

That's an important question given the current spate of earnings warnings and massive corporate debt loads. If more credit problems flare up soon, ISDA documentation will likely come under even more scrutiny, with Conseco simply having been the first warning shot across the bow of the credit derivatives market. In a litigious society where a presidential election can be contested for six weeks, don't expect an easy path to defining when a real default begins and mere credit impairment ends. DS