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Sovereign CDS, determinations committees, and the restructuring credit event

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For much of the past year, it was difficult to pick up a newspaper or business magazine without coming across a story about the sovereign debt crisis unfolding in Greece and across Europe generally. Most of these stories reported on the development of a plan to reduce Greece's public debt burden, before concluding that investors in Greek sovereign bonds will, at some point, need to accept a reduction in the principal amount of their bonds, commonly referred to as a 'haircut'. Recently, as the size of the haircut has come into sharper focus, there have been a flurry of stories devoted to the topic of sovereign credit default swaps (CDS) and whether the terms of the Greek sovereign debt restructuring will constitute a 'credit event' for sovereign CDS covering Greek bonds.

Usually, these articles attempt to make the topic more accessible to people not familiar with CDS products by using a simile to describe CDS – it's like an insurance policy, it's like a pressure gauge, it's like a box of chocolates, and so on. The problem with these examples is that they obscure one major point – a CDS is a contract between two parties which incorporates by reference a number of market standard terms. While, similar to a traditional insurance policy, the CDS protection seller is obligated to compensate the CDS protection buyer in the event that an obligation covered by the CDS experiences certain events. However, unlike insurance, the buyer of CDS need not own or have an insurable interest in the obligation covered by the CDS. The periodic payments or 'spread' paid by protection buyers will be higher for obligations that are perceived to have a higher risk of default. Whatever else people may think about the information a CDS spread might provide market participants, the CDS behaves in accordance with its terms and the market standard mechanisms for interpreting these terms.

Since 2008, there have been 75 credit event auctions globally but only one of these related to a sovereign – the Republic of Ecuador in January 2009. Therefore, the market has had little experience with sovereign CDS credit events. During this same period of time, the notional amount of sovereign CDS has increased dramatically. As of 29 October 2011, 9 of the top 10 CDS positions on the basis of net notional amount were sovereigns: France, Italy, Germany, Brazil, Spain, United Kingdom, China, Japan, and Mexico. By this, or any other measure, sovereign CDS has become an integral part of global financial markets.

CDS referencing nearly every major sovereign across the globe are traded daily. These contracts are traded by a range of market participants for a number of different reasons. For example, global banks have counterparty risk desks that buy sovereign CDS protection to hedge country-specific exposures gained by doing business in those countries. At large financial institutions such as pension plans and insurance companies, risk managers use sovereign CDS to hedge macroeconomic risk under the theory that the behaviour of the sovereign debt in a region will roughly approximate the economic conditions in that region. On the asset management side, sovereign CDS protection is used to actively manage exposures to cash investments such as bonds and loans. Additionally, macro and credit hedge funds are frequent participants in the sovereign CDS markets. Macro hedge funds typically trade across asset classes and in different regions looking for relative value investments, so sovereign CDS is just one of many vehicles they can use to express their views. Taken collectively, much of the daily volume in sovereign CDS markets is generated between these types of firms and the derivatives dealers who are their counterparties.

As the CDS has emerged as an asset class, much work has been undertaken by the industry to standardise its contractual terms. The vast majority of all CDS contracts including sovereign CDS are documented using the 2003 Credit Derivatives Definitions ('CDS Definitions') published by the International Swaps and Derivatives Association ('ISDA'). By using the CDS Definitions, market participants are agreeing to standard terms to define credit events, notice delivery procedures, and settlement following a credit event.

There are three principal credit events for sovereign CDS: Failure to Pay, Repudiation/Moratorium, and Restructuring. By far, as demonstrated by the debate surrounding Greece, the most complicated of these events is Restructuring.

The CDS Definitions define a 'Restructuring' as a reduction in coupon or principal, a deferral of an interest or principal payment, a change in the ranking of priority of payments, or changes to the currency of the interest and principal payments.

A critical element of the Restructuring credit event is that the event has to be binding on all holders of the affected obligations. This means that: (i) the restructuring is mandatory for all holders; or (ii) all holders of an obligation agree to the restructuring; or (iii) the consent of only a specified percentage of holders (e.g., a majority of holders) is required to approve the restructuring on behalf of all of the holders of the obligation (i.e., the minority as well). It is irrelevant whether the amendments are voluntary or not, as the required element is 'binding on all holders' not 'enforcement'.

Any threats on the bondholder, whether implicit or express, economic or political, made in connection with a bond tender or exchange offer

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are irrelevant for purposes of whether a Restructuring credit event occurs. Duress or coercion may influence a bondholder's decision to participate in an exchange offer that has a fundamentally negative impact on its investment, but this is necessarily subjective and not an element of the Restructuring definition. Therefore, while it may seem incorrect to some, the CDS market will continue to read all extrinsic factors out of the contract when evaluating whether a bond restructuring is binding on all holders.

In addition to being binding on all holders, a restructuring must be directly or indirectly the result of deterioration of creditworthiness to trigger a credit event. Proving such a nexus can easily bring into play the need to examine a number of subjective criteria. Given the need to weigh both objective and subjective criteria, the determination of the existence of a Restructuring credit event has at times proven quite challenging and controversial.

In 2009, the North American and European CDS markets were fundamentally transformed by two legal initiatives promoted by ISDA to enhance CDS fungibility and reduce legal uncertainty. Modestly called the 'Big Bang Protocol' and 'Small Bang Protocol' (together, the 'Protocols') these changes modify parts of the CDS Definitions such that the occurrence of credit events are now generally determined by a Determinations Committee.

Among the many modifications brought about by the Protocols was the establishment of regional Determinations Committees for the America, Asia (other than Japan), Australia and New Zealand, EMEA (Europe, Middle East and Africa), and Japan. Each committee is comprised of both dealers and non-dealers.

The main responsibilities of these committees are to determine whether a credit event has taken place and, if so, the type of event and the date it occurred. If a committee determines that there has been a credit event (and the defaulted name is of significant importance to the CDS market, measured by number of contracts outstanding and number of dealers making markets), it can mandate that an auction take place to determine the final recovery rate of effected CDS. That determination will be binding upon all market participants who have opted to have their CDS subject to the Protocols.

The first and to date only time a committee was unable to achieve the required consensus as to the occurrence of a credit event arose in the case of CEMEX, S.A.B. de C.V. ('Cemex'). The inability of the committee to reach consensus forced the committee to refer the decision to an external review panel. Cemex was one of the largest cement makers in the world and had outstanding debt of approximately $18.78bn at the end of 2008. On 16 April 2009, Cemex entered into a Conditional Waiver and Extension Agreement (the 'Extension Agreement') with its bank lenders, pursuant to which the lenders agreed to defer principal payment obligations with respect to debt that were originally due between 24 March 2009 and 31 July 2009. The due date of approximately $1.16bn in principal amount of Cemex's debt was extended pursuant to the Extension Agreement. After Cemex secured this extension, it announced, on 9 March 2009, that it was entering into discussions with its lenders to restructure.

Leading up to these steps, CEMEX experienced multiple ratings downgrades in late 2008 and early 2009. On the other hand, CEMEX's stock price rose and CEMEX's CDS spreads tightened during the period between March and August 2009 after CEMEX informed the market about the steps it was taking.

The CEMEX situation demonstrates the challenge of applying the various elements of the Restructuring Definition. Did CEMEX restructure or simply refinance its debt? Was the CEMEX transaction binding on all participants? Did the transaction occur as a direct or indirect result of a decline in the creditworthiness or financial condition of CEMEX?

The committee's external review panel examined a number of factors, ultimately concluding unanimously that a Restructuring had occurred, and, by extension, conducting the first real world test of the committee process in the context of a controversial issue.

Based on news reports, it appears that the Greek bond restructuring is voluntary and not binding on all bondholders, as ISDA recently noted in a statement published on its website on 31 October 2011. If so, it does not appear likely at this stage that the Greek plan will trigger payments under existing CDS contracts. While this has caused a lot of outrage amongst financial journalists, the Restructuring definition cannot catch all possible events. By trading CDS, market participants essentially forego certain rights they would have as a direct holder of a bond, such as the right to participate in a bond exchange, in return for the liquidity and ease of trading that CDS offers. The reason that liquidity exists in CDS markets has much to do with the standardisation of the terms, including the use of the committees to ensure that the contracts are interpreted in a uniform manner. As noted above, sovereign CDS is utilised for many reasons other than hedging. An informed market participant will not only be aware of the key differences between CDS and bonds, he will also expect and take comfort in the fact that decisions will be made in a way that is transparent and open. ■

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