

# ISDA's CDS Consultation: A Potential Fix for Narrowly Tailored Credit Events



## IN SHORT

**The Situation:** The International Swaps and Derivatives Association ("ISDA") has published proposed changes to the 2014 Credit Derivatives Definitions ("Definitions") that are meant to address issues relating to narrowly tailored credit events.

**The Result:** The proposed changes would likely mitigate the risk of such events occurring in the future, but they would also add discretion, subjectivity, and uncertainty to the Determination Committee process.

**Looking Ahead:** Market participants have been asked to weigh in on the proposed changes by March 27.

On March 6, 2019, ISDA published [proposed amendments](#) (the "Consultation") to the Definitions to address issues relating to narrowly tailored credit events ("NTCEs"). The proposals relate to two highly contentious issues that arose in connection with the late 2017 refinancing of Hovnanian Enterprises: (i) whether a failure to pay credit event occurs when a company intentionally withholds debt payments it is financially able to make (the "NTCE Issue") and (ii) how original issue discount ("OID") debt should be treated upon a nonbankruptcy credit event (the "OID Issue").

Hovnanian caused a stir in the credit default swap ("CDS") markets when it obtained financing on attractive terms by (i) agreeing to skip an interest payment it would owe an affiliate and (ii) exchanging existing bonds with near-par market values for new bonds with market values far below their par value. The agreement to miss a payment was expected to trigger a failure to pay credit event, and the exchange was expected to enhance the recovery for protection buyers, but Hovnanian made the payment just before its cure period lapsed after settlements were reached among CDS buyers and sellers.

To address the NTCE Issue, the Consultation proposes to add a "Credit Deterioration Requirement" to the "Failure to Pay" definition in Section 4.5 of the Definitions. The credit deterioration requirement would effectively prohibit the Credit Derivatives Determinations Committees ("DCs") from finding that a failure to pay has occurred "if such failure does not directly or indirectly either result from, or result in, a deterioration in the creditworthiness or financial condition of the Reference Entity." The Consultation also provides interpretive guidance to help the DCs decide whether this requirement has been met in a given situation.



If adopted, the Consultation's proposed changes could significantly curb the likelihood of future narrowly tailored credit events.



This proposed change would provide additional discretion to the DCs and add subjectivity into failure to pay credit event determinations, which to date have applied a bright-line test. A similar requirement has long existed for restructuring credit events (see 4.7(a) of the Definitions), which typically do not apply to American CDS contracts but do apply in other

regions. This requirement was at issue in the [Cemex Restructuring Credit Event](#) that led to the very first external review of a deadlocked DC (in connection with which Jones Day presented the prevailing argument).

To address the OID Issue, the Consultation suggests modifying the definition of "Outstanding Principal Balance" set forth in Section 3.8 of the Definitions. The Outstanding Principal Balance of an obligation for CDS purposes is calculated based on the "Quantum of the Claim," meaning that its principal balance can be reduced in accordance with applicable laws. The proposed change is meant to (arguably) broaden "applicable laws" to expressly include any bankruptcy or insolvency law, even in a situation in which such law does not yet apply (i.e., prebankruptcy).

This change also would provide additional discretion to the DCs, giving them enhanced ability to discount obligations in connection with CDS auctions. Given the sparsity of bankruptcy case law regarding OID, this also increases the chance that a DC will need to consider bankruptcy law issues that a court has not yet even considered (e.g., whether claims should be discounted in connection with an exchange offer that has increased the principal amount of debt outstanding). It also should be noted that, while this proposed change is purportedly intended to "address issues relating to [NTCEs]," it certainly would not be limited to NTCE situations. In fact, if the proposed Section 4.5 change is made, this change to Section 3.8 should only ever come into play in non-NTCE situations.

Coming up with an industry solution to the CDS market's NTCE "problem" is a daunting task, but the working group responsible for the Consultation appears to have found a solution that could work if market participants buy in. Market participants may find, however, that they are being asked to choose between two unappealing options. The first is status quo: A world with NTCEs that, according to [ISDA's board](#) and regulators like the [CFTC](#) and [FCA](#), threatens the integrity of the CDS market. The second is an adoption of the proposed changes that would hand more discretion to the DCs, increase the subjectivity of DC decision-making process, and add uncertainty to DC outcomes. As we mentioned in our recent [Commentary](#) regarding Windstream, CDS market participants already put a lot of faith in the DCs. Now we shall see if they are willing to go even further in order to prevent NTCEs.

## FIVE KEY TAKEAWAYS

1. If adopted, the Consultation's proposed changes could significantly curb the likelihood of future NTCEs.
2. In order to accomplish this goal, market participants are being asked to embrace changes that would give the DCs more discretion, increase the subjectivity of the DC decision-making process, and add uncertainty to DC outcomes.
3. Market participants will need to weigh the benefits and detriments of the changes, as they provide feedback to the Consultation, and consider adopting the proposed language into their CDS contracts.



[George J. Cahill](#)  
New York



[Locke R. McMurray](#)  
New York



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