The invisible threat

Executive summary

- *The Treasurer* has focused recently on the massive development of credit derivatives markets over the last few years, and its impact on corporates. This article examines the impact of credit derivatives on a company's syndicated debt.

From a lender's point of view, one of the attractive features of a credit derivative is that it usually allows credit risk to be transferred without regard to the restrictions in the loan agreement. Lenders are not usually under any obligation to provide borrowers with any information about their credit derivative cover, and typically take the view that it is commercially in their best interests not to. As a matter of law, these transactions do not generally give the counterparties direct rights against the borrowers, so, the argument goes, they need not be a concern to them.

While there could be potential benefits for borrowers in terms of the liquidity and pricing opportunities deriving from the credit derivatives markets, there are also problems to be addressed. As long as the borrower is untroubled by financial difficulties, these problems may not materialise. At the point at which the borrower needs a waiver, however, they may become critical. There is a risk that a lender's voting behaviour may be influenced, or even in some cases determined, by an unknown third party. In some cases, ultimately, the third party may also acquire the lender's loan participation.

Credit default swaps (CDS) have excited much comment during the current world credit crisis since they have played a role in spreading risk more widely across the market. This can help share the pain of actual defaults but if serious losses occur then the collapse of chains of holders can aggravate a problem. Central banks and financial regulators will be concerned about the implications for financial stability, but the focus of this article is on the features of CDS which impact on a borrower's syndicated debt, including some potential issues and strategies for borrowers.

IMPACT ON SYNDICATED DEBT Aspects of CDS relevant to a borrower's syndicated debt include:

Settlement on credit event When a credit event – usually, failure to pay, bankruptcy or restructuring – occurs, then either party can call for settlement.

Physical settlement involves the delivery of securities or loans satisfying specified criteria with a par value equal to the notional amount of the CDS, in exchange for a cash payment of the notional amount (the par value). Deliverable securities may include 'consent-required loans' and 'assignable loans' as well as listed bonds. As a result, physical settlement may involve a transfer of the borrower's syndicated debt to the counterparty. The lender may, however, elect to deliver other deliverable obligations, and thus retain its participation.

Although physical settlement is the most common method, it is not always possible, as the notional amounts of CDS in the market may exceed the amount of the underlying debt. Following cash settlement, the lender retains its participation in the syndicated debt.

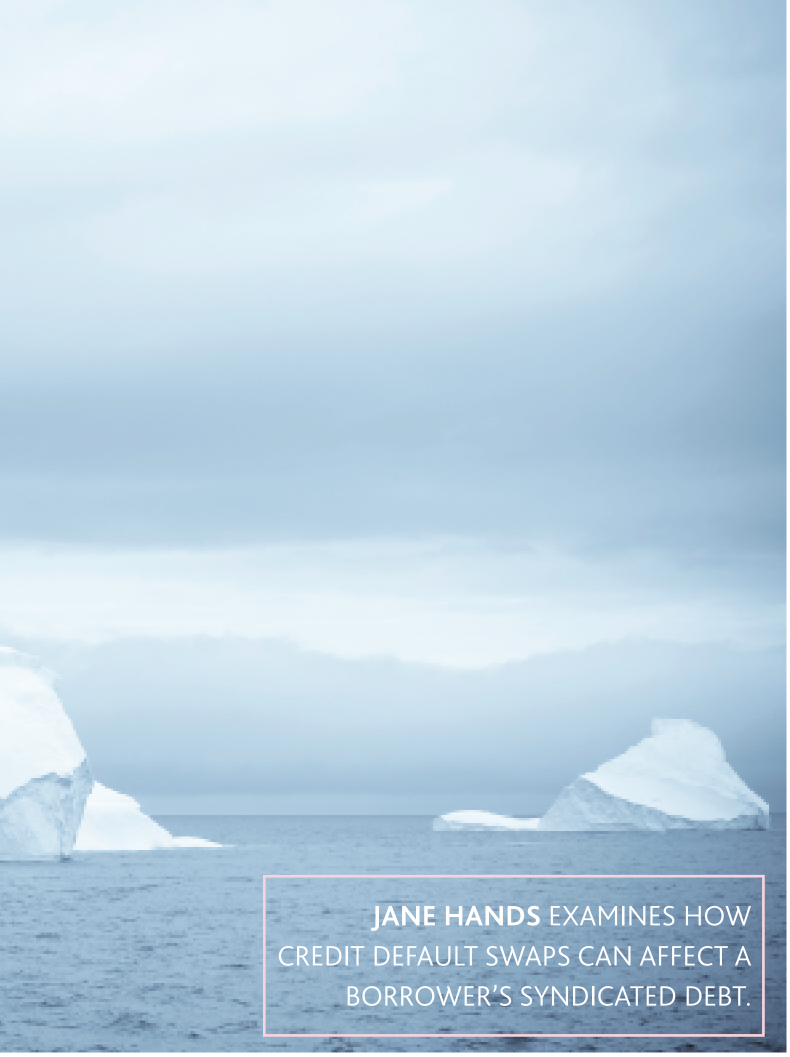
Invisibility Although in some cases the borrower knows about the CDS from the outset, more usually it would not, nor have any contractual right to do so; the only exception would be if physical settlement required the borrower's consent, or consultation with it.

Confidentiality Lenders are usually permitted by the loan agreement to disclose any appropriate information received from the borrower to any person with whom they agree (or may agree) a CDS. A confidentiality undertaking is usually required.

Voting Depending on the terms agreed, the counterparty may have the right to instruct the lender as to how to vote. Typically, however, voting rights remain with the lender until physical settlement, when control of voting rights passes to the counterparty.

The CDS market If the borrower needs to request a waiver for a breach of covenant under the loan agreement, its primary focus may be on the CDS cover referencing the debt which is held by its lenders. It will, however, also need to bear in mind the interests of holders of CDS referencing the debt which are not also its lenders, such as its bondholders. Indirect pressure from the CDS market may be substantial, but need not always be disadvantageous (see *The Treasurer*, March 2007, page 11).

A LENDER'S CDS COVER COULD BECOME A PROBLEM FOR A BORROWER FACING FINANCIAL DIFFICULTIES.



JANE HANDS EXAMINES HOW CREDIT DEFAULT SWAPS CAN AFFECT A BORROWER'S SYNDICATED DEBT.

POTENTIAL ISSUES AND STRATEGIES FOR BORROWERS A lender's CDS cover could become a problem for a borrower facing financial difficulties. While there have not been many major restructurings in the last few years, and of these only a few have been affected by credit derivatives, the recent growth in credit derivatives has focused concern that, in an economic downturn, credit derivatives may "damage the timeliness and effectiveness of workouts following credit events and could, in an extreme scenario, undermine an otherwise viable restructuring" (FSA, November 2006).

In general, therefore, borrowers need to be aware that the existence of CDS cover may affect the response of lenders to restructuring negotiations. More specifically:

Possible credit event A covered lender presented with a request to waive an event of default, or amend the facility agreement, may be influenced by its assessment of whether a credit event may occur.

Where a credit event appears remote, the lender is unlikely to be influenced by its CDS cover, although the existence of the protection could lead it not to respond.

Where a credit event is probable, the lender is bound to be aware of the advantage to it in the occurrence of the credit event. Rather than being motivated to work with the borrower to settle a waiver or amendment, the lender may have an interest in the occurrence of the credit event: at that point, it can call for settlement.

This potential problem should not be exaggerated. In practice it is rare for a lender to cover the whole of its exposure. The fact that a portion of its exposure is uncovered may mean that, to that extent, the lender retains an economic interest in the successful outcome of a restructuring.

In these circumstances, however, the invisibility of the CDS presents a threat to a borrower. In its efforts to formulate a restructuring plan which will meet with the approval of its creditors, the borrower may be frustrated by the fact that it does not know, and has no contractual entitlement to find out, what, if any, CDS protection is held by its lenders, and what the terms of that protection are. If the borrower had this information, it would have a greater chance of putting together a proposal that would satisfy the demands of its creditors. These difficulties are well attested, notably in the case of Marconi.

Possible disclosure obligation In today's market, borrowers may wish to discuss these potential difficulties with their lending syndicates, before signing. It is possible that a limited disclosure obligation could be framed in a way that is acceptable to lenders and at the same time assures borrowers of some information which might enable them to formulate a proposal requiring a vote in a way which might maximise the chances of approval.

The value of a disclosure obligation would be limited, as a snapshot of the facts on the date a disclosure is made. A lender could sell its protection as soon as it had disclosed its existence. The likelihood of this happening would have to be assessed. It would be important to appreciate also that the interests of covered lenders will differ, depending on the terms of their protection.

To be acceptable to lenders, a disclosure obligation must be limited and conditional. One issue would be the trigger for the obligation. Since the purpose would be to help formulate a plan to avoid a credit event, the disclosure obligation might perhaps be triggered by a request from the agent following notification of an event of default. It may be necessary to take account of confidentiality obligations between the parties to a credit derivative.

Market practice currently does not involve the lenders in giving any undertaking of this kind. For many lenders the invisibility of the protection afforded by CDS may be paramount. For others, however, a disclosure obligation relating to a practice widely regarded as a norm may not be unacceptable.

POSSIBLE BORROWER ACTION Borrowers need to be aware that CDS cover may affect the response of lenders to a request for a waiver or amendment. Borrowers should consider asking the lenders to undertake a limited disclosure obligation. There may be circumstances in which it might be justifiable for a borrower to restrict the lenders' ability to enter into 'single name' credit derivatives, so that its prior consent is required.

The possibility of transferring the loan participation to a third party as a result of settlement of a CDS underlines the need for borrowers to focus on restrictions on transfer.

Borrowers also need to ensure that lenders obtain confidentiality undertakings before disclosing any information to CDS counterparties.

Go to www.treasurers.org/technical/lmaguide.cfm for more on the influence of credit derivatives on syndicated lending; the issues and opportunities for borrowers from non-bank lenders; and the ACT Guide to the LMA documentation for investment-grade borrowers generally.

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