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The Hidden Aspects of Workouts (joint paper with Prof. John Stumbles)

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Credit Derivatives

The Hidden Aspects of Workouts
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Credit Derivatives – What are they? Why?

Financial instruments designed to allow the independent trading/hedging of credit risk

Types:
- Credit Default Swaps ("CDSs")
- Synthetic collateralised debt obligations
- Credit linked notes

Why:
- Active Portfolio Management
- Management of individual exposures
- Market making and trading

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Credit Derivatives Market

Global Credit Derivates Market	**US Dollar**
1997	180 billion
1999	586 billion
2001	1,189 billion
2003	3,558 billion
2004	8,400 billion
2005	17,100 billion
2006	26,000 billion

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Main Buyers and Sellers

	% of Trade
Banks	50% (falling as a %)
Hedge/PE Funds	17% (on the rise)
Securities Firms	15%
Insurers/Re-insurers	8%
Other (corporates, super funds)	10%

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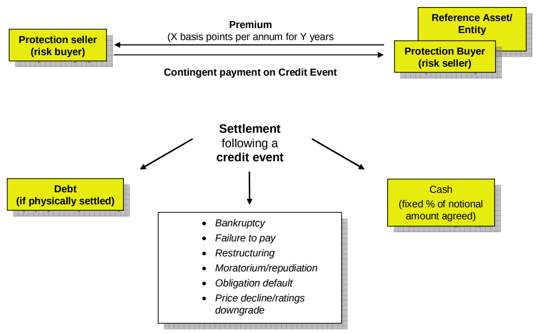
Single Name Credit Default Swaps



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Documentation

- ISDA Master Agreement
- Schedule to ISDA Master Agreement
- Confirmation
- Credit Support Documents

Note: ISDA Credit Derivatives Definitions - incorporated by reference

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Confirmation

Confirmation particularises:

- Notional amount
- Reference Entity
- Scope of protection (obligations covered)
- Tenor
- Premium
- Settlement Method

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Settlement of CDS's

1. **Physical**
   - Protection seller pays the protection buyer the debt in cash
   - Protection buyer delivers the protection seller the debt obligation
2. **Cash**
   - Protection seller pays the difference between debt and "market value" of the debt; OR

     Protection seller pays an agreed percentage of the debt
   - Protection buyer remains holder of the debt

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ISDA Credit Events

- Failure to Pay
- Bankruptcy
- Restructuring

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Failure to Pay

- Inconsistency with payment clause in underlying documentation
- Potential for inconsistent 'grace periods'
- Payment default may arise earlier in time in, for example, the APLMA Multicurrency Term and Revolving Facilities Facility Agreement
- Payment default may arise later in time in ISDA master agreement
- Financiers' reluctance to trigger payment default in loan agreement if wish to avoid indication of insolvency and/or resignation of borrower's directors

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Bankruptcy

- ISDA Master Agreement –triggered on filing of court process unless dismissed in 30 days
- APLMA – Potential for different grace period
- Differing potential thresholds if a security is enforced
- APLMA – covers negotiations with financiers with aim of rescheduling debt

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Rescheduling Credit Event

- Scope of Reference obligations
- Characteristics of reference obligations (eg: unsubordinated, listed, particular currency)
- Threshold amount (default choice of US$10 million)
- Multiple holder obligation- need obligation held by at least 4 unrelated holders under documentation variable only with consent of 66 2/3% of holders

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Problems with Restructuring credit event

- Timing – ambiguity when restructuring agreement actually reached
- Debt Extension
- Debt Exchange
- Prepayment
- Reference Entity

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Assessment

- Practical utility of each credit event
- Is there a a difference between utility of each credit event?
- Extent of impact of CDSs on workouts

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Major Credit Events since 1999

Credit Events called under Credit Derivatives:

AT&T Canada	Enron	Indonesia Sov. Debt
Air Canada	Global Crossing	Russia Sov Debt
British Energy	K-Mart	**Railtrack**
Collins & Aikman	**Marconi**	United Airlines
Delphi	**Parmalat**	**Worldcom**
Delta Airlines	Swissair	Xerox

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Risk for workouts

- Disclosure Issues
- Disparate Economic Interests and Motivations
- Syndicate Stability and Competence

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Credit Derivatives in Restructurings

- Key Question: is the borrower a 'reference entity' in the CDS market?
- Has each member of the syndicate disclosed whether they are covered by a CDS?
- What are the terms of the CDS including tenor?
- What are the significant differences (if any) between the terms of each CDS?
- Is it possible to identify any convergence of interests?
- What are the approval mechanisms in the syndicate? Problems if need 100% approval

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Syndicate Example

Facts:

- 100% approval needed for standstill
- Standstill likely to involve a restructure in which each financier accepts a debt/equity swap for 20% of its debt
- Trade on with no standstill highly risky
- Receivership return calculated at 60 cents in the dollar.
- Banks B and E are on the steering committee. Banks A, C and D are not.
- Two financiers out of the ten have purchased credit protection in varying degrees. Three of the ten financiers have provided credit protection

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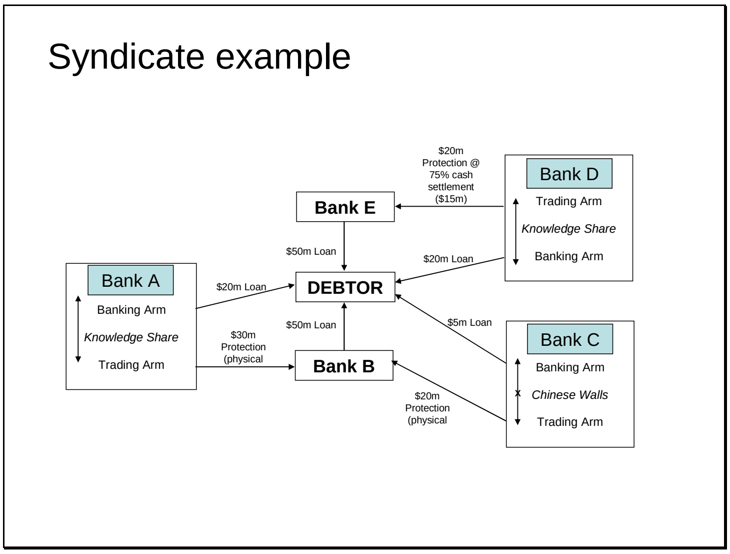

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Syndicate Example

Bank	Face Value Debt	After Credit Protection	Probable Mind Set of Bank
A	$20m (standstill is a credit event)	$50m	Won't want a credit event to occur. Probably want **trade on.**
B	$50m	Nil	Will be trying to engineer a credit event. **Receivership** would be preferred option.
C	$5m (standstill is not a credit event)	$25m	Playing "ransom card" to get paid out as only a small player. Is threatening to vote "no to standstill but unaware of $20m protection by trading arm.
D	$20m (standstill is not a credit event)	$20m (plus $15m cost)	Definitely wants **standstill** but not the biggest voice at the table.
E	$50m	$50m (with $15m cash coverage)	**Undecided:** - Standstill – 8-% + equity - Receivership – 90% + 10% write off - Trade on – may be 100%

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Developing Trends

- Growth of market
- Increase in Australian reference entities?
- Credit Derivatives – type and complexity mushrooming
- Cash settlements will increase
- Are Financial Institutions' back offices keeping up?
- Basel II – Capital Adequacy and Credit Derivatives
- Non-disclosure / inequality of information flows

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