Be Wary of Speculative CDS Bets and Manufactured Defaults

Amundsen Davis Corporate Alert
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On March 6th, the International Swaps and Derivatives Association (ISDA) published for public comment a series of Proposed Amendments to the 2014 ISDA Credit Derivative Definitions Relating to Narrowly Tailored Credits Events, which redefine "failure to pay" events that trigger a credit default swap (CDS) payout.

A CDS is zero-sum derivative through which one party can offset its credit risk (that is, its risk of default) with that of another investor. For example, if an investor has a "long debt" position in a debt issuer, the debt-purchasing investor may also purchase CDSs to mitigate its losses in the event the debt issuer defaults on its debt obligations. This example illustrates how market participants can use the CDS market to hedge against credit risk. Alternatively, by purchasing CDSs without also purchasing any of the underlying debt, market participants can make speculative bets on whether a debt issuer will default on its obligations.

Here's an example of a variation on a speculative CDS trade: Party A agrees to provide financing to a debt issuer (*i.e.*, a borrower), but only if the debt issuer agrees to miss an interest payment on that debt (that is, the debt issuer agrees to intentionally default). However, in this scenario, Party A also owns CDSs betting on the debt issuer's default with a separate counterparty (Party B), which will provide Party A with a windfall upon the debt issuer's default. Market participants refer to this as a "manufactured default." One of the most well-known instances of a manufactured default occurred in 2017 when Blackstone Group's GSO Partners agreed to extend attractive financing to Hovnanian Enterprises on the condition that Hovnanian default on a portion of its debt, and GSO also owned CDSs betting that Hovnanian would default.

ISDA's proposal aims to eliminate the use of manufactured defaults by redefining what constitutes a "failure to pay" event. The proposal states that the failure to make a bond payment will trigger a CDS payout only if the default is also tied to financial stress. Specifically, there must be a "causal link between the non-payment and the deterioration in the creditworthiness or financial condition of the [defaulting entity]." If a debt issuer agrees to default on its debt obligations in order to receive attractive financing contingent on a technical default (like in the

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case of GSO and Hovnanian), the new definition of a "failure to pay" event would not be satisfied and a CDS payout would not be triggered.

Why is this important?

ISDA is the CDS industry's main trade group, and its proposal has the backing of large industry players including Wall Street banks and activist hedge funds. While these proposed changes are not being implemented by a regulatory body, the Credit Derivatives Determinations Committee, which determines in individual cases whether a "credit event" has occurred, will likely apply the new ISDA definitions in a manner that precludes manufactured defaults from triggering CDS payouts.

Although the U.S. Commodity Futures Trading Commission (CFTC) has not taken formal regulatory action on this issue, in April 2018 the CFTC stated that "manufactured credit events may constitute market manipulation and may severely damage the integrity of the CDS markets."

In light of ISDA's proposal and the CFTC's statement that manufactured defaults and other certain credit events may constitute market manipulation, market participants should consider the following:

- What is the intended purpose of a CDS position? While hedging against credit risk and even speculation are legitimate trading strategies, taking a CDS position with the underlying intention of enticing a debt issuer to default may be problematic, even if it's just a "technical" default.
- If the CDS is bilateral, who is the counterparty? Market participants should be wary of entering into a CDS trade with a counterparty that has a history of causing manufactured defaults or similar narrowly tailored credit events which trigger a CDS payout.
- If ISDA's proposal is adopted, when asked to determine whether a "credit event" has occurred, the Credit Derivatives Determinations Committee, using the new "failure to pay" definition, will likely apply market-standard terms in a manner that precludes manufactured defaults from triggering CDS payouts.
- The CFTC may pursue enforcement action against firms which create manufactured defaults in order to trigger CDS windfalls.