Derivatives: Credit Default Swap Case Studies

“RADIX MALORUM EST CUPIDITAS?”

Polling Question # 1
What are credit default swaps?

A. Weapons of mass destruction

B. Insurance

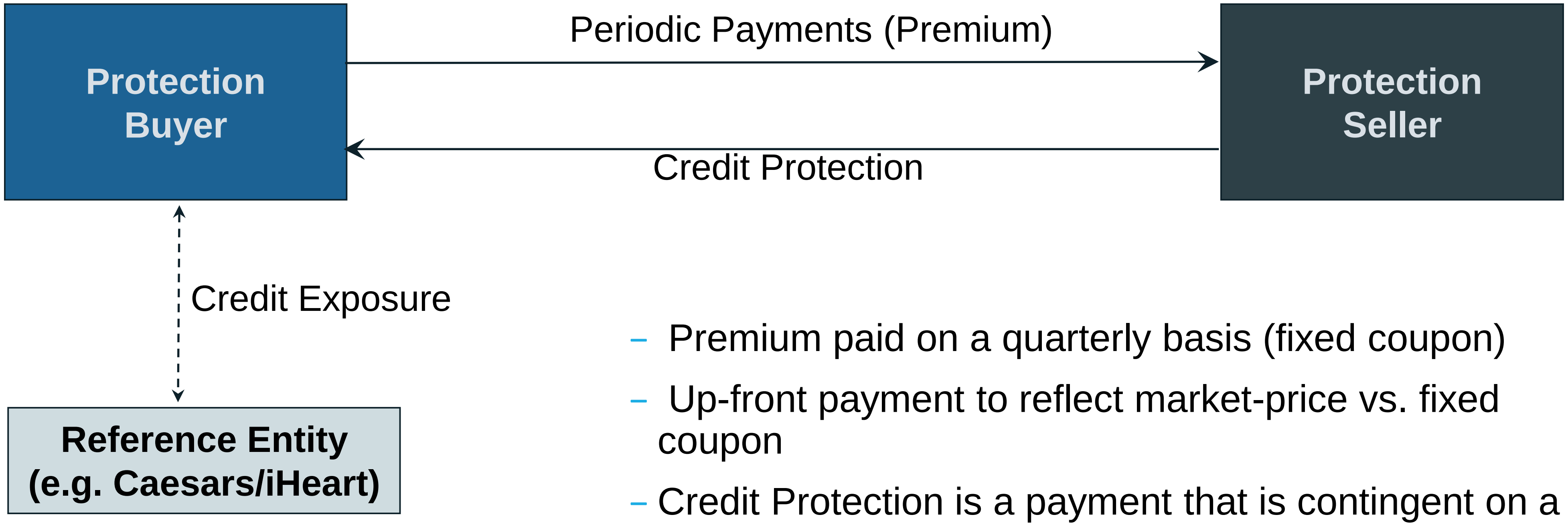
C. A type of financial product that has encouraged the growth of a finance of chance, and of gambling on the failure of others

D. An investment instrument enabling the market to take exposure to a reference entity

E. A, B, C and D

F. Who knows?

What is a credit default swap?



- Premium paid on a quarterly basis (fixed coupon)
- Up-front payment to reflect market-price vs. fixed coupon
- Credit Protection is a payment that is contingent on a triggering *credit event*

What is a credit default swap?

Reference Entity
(Reference Obligation/Seniority)

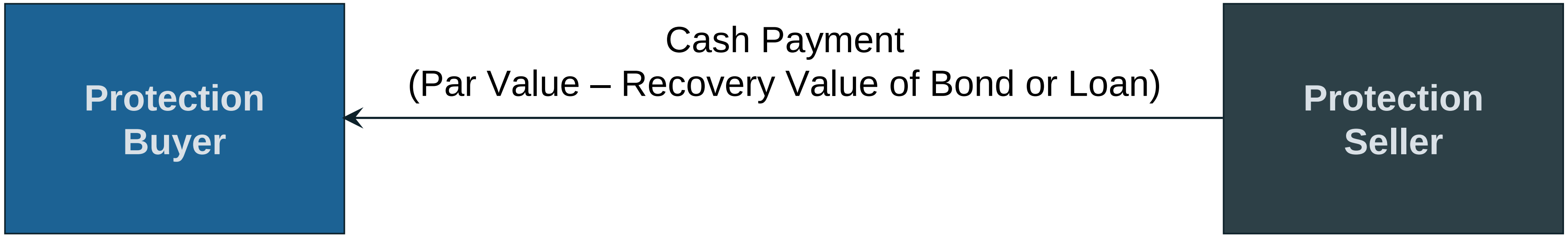
Credit Events
(Obligations)

Settlement
(Deliverable Obligations)

Auction (Cash) Settlement
(Standard)

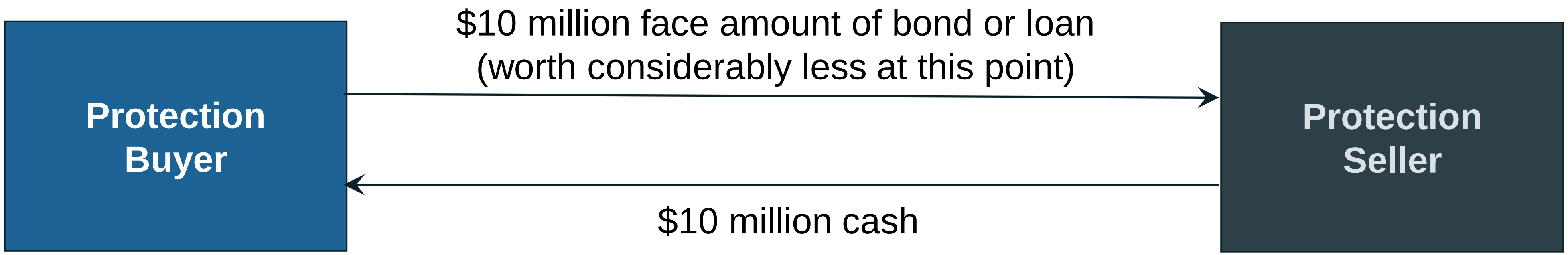
Physical Settlement
(Fallback)

Auction (Cash) Settlement



EXAMPLE	
Notional Amount	$10 million
Initial Price	100%
Final (Recovery) Price	60% - typically based on the bond/loan trading at the lowest level (“cheapest to deliver obligation”)
Payment by Protection Seller	$10 million x 40% = $4 million

Physical Settlement (Fallback)



- Cheapest to deliver concept
- Problematic due to exponential trading vs available Deliverable Obligations

CDS Users

Banks and loan portfolio managers use CDS to hedge credit risk of their bond and loan exposures. Some loan buyers may not only reduce credit risk, but also use CDS as a capital management tool providing regulatory capital relief.

Hedge Funds use a variety of credit trading strategies based on relative value, credit volatility, and correlation (among other things).

Asset Managers typically use the CDS market as a relative value tool, or to create a specific exposure that cannot be found in the bond market (i.e., maturity); asset managers also express macro views via index CDS.

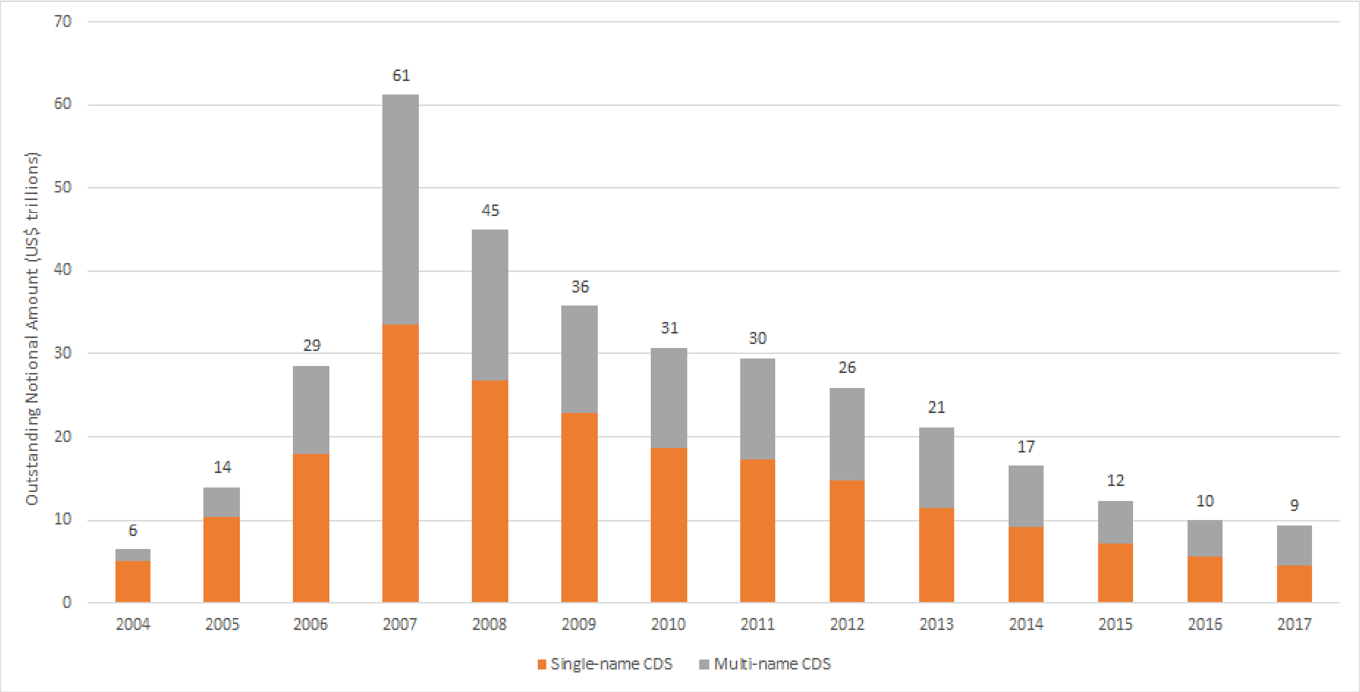
Life Insurers may use CDS in a process called “replication” where they write/sell protection (in consideration for the premiums) to enhance asset portfolio returns.

Corporations use CDS to manage credit exposure to third parties. Treasurers monitor their own CDS spreads as a benchmark for pricing new debt instruments.

Notional Amount of Global Credit Derivatives Market

The notional amount of outstanding credit derivatives contracts totaled $9.4 trillion at the end of the second half of 2017 compared with $61.2 trillion at the end of the second half of 2007.

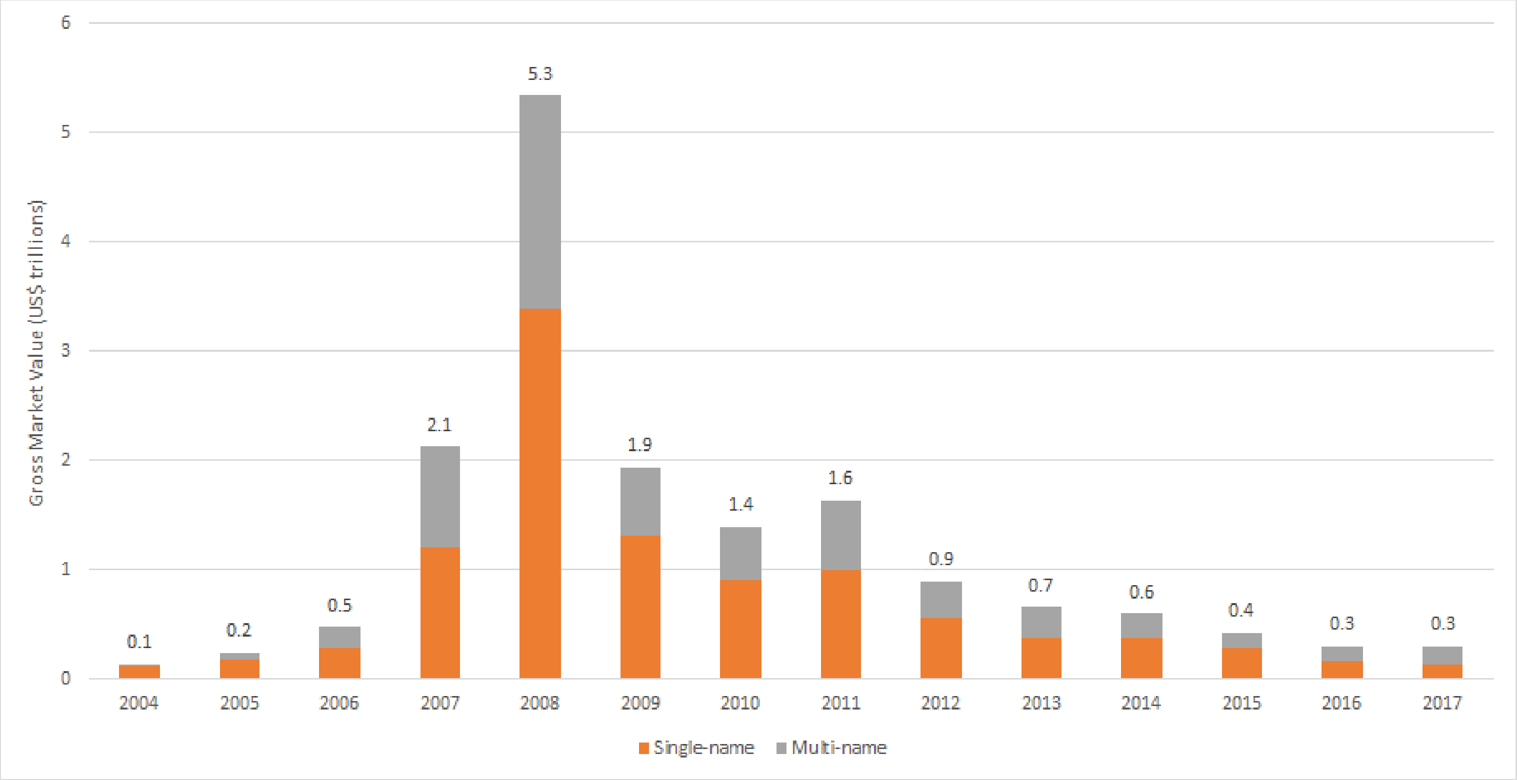
Single-name CDS outstanding notional totaled $4.6 trillion, while multi-name CDS notional was $4.9 trillion at the end of the second half of 2017. Multi-name CDS notional included $4.4 trillion of Index CDS.



Source: BIS OTC Derivatives Statistics

Gross Market Value of Global Credit Derivatives Market

Gross Market value of global credit derivatives market, which provides a more meaningful measure of market and counterparty credit risk, totaled $0.3 trillion at the end of the second half of 2017. “Gross Market Value” is the sum of the absolute values of all outstanding derivatives contracts with either positive or negative replacement values evaluated at market prices prevailing on the reporting dates.



The Role of ISDA

Form of documentation: ISDA Master Agreements

Credit definitions

Determinations Committees

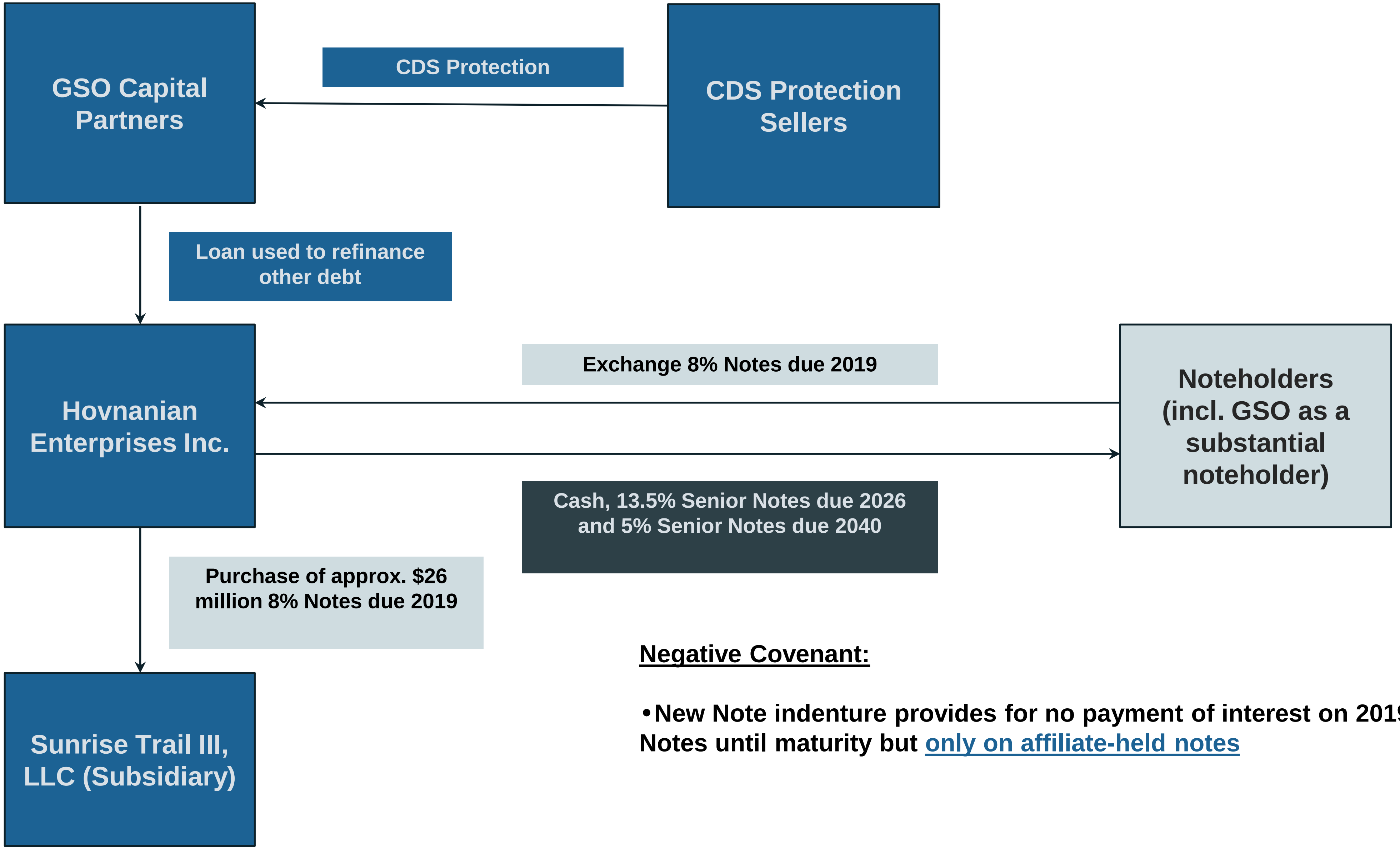
K. Hovnanian Enterprises Inc.

Key Players

Hovnanian is a large construction firm specializing in residential housing. In 2017 Hovnanian was facing some pressure to refinance certain debt.

GSO Capital Partners = protection buyer on Hovnanian.

Solus Alternative Asset Management = protection seller on Hovnanian.



<u>Negative Covenant:</u>

- **New Note indenture provides for no payment of interest on 2019 Notes until maturity but <u>only on affiliate-held notes</u>**

Hovnanian – Trading Prices

Note	July 10, 2017	July 31, 2017	Oct. 30, 2017	April 10, 2018
8% Notes due 2019	101.46	100.13	106.92	111.768 (Held entirely by Sunrise Trail III)
9.5% notes due 2020	98.6	104.0	102.96	100.474
2% Notes due 2021	82.78	81.03	83.91	81.958
5% secured notes due 2021	Not issued	Not issued	93.40	91.676
10% secured notes due 2022	Not issued	Not issued	109.24*	107.212
10.5% secured notes due 2024	Not issued	Not issued	110.83**	102.506
13.5% notes due 2026	Not issued	Not issued	Not issued	115.726
5% notes due 2040	Not issued	Not issued	Not issued	42.479

*First available trading data on Sept. 25, 2017, showing trading price of 103.48

** First available trading data on Sept. 25, 2017, showing trading price of 105.65

Hovnanian Litigation

After announcement of exchange offer, Solus sued GSO and Hovnanian, claiming the following:

- GSO and Hovnanian's actions amounted to a fraudulent scheme to manipulate the CDS market in violation of Section 10(b) of the Securities Act.
- Hovnanian failed to disclose material information in violation of Sections 10(b) and 14(e) of the Securities Act.
- GSO and Hovnanian tortiously interfered with Solus's prospective economic advantage.

Solus sought:

- Preliminary and permanent injunctions to prevent exchange offer from proceeding.
- Damages for losses it would incur as a protection seller in the event a credit event occurred and the cheapest to deliver notes were priced in the auction.

Hovnanian Litigation - Outcome

Full-day court hearing in January, days before expiration of exchange offer, on preliminary injunction motion.

Judge Laura Swain (SDNY) denied Solus's motion of preliminary injunction in time for exchange offer to proceed.

Solus continued to pursue other claims, but as a practical matter Hovnanian's failure to pay on the 8% 2019 notes and expiration of grace period needed to occur before those claims could be pursued in earnest.

ISDA statement on "narrowly-tailored" credit events, April 11, 2018.

CFTC statement on manufactured credit events, April 24, 2018.

Just before grace period expired, case settled. Hovnanian paid the interest on the notes and there was no credit event.

Polling Question # 2
Should Hovnanian have disclosed in 2017 that it was in discussions with GSO?

A. Yes

B. No

C. Maybe

The McClatchy Company

Key Players

McClatchy is a publicly traded American publishing company based in Sacramento, California. It operates 29 daily newspapers in fourteen states and has an average weekday circulation of 1.6 million and Sunday circulation of 2.4 million.

Chatham Asset Management = New Jersey based hedge fund sponsor.

Succession Events

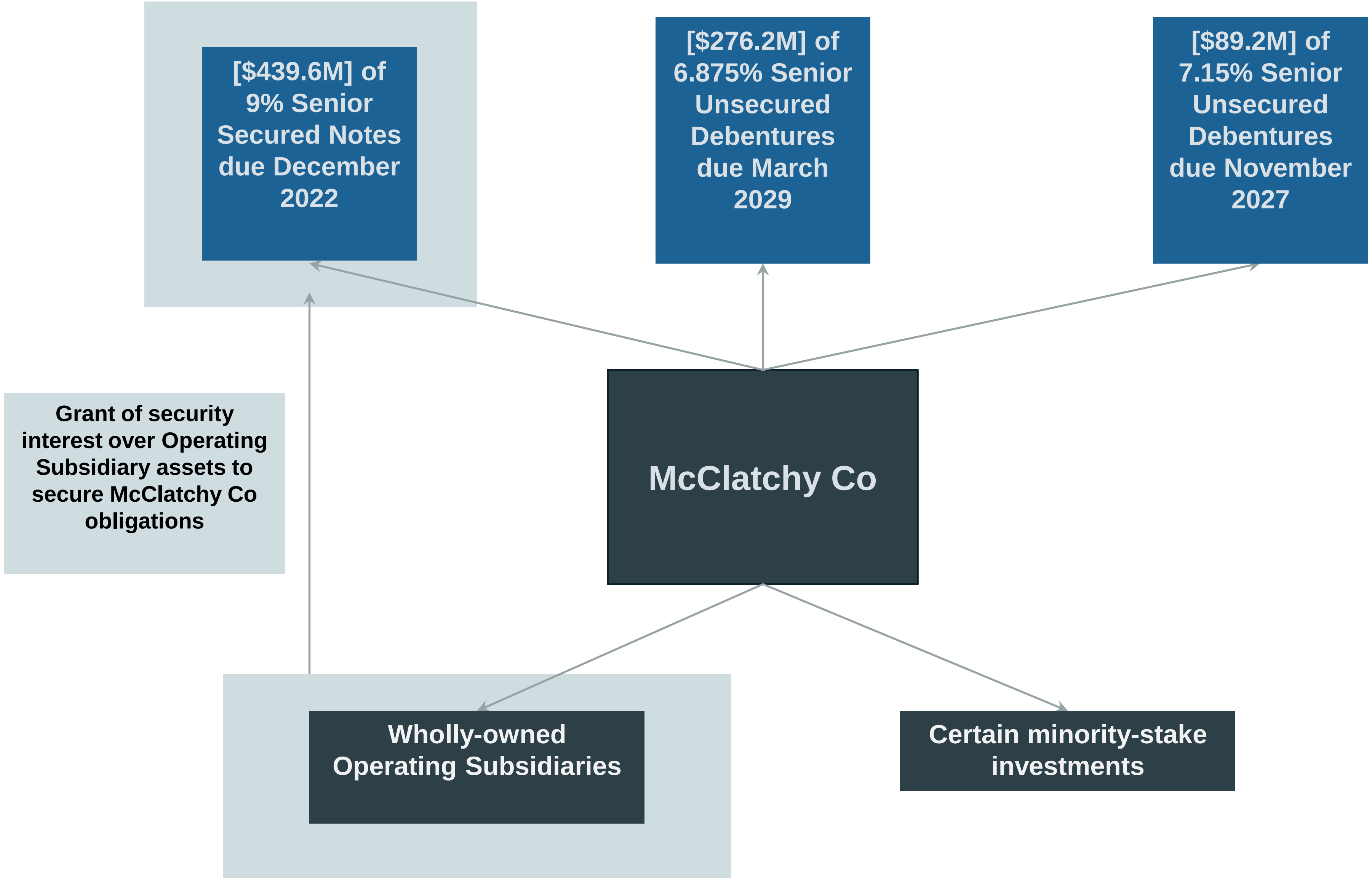
Broadly speaking, such an event is a situation where one of more entities *succeed* either directly or as a provider of a Relevant Guarantee.

When a Succession Event occurs, the CDS contract can split between the existing Reference Entity and successor entity(ies) or solely reference the successor entity(ies)

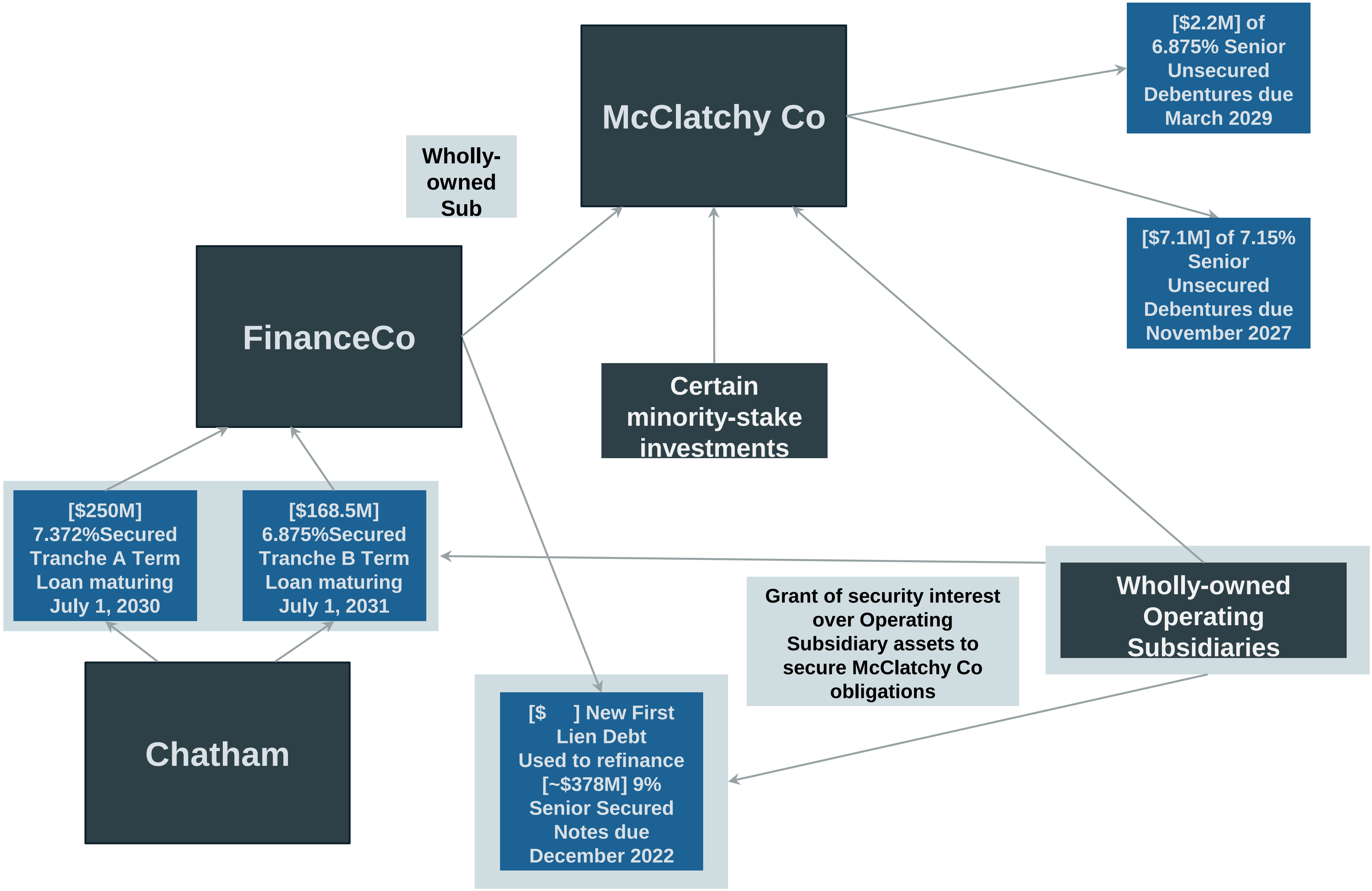
Thresholds:

% of Relevant Obligations Moving to Successor Entity ("S")	Impact on CDS	Notes
S1 >= 75%	S1 is Sole Successor	
75% > S1 > 25%, RE <= 25%	S1 is Sole Successor	
75% > S1 > 25%, 75% > S2 > 25%, RE <= 25%	S1 and S2 Successors	Can apply to 2 or more successors
S1 > 25%, [S2 > 25%,] RE > 25%	S1[, S2] and RE Successors	
All Successors <= 25%, RE still exists	No Successor, RE and CDS unchanged	
All Successors <= 25%, RE ceases to exist	Largest Successor is Sole Successor.	
Seller of Protection consolidates with RE	Buyer of protection may choose to unwind the trade (at close-out amount)	Section 11.4 of Credit Derivatives Definitions

Existing Capital Structure



Post Refinancing Capital Structure (as initially proposed)



The implications of Hovnanian and McClatchy

Polling Question # 3

Do the actions of Hovnanian and GSO or McClatchy and Chatham raise market manipulation concerns?

A. Yes

B. No

C. Maybe

Other implications of Hovnanian and McClatchy

How do you see this “unconventional” use of CDS affecting the CDS market?

Can ISDA do anything?

How can market participants protect themselves?

Polling Question # 4
How would you characterize the use of CDS in Hovnanian and McClatchy?

A. Ingenious
B. Unconventional
C. Narrowly-Tailored
D. Manufactured
E. Fraudulent
F. I don’t care, it’s lunch time!

Questions?