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Isda is replacing the mechanistic determination of a failure-to-pay credit event with a more subjective rule

The resolution of narrowly tailored credit events is a leap forward for the CDS market

The dubious reputation that credit default swaps (CDS) sometimes (unfairly) enjoy has not been improved by so-called narrowly tailored credit events (NTCEs, also known as manufactured credit events). To recap, these are prearranged payment defaults between the company on which CDS has been bought (the reference entity) and one or more parties. These defaults have minimal real impact on the reference entity or its general creditors, but enable the purchasers of CDS to make out like bandits because a failure-to-pay credit event is triggered (leaving sellers of CDS out of pocket). Such shenanigans could undermine the role of CDS as an instrument of credit risk insurance and measure of creditworthiness. It is therefore encouraging to see that regulators are on top of the issue.

One recent example involved US homebuilder Hovnanian and hedge fund GSO Capital Partners. At the end of 2017, GSO agreed to provide funding to enable Hovnanian to refinance 7% notes coming due in January 2019. Hovnanian made an exchange offer for 8% 2019 bonds, $26 million of which it planned to purchase for itself and subsequently default upon, triggering a failure-to-pay credit event on the CDS, which GSO had presumably bought in spades. This led to a bizarre divergence between cash and CDS markets, with six-month Hovnanian protection trading above 10,000 basis points, while some of the cash bonds posted above par.

So what? Cash-strapped triple C names such as Hovnanian will do what they can to secure a liquidity lifeline, and blood on the carpet is to be expected; better stay in the investment grade space where, in terms of pure credit spreads, there is a more favourable risk/reward trade-off.

Accessing IG credit without rate risk

However, the CDS market provides the only real means of accessing IG credit without the baggage of rate risk and the poor liquidity of cash bonds. It is also the only medium for taking IG credit exposure that can be levered on an unfunded basis at zero cost and which offers flexible maturity points to capture the benefits of roll-down. Collusive schemes that benefit certain parties through knowledge asymmetry and create significant divergence between a credit's performance in the cash and CDS markets impair the latter's effectiveness as a barometer of credit risk, and undermine the integrity of the CDS market while threatening to sap its liquidity.

Good, then, that NTCEs have been met with a robust regulatory response. The US Commodity Futures Trading Commission and the UK's Financial Conduct Authority employed heavily freighted terms such as "market abuse" and "market manipulation" when they addressed the issue. The International Swaps & Derivatives Association (Isda) acknowledged the influence of these agencies in its decision to propose an amendment to 2014 definitions to address the issue (final details to come). It plans to replace the mechanistic determination of a failure-to-pay credit event with one that requires the Determinations Committee (DC) to assess whether a payment failure "resulted from or in a deterioration in creditworthiness or financial condition of the reference entity".

Uncertainty should deter opportunism

This approach conceptualises CDS once again as an instrument of credit insurance. While there is "eligible information" that the DC may take into account in determining credit deterioration, a degree of subjectivity remains. And this may be no bad thing: the uncertainty that is its corollary precludes a mechanistic outcome and will therefore discourage opportunistic transactions.

This will not be the last word in CDS rule-making. However, it is auspicious that Isda has chosen to listen to hedge funds and asset managers (which played a role in drafting amendments) in its efforts to improve the robustness of the product. The resolution of NTCEs is a leap forward.

Addressing a key abuse will enhance market integrity and the efficiency of CDS as the purest metric for expressing the market's perception of an entity's default risk. As participants increasingly seek to hedge (or take outright exposure) through CDS in the face of an increasingly illiquid bond market, it is important to have eliminated a flaw in their fabric.