Loan-only Credit Default Swaps: The March to Liquidity

By Angus Duncan

Settlement and pricing, standard-form documentation and information asymmetries must be addressed for the use of loan-only credit default swaps to increase.

Since their inception over a decade ago, derivative instruments have played an integral part in the emergence of innovative methods of credit risk transference, hedging and investment strategies for a wide range of market participants. According to the International Swaps and Derivatives Association (ISDA), these products constitute one of the fastest-growing sectors of global financial markets.[1] The next frontier in markets that provide for an exchange and over-the-counter (OTC) derivative trading seems to be structured finance, as evidenced by the increasing demand for products such as credit default swaps of asset-backed securities (CDS of ABS) and more recently loan-only credit default swaps (LCDS). On June 8, 2006, ISDA published a LCDS template for the U.S. market, a watershed event expected to boost demand for LCDS.[2]

This article examines the LCDS market and its potential for growth in tandem with the CDS of ABS market. What are LCDS and why are they attractive to investors? The article also analyzes the drive for standardization and liquidation in the market and the potential legal obstacles to achieving this goal. Finally, it addresses innovations that will be needed to transform LCDS from a purely hedging instrument to a fully tradable derivative instrument.

What Are LCDS?

Although credit default swap contracts on leveraged loans have been entered into for several years, the development of the embryonic LCDS market in Europe is primarily attributed to the pioneering work by Dresdner Kleinwort Wasserstein and Morgan Stanley quoting CDS prices on Wind leveraged loans in November 2005.[3] LCDS, or syndicated secured loan CDS, are similar to standard-form CDS in that a protection buyer pays a "premium" (measured, most commonly, in basis points per annum on a notional amount) in exchange for a "default loss payment" in the event of a predefined credit event that relates to a reference obligation. The CDS operates as the basis of a risk-ratio measure, in most cases based on credit. The principal difference between a standard-form CDS and, LCDS is that the reference obligation in the case of LCDS is a syndicated loan, as opposed to a bond.

Unlike standard-form CDS, in Europe a standard LCDS contract is cancelable if the reference obligation is materially paid down. The U.S. model is slightly different with the LCDS contract being cancelable only if a dealer poll conducted to find a replacement for the original obligation is unsuccessful. Upon cancellation, no money changes hands except for the accrued premium payment. Cancellation is very important in the case of LCDS as the loans deliverable under a LCDS contract are likely to be amortizing or subject to prepayment. Cancelable contracts allow a protection buyer in the European market more effectively to match the tenor of the loan being hedged, thereby removing a source of basis risk.[4] This feature is likely to be desired by those investors seeking to hedge specific loans, while protection sellers (such as hedge funds) may view this feature as negative.[5]

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Why Are LCDS Attractive to Investors?

As things stand today, LCDS provide the same benefits to investors as do standard-form CDS on bonds.[6] However, according to Fitch Ratings, syndicated loan volumes have skyrocketed on both sides of the Atlantic over the past several years, with levels approaching $3 trillion at the end of 2005.[7] With liquidity in the leveraged loan sector increasing, LCDS will offer investors (for example, hedge funds) a vehicle to establish long credit (that is, short protection) positions synthetically, particularly with respect to difficult-to-access cash markets and companies that are not traded on the bond markets.

The opportunity to trade leveraged loans synthetically would also appeal to banks given Basel II's regulatory capital requirements. Basel II, unlike its predecessor, ties a bank's capital requirements to a borrower's creditworthiness. While these regulations are yet to be implemented, they are likely to display regional variation and may induce banks to shed their lower ranked and nonperforming loans or, alternatively, to hedge their exposure on these loans by using LCDS. Buying protection on a risky loan reduces a bank's credit exposure, thereby lowering the amount of capital it is required to hold. For instance, under Basel II, a generic single-B loan that would generally have a risk weighting of 187 percent could fall to just under 10 percent if the bank buys protection from a well-rated counterparty.[8]

A market for liquid single-name LCDS (a LCDS contract with a single reference entity) is also likely to lead to portfolio credit derivatives, including traded indices and synthetic collateralized loan obligations (CLOs). Eventually, LCDS could offer CLO managers an advantage in sourcing leveraged loans by shortening the warehousing period, allowing managers to respond quickly to market opportunities for launching CLOs.[9]

Liquidity in the LCDS Market

The development of liquidity in the LCDS market can be compared to the path taken by the slightly more mature CDS of ABS market. The CDS of ABS market was initially hampered by a dearth of credit protection buyers. This stemmed from the difficulty in persuading market participants to purchase protection on ABS, where structural features such as credit enhancement and performance-based triggers made the likelihood of default significantly lower than corporate CDS and where nearly 90 percent of the market was triple-A–rated deals. As such, liquidity in this market has come from the large mezzanine sector (primarily triple-B home equity) with hedge funds using the market to short U.S. consumer and housing risk.[10]

In general, leveraged loans are likely to be lower rated and more volatile than ABS, making the purchase of credit protection more attractive.[11] While volatility is the primary concern of high-risk players, like hedge funds looking to sell protection, the short supply of banks willing to buy protection in the leveraged loan market might be a concern in terms of market liquidity. However, as mentioned earlier, Basel II's capital requirements may provide banks with incentives to enter the market depending on a bank's own capital structure and regulatory limits. LCDS would also attract investors such as pension funds as they can provide synthetic exposure to leveraged loans, a market that these types of institutions generally avoid. Hedge funds and correlation trading desks at banks that face certain restrictions when buying the loans themselves are also likely to be interested in synthetic exposure.[12] Thus, there seems to be a natural market for LCDS besides the buyers of protection themselves.

Eventually, the creation of a truly liquid market depends on the ease with which these instruments can be traded. In this regard, there are three important issues that need to be addressed: settlement and pricing, standard-form documentation and information asymmetries.

Settlement and Pricing in the LCDS Market

CDS contracts typically settle in one of three forms: cash settlement, physical settlement and, more recently, pay-as-you-go for CDS of ABS ("PAYG"). In the case of cash settlement, a valuation date is specified in the contract. If a default event occurs, bids are sought on the reference obligation on the valuation date. The difference between the par value of the reference obligation and the final bid price is the cash settlement amount payable by the protection seller to the protection buyer. As such, cash settlement allows

"synthetic investors" (those that do not own the underlying asset) to be exposed to the underlying market risk. This form of settlement becomes unwieldy in markets such as LCDS where the underlying asset is difficult to price and the process of valuation itself can negatively affect the protection seller.

In the case of physical settlement, delivery of the underlying reference obligation is exchanged for its par value. This form of settlement is particularly inconvenient in illiquid markets where the underlying asset may not be readily available. Thus, if an event of default occurs, the protection seller would make a payment equivalent to the par value of the underlying asset and the buyer would transfer ownership of the defaulted asset to the protection seller. Fitch's report on the LCDS considers physical settlement, through assignment or participation, as the mode of settlement in both the European and U.S. markets for the foreseeable future.[13]

Given the different nature of products such as CDS of ABS, a third, relatively new, settlement mechanism has been developed in the United States. PAYG attempts to avoid the difficulty of arriving at fair and timely outcomes from the perspective of both sellers and buyers of protection. Under PAYG, amounts classified as "floating payments" are paid by the protection seller to the protection buyer. These are principal or interest shortfall or principal write-down amounts on the reference obligation on a current basis. The buyer makes reverse payments called the "fixed amount" (the premium payment) to the seller, as well as "additional fixed amounts," which, in most cases, are repayment on write-downs and shortfalls that are subsequently reversed. This type of settlement means that a buyer of protection does not have to declare the occurrence of a credit event merely for an adverse change in the reference obligation. This flexibility avoids the permanence of a written-down notional amount. Furthermore, parties can stipulate a "step-up" in the fixed-rate payable as well as an option to terminate the transaction.

The Development of Standard-Form Documentation

The creation of standard-form documentation is an extremely important step toward developing a liquid market for derivative products such as LCDS. This is because credit default swaps are transacted in OTC markets as private contracts between two parties. Since these contracts are individually negotiated, they include trade-specific provisions that can hamper liquidity. The creation of standard-form documentation, providing for greater consistency, makes the product fungible, allowing for the involvement of proprietary traders and the creation of an exchange-traded market.

In the LCDS market, a template for a loan-only CDS document was published as recently as June 8, 2006. This standard-form confirmation is primarily intended for use in the U.S. market in conjunction with a physical settlement terms rider published by the Loans Syndication and Trading Association (LSTA).[14] The rider provides detailed rules and guidance intended to harmonize the standards for physical loan settlement under a credit default swap with existing standard market practices in the secondary loan market. This harmonization is essential, particularly when market participants face sourcing a deliverable obligation in a default scenario. The rider also affirms that physical delivery of loans after a credit event will use closing mechanics and procedures developed by LSTA modified to encourage the expeditious settlement demanded by market participants. However, consistency and the avoidance of mismatch between LSTA provisions and ISDA definitions continue to attract much discussion.

The physical delivery requirement is likely to be one of the largest obstacles for the LCDS market. This is a consequence of current market practices with regard to the transference of leveraged loans.[15] For LCDS, a deliverable obligation has to be a syndicated loan at the requisite lien level. If a large-scale default were to occur, given the time and the document-intensive manner in which the secondary loan market currently settles, the protection seller could be exposed to losses on the reference loan. The rider addresses this problem by including a "market standard indemnity" provision.

The market standard indemnity provision encourages expeditious settlement by protecting the interests of the protection seller. It provides that the protection buyer will indemnify the seller in the event of a loss occurring as a consequence of "market practice" at the time of settlement. It also serves as a guarantee that the protection buyer is delivering a market standard document that must be acceptable to protection sellers. While this offers protection sellers some comfort, physical settlement continues to be an unwieldy option, particularly for

investors merely looking for synthetic exposure to the LCDS market.

Information Asymmetries

The private and unregulated nature of the loan market also presents a slew of issues in terms of asymmetric information that affects liquidity in the LCDS market. For instance, unless the purchaser of a LCDS contract is a lender of record, it might be very difficult to trace all the available loan information. Furthermore, privileged information on the loan may only be available to the lender of record but not to those who only own the derivatives on the loan. Thus, a protection buyer who owns an underlying loan could have voting rights to the defaulted loan but no economic exposure.[16] This example highlights a potential moral hazard issue with regard to these instruments. Overall, the lack of transparency and information asymmetry has a negative impact on liquidity and gives rise to difficult pricing issues.

On the Horizon

The market for LCDS is presently in flux with several exciting developments on the horizon. While dealers have been trading CDS on loans with nonstandard documentation since 2004, the number of dealers purportedly interested in these instruments after standardization is said to be considerable.[17] The entrance of new players will give a significant boost to liquidity in the market.

Spreads on LCDS might also start to widen with increased leverage affecting default recoveries in the future. In today's credit environment, leveraged loans have exhibited relatively high recovery rates. As a consequence, the value of any protection purchased on them is very small, leading to tight spreads on LCDS. If the market environment prompts increased leveraging in the form of secured financing, it would mean fewer assets to support a greater level of indebtedness. This, in turn, would lead to lower recoveries in the event of default, consequently widening spreads on LCDS.

The information asymmetries discussed above also raise the issue of arbitrage possibilities in the market as a consequence of mispricing. LCDS features such as cancelability, lack of transparency and quality and the default risk of underlying loans must all be taken into account when calculating spreads. The lack of liquidity and indices in the market will also exacerbate the pricing problem. As such, and at least initially, there are likely to be arbitrage opportunities in the market for LCDS. However, they will be fleeting as the fledgling market develops to include traded indices and pricing becomes more transparent.

Endnotes

1 The volume of credit derivatives transacted in 2004 grew to US$8.42 trillion, compared to US$5.44 trillion in 2003—an annual growth rate of 123 percent. A summary of ISDA's survey of the credit derivatives market is available from *www.isda.org; see also* Jan Job de Vries Robbe, *The Continuing Evolution of the Structured Credit Market*, J.I.B.L.R. 2005, 20(12), at 28–632.

2 *See www.isda.org* (accessed on June 20, 2006).

3 *LBOs Speed Up Evolution of Debt*, EUROWEEK (Mar. 2006).

4 Fitch Ratings Special Report, *Loan-Only Credit Default Swaps*, available at *www.fitchratings.com.*

5 *Id.*, at 9.

6 *Id.*, at 4.

7 *Id.*, at 2.

8 *Secondary Market Becomes Primary Priority*, EUROWEEK (Mar. 2006).

9 Fitch, *Loan-Only Credit Default Swaps, supra* note 4, at 11.

10 Louise Bowman, *CDS on Leveraged Loans*, EUROMONEY (June 2006).

11 The credit quality and volatility of ABS as compared to leveraged loans is a consequence of the collateral backing ABS, which is usually of better quality than the security backing leveraged loans.

12 *Leveraged Loan CDS to Boom as Docs Agreed*, EUROWEEK (Mar. 17, 2006).

13 Fitch, *Loan-Only Credit Default Swaps, supra* note 4, at 7.

14 The Physical Settlement Terms rider is available at *www.LSTA.org*.

15 More information on current market practices with regard to transference of leveraged loans can be found on the LSTA Web site accessible at *www.LSTA.org.*

16 Bowman, *supra* note 10.

17 Fitch, *supra* note 4.