



## **You say voluntary, I say mandatory...**

### **Anu Munshi, partner at B&B Structured Finance, explores the impact of debt restructuring on CDS contracts**

An old school friend with a great business idea comes to you and three other similarly well-off school friends and asks if you'd lend him money for his business. He needs US\$40,000 and expects he can pay it back in one year with 10% interest. The four of you agree to lend him the money, each one giving US\$10,000.

In nine months' time, your friend asks to meet all of you for a drink at the pub and tells you that he's behind schedule on payments. His business is going well, but he has just not received money from one of his main clients as they have requested a longer period of time to pay him.

He expects to have the money within the next six months, so asks if you can extend your loan to him to 1.5 years instead of the original one year. He will pay you a higher interest of 15% for the remaining term until he repays the loan.

Your three friends have a good feeling about this business. Your borrower friend's main client is an established institution and is likely to provide solid revenues to your friend's business going forward.

Your friend just needs a bit more time to get the cash from his client and then his business will be self-sustaining. If the group doesn't grant him the extension, he won't have the money to repay the loan, so all of you will recover less than your principal and the higher interest sweetens the deal.

But you have your doubts about whether your friend's main client will pay him. You also need your money back within the original timeframe. But the four of you had initially agreed that a majority vote of 75% on any decisions relating to the loan would bind all of you, so you have to extend your part of the loan as well.

You and your friends are going to feel very differently about this result. Your friends have agreed to extend or restructure the loan as they think they'll get all their money back, albeit a bit later. But you've been coerced into restructuring the loan and have doubts about whether you'll get your money back.

Restructuring works in much the same way in institutional credit markets (though the negotiation happens in boardrooms instead of pubs - sometimes). Investors agree to restructure debt because they would rather wait longer to get repaid in full than demand their money when it's due and recover a fraction of their principal.

But if not all investors agree to restructure the debt and a majority vote binds all holders of the debt, as in the case of collective action clauses (CACs), then the terms of the debt can be restructured anyway. Such restructuring of debt resulting from a deterioration in the issuer's creditworthiness triggers a credit event in a credit default swap (CDS) because it is effectively a default as the terms of the debt have changed due to the issuer being in distress.

If we imagine that a CDS market exists on your borrower friend's creditworthiness, the extension of the loan from its original maturity would trigger a credit event on your borrower friend's CDS because you and your lender friends are all bound by the new terms of being repaid at a later date.

Your borrower friend may be keen to avoid triggering a credit event so as to avoid the stigma and financial consequences of having defaulted. So he asks the four of you, his lender friends, if you would be amenable to an alternative solution where he repays you the loan on the original maturity date but takes out another loan from you on the same date for another six months. The result is the same as extending the loan from its original one-year maturity to 1.5 years, but instead of restructuring the original loan he is repaying the old loan and borrowing money through a new loan.

What's the key difference between these two alternatives? The difference is that you are free to act as you want in the second alternative because the 75% majority vote relates to the original loan.

Any new loan is not automatically bound by the same rules. So, when your friend asks if you are all amenable to the alternative solution of receiving your money back from the original loan and giving out a new loan, you can choose to say, "Sorry mate, but I'm out. I can't give you a new loan."

This is what you could call a 'voluntary' restructuring as it has the effect of restructuring the original debt but it doesn't bind any creditors who don't want the debt to be restructured. Such a 'voluntary' restructuring does not trigger a credit event in a credit default swap because the original debt has not been restructured; rather, the creditors have agreed to an alternative solution that involves new debt because they have made a commercial decision to preserve their capital.

As your other three lender friends are willing to extend the loan, your borrower friend can return the US\$40,000 to all of you, re-borrow US\$30,000 from your other lender friends for six months more and not trigger a credit event. This alternative solution works as long as US\$30,000 is enough for your borrower friend. If he needs the entire US\$40,000 for another six months, he has little choice (apart from blackmailing you, emotionally or otherwise) but to restructure the original loan, which forces you to extend your US\$10,000 portion of the loan – given the majority vote - and trigger a credit event as a result.

So, if you think about it, all restructuring of debt is voluntary to a large extent as it depends on an agreement from all or a majority of creditors. But any restructuring that binds all holders to its terms is mandatory for even those who did not opt for the new terms, whereas any restructuring that doesn't bind all holders to its terms is truly voluntary.

There has been a lot of talk of late about CDS not serving as an efficient hedge in the context of a voluntary restructuring on Greek debt, as it would not trigger the CDS contract and therefore would not reflect the true loss. But it is by no means certain that enough creditors will agree to a voluntary restructuring of Greek debt to raise the funds that Greece needs, so Greece may not be able to pull off a voluntary restructuring.

More importantly, even if enough creditors agree to a voluntary restructuring the first time around, the general feeling is that Greece will be back asking for another round of restructuring in a few

months' time. Creditors may not see the commercial benefit of deferring the date when they get their money back the second time around, at which point it will be difficult to orchestrate another voluntary restructuring. If your borrower friend comes back in 1.5 years and asks the group of three lender friends for another extension, they are unlikely to feel as confident about the prospects of being repaid in full and may decide to cut their losses.

So, where an entity is seen as being unlikely to repay its debts, a voluntary restructuring today very likely only defers an ultimate mandatory restructuring, which will trigger a credit event on the CDS contract.

Interestingly, the market already seems to be pricing in the full loss on Greek debt today. To buy US\$10m CDS protection on Greece today, you need to pay approximately US\$6m - or 60% of the notional amount of the CDS contract - on day one.

If Greece were to default tomorrow, you would need to receive at least US\$6m as compensation to make it worth paying 60% upfront to buy protection. Based on the CDS payout of par minus recovery, this implies a recovery value on Greek debt of around 40%, which looks pretty close to a likely recovery value on Greek debt. In other words, the CDS contract already reflects the likely full loss amount on Greek debt.

People can debate all they want about voluntary versus mandatory, but in the case of Greece, it's just a matter of time before the sovereign defaults. You say voluntary, I say mandatory. But the market has spoken; politicians should listen.

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