Opinion **Credit default swaps**

Reform the credit default swap market to rein in abuses

Windstream's fight with Aurelius highlights complexities of 'empty creditors'

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US securities regulators have called for a clean-up but need not wait for industry-wide changes. There are concrete steps individual companies, investors and judges can take to address the problem © Bloomberg

Henry Hu FEBRUARY 24, 2019

Credit default swaps are the banking equivalent of home insurance. Much as property owners buy coverage for fire and other disasters, banks, bondholders and other creditors purchase CDS protection against losses in case a corporate borrower runs into trouble.

But this valuable financial innovation is susceptible to opaque gaming and counterintuitive incentives. We badly need reforms, as was underscored when Aurelius Capital Management scored a court victory that may push telecoms company Windstream into bankruptcy.

When creditors are faced with an overstretched borrower, they often choose to work with them. They may waive breaches of contract or agree to out of court restructurings because they ultimately want the debt repaid.

But the CDS market has created a category of investors, which I dubbed "empty creditors" in 2007. In extreme cases, they stand to make more money on CDS if a company defaults than they would if it repaid its debts. These "net short" creditors are motivated to grease the skids to insolvency, even when bankruptcy makes no sense.

In the Windstream case, Aurelius owns some of the Arkansas-based company's bonds, but it is widely believed to have a far larger investment in Windstream CDS. In September 2017, the hedge fund sent a formal notice to Windstream complaining that the telecoms group had breached a provision of a debt contract two years earlier — something no other creditor had complained of.

Windstream warned that if this breach counted as a default, it might have to declare bankruptcy. Aurelius pressed ahead. A judge, unpersuaded by the CDS issue, found for Aurelius on all counts. He ordered Windstream to pay a $310m judgment. The company's share price fell by nearly two-thirds.

The case highlights another problem: CDS positions do not have to be disclosed. Debtor companies and investors must guess whether a net short creditor might be lurking.

The CDS market is also plagued by other gaming. In 2017, homebuilder Hovnanian agreed to intentionally default on an interest payment as part of a deal with Blackstone's GSO arm, which had bought CDS protection on the company. GSO helped Hovnanian refinance up to $320m of its debt at a favourable interest rate in return for a missed payment that would have triggered a payout on the CDS. After a CDS seller sued, the manufactured default was called off.

US securities regulators have called for a clean-up, but we do not have to wait for regulatory changes or industry-wide changes. There are concrete steps individual companies, investors and judges can take to address this problem.

Publicity would help. As soon as a troubled company has a reasonable basis for believing that some of its creditors are motivated by their outsized CDS holdings, management should say so and present evidence for the claim.

Loan agreements and bond indentures could limit the rights of net short creditors, since they are motivated to cause firms to default. Limiting their ability to do so could benefit companies, normal creditors, shareholders, third parties such as CDS sellers, and overall market efficiency.

Judges can also rein in net short creditors, as they have started to do with shareholders. Net short shareholders benefit from falling share prices because their short positions outweigh their equity holdings. These "empty voters" with negative economic exposure have incentives to use their rights to destroy value, by, for example, voting to elect Mr Bean to the board.

In 2012, the hedge fund Mason Capital sought to block Canadian telecoms group Telus's planned recapitalisation. Based partly on my affidavit, a judge in British Columbia found that Mason Capital's likely status as an empty voter was relevant to considering its opposition. The court approved the Telus plan.

A judge faced with an empty creditor with negative economic exposure should consider doing the same. The world is already economically uncertain. There is no reason to allow CDS gaming and extreme empty creditors to make it more so.

The writer teaches at the University of Texas Law School and has written about the role of CDS in corporate defaults

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