BARCLAYS

Global Credit Strategy

Addressing the Potential Pitfalls of CDS

- **2018's potential credit event in Hovnanian CDS, which was ultimately avoided, illustrated the possibility that failure-to-pay credit events could be tailored in such a way that CDS protection buyers receive a payout without a corresponding deterioration in the financial health of the issuer.**
- **The Hovnanian situation also demonstrated that under current credit derivatives definitions, a new cheapest to deliver obligation could be created to artificially boost the payout for protection buyers in a CDS auction.**
- **Both of these possibilities can result in distortions in CDS pricing and effectively divorce the value of CDS from the economic outcomes of issuers.**
- **To address these potential scenarios, ISDA has published a supplement to the definitions that amends the definitions of "Outstanding Principal Balance" and "Failure to Pay." We review the changes and explain how they would have been applied in past narrowly tailored credit events.**
- **The supplement is an important step forward, but is unlikely to address all possible scenarios. However, we think the degree of discretion given to the Determinations Committee, combined with increased regulatory scrutiny of the CDS market, should serve as a deterrent to future narrowly tailored credit events.**
- **In order for the supplement to apply to uncleared trades, market participants will need to adhere to a protocol, which is now open. Cleared trades will be automatically converted by the clearinghouse.**
- **While these changes should be positive for the CDS market, investors still need to be aware of potential pitfalls, including manufactured orphaning events, difficulty in delivering loans (more of an issue in Europe), and the lack of asset package delivery (APD) for European corporates.**
- **We argue that APD should be introduced for European corporates and that there should be improvements to loan deliverability in general. Finally, we suggest changing succession event language to address "orphaning by refi," a relatively frequent occurrence in Europe, which could also address manufactured orphaning events.**

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Narrowing in on Narrowly Tailored Credit Events

On July 15, 2019, after extensive consultation with market participants, ISDA published the *2019 Narrowly Tailored Credit Event Supplement to the 2014 ISDA Credit Derivatives Definitions* to specifically address manufactured or narrowly tailored credit events (a copy of the supplement can be viewed *here*). ISDA defines narrowly tailored credit events (NTCEs) as "arrangements with corporations that cause a credit event leading to settlement of CDS contracts while minimizing the impact on the corporation." These events have been causing concern in the marketplace because they divorce the value of CDS from the economic outcomes of issuers.

We discussed this topic in detail last year (see *Addressing Manufactured Credit Events in the CDS Market*) and cited the cases of Codere and iHeart as two examples of credit events that were due to technical triggers rather than true credit deterioration. We also discussed the case of Hovnanian CDS, which we believe is what ultimately drove ISDA to amend the credit derivatives definitions. While our previous publication discusses the Hovnanian situation in detail, to recap briefly, the company entered into a refinancing agreement with an investor whereby it received favorable financing terms in return for agreeing not to pay interest on bonds owned by a subsidiary, with the expectation that the missed payment would trigger CDS.

Although Hovnanian CDS did not end up being triggered, this was the first situation we can recall that attempted to create a new cheapest to deliver obligation as part of a NTCE. The supplement published by ISDA attempts to prevent such events in the future.

At a high level, The NTCE supplement amends the definitions of "Outstanding Principal Balance" (OPB) and "Failure to Pay" (FTP) to i) remove the incentive for market participants to work with issuers to create off-market obligations with the intent of producing a higher payout at CDS auctions and ii) minimize the likelihood of a failure-to-pay credit event without credit deterioration for the CDS reference entity.

Outstanding Principal Balance

2014 Definitions – The Current State

In the 2014 definitions, the concept of OPB is used to determine the principal amount of a bond or loan that must be delivered to physically settle a CDS position. Part of the OPB calculation is the "Quantum of the Claim,"[1] which is determined according to "any applicable laws (insofar as such laws reduce or discount the size of the claim to reflect the original issue price or accrued value of the obligation)." The 2014 definitions do not specify what constitutes "applicable laws," so there is some ambiguity to begin with, but if a bond is issued at a significant discount to par and "applicable laws" do not reduce the size or the quantum of the claim, then it could be delivered at par for the purposes of physical settlement.

This creates a situation in which a buyer of CDS protection could provide an incentive to a CDS reference entity to issue a bond at a substantial discount to par (perhaps in return for a favorable refinancing package) in order to achieve a lower recovery value in the CDS auction than would otherwise have been possible.

NTCE Supplement – Changes to OPB

To protect against this scenario, the NTCE supplement amends the definition of OPB in several ways. It clarifies that "applicable laws" in relation to the quantum of the claim

[1] "Quantum of the Claim" means the lowest amount of the claim that could be validly asserted against the reference entity in respect of the non-contingent amount if the obligation had become redeemable, been accelerated, terminated, or had otherwise become due and payable at the time of the relevant determination, provided that the quantum of the claim cannot exceed the non-contingent amount.

include "any bankruptcy or insolvency law or other law affecting creditors' rights to which the relevant obligation is, or may become, subject."

It also specifies that if i) "Fallback Discounting" is specified in the confirmation (under the supplement, this will be the case for corporates and financials, but not for sovereigns), ii) the OPB of an obligation that was issued below 95 is not reduced or discounted by "applicable laws," and iii) it does not have terms relating to the accretion of principal over time, then the OPB is determined by straight-line interpolation between the issue price of the bond and its principal redemption amount. For example, if a bond is issued at 60, is non-accreting, and can be redeemed at par in ten years, the OPB in one year would be 64 using straight-line interpolation.

The supplement also addresses when and how straight-line interpolation would apply to exchanges where the issue price is below 95 (which would be a more common occurrence). In such cases, the issue price is based on the OPB of the original obligation that was exchanged. So if a $100mn par bond is exchanged for a new $50mn par bond, the issue price for the purposes of determining whether straight-line interpolation would apply is 200 ($100mn/$50mn * 100). In this case, straight-line interpolation would not apply; therefore, the new $50mn par bond could be used to settle $50mn of CDS. As a result, CDS would not be affected (ie, it would work the same as it currently does) in a normal distressed exchange where an issuer exchanges an unsecured bond for a lower notional of secured bonds.

We can apply this new language to the Hovnanian exchange offer[2] that was announced on April 6, 2018 (even though it was ultimately not completed) to see how it would have worked. Hovnanian offered to exchange its existing 10% of 2022 and 10.5% of 2024 second-lien bonds for a new 3% of 2047 senior unsecured note. In exchange for each $1,000 of principal tendered, the holder would receive $1,250 of principal of the new notes. In this case, we think that the issue price of the new bond would be considered to be 80 ($1,000/$1,250 * 100); therefore, it would be subject to straight-line interpolation.

The amendments also include language to address a situation in which an existing obligation is exchanged for more than one obligation. In that case, the calculation agent would determine how the OPB of the original obligation is allocated among the new obligations while taking into account "the interest rate, maturity, level of subordination and other terms of the obligations." We believe this language is broad enough to capture scenarios where an obligation is exchanged into more than one obligation with very different characteristics (and therefore very different dollar prices).

In our view, this provision could have addressed the first Hovnanian exchange offer[3] on December 28, 2017, whereby the company offered to exchange its existing 8% of 2019 notes for a combination of cash, new 13.5% of 2026 notes, and new 5% of 2040 notes. The exchange resulted in two new bonds with very different characteristics and prices. The 2026s traded well above par, while the 2040s traded around 40. We think the provision was written with exchanges such as this in mind, but given that it lacks detailed guidance, it is not possible to know what OPB the Determinations Committee (DC) would have assigned to each bond. However, we believe this was intentional in order to give the DC enough discretion to arrive at an economically sensible outcome.

While changes to the definition of OPB alone are not enough to address the potential for NTCEs, we think that in combination with the changes to FTP, they should be effective for most foreseeable events.

[2] https://khov.gcs-web.com/news-releases/news-release-details/k-hovnanian-enterprises-inc-commences-exchange-offer-and-consent
[3] https://khov.gcs-web.com/news-releases/news-release-details/k-hovnanian-enterprises-inc-announces-exchange-offer-and-new-0

Failure to Pay

2014 Definitions – The Current State

In section 4.5 of the 2014 definitions, the concept of a FTP is defined as follows (emphasis added):

> "Failure to Pay" means, after the expiration of any applicable Grace Period (after the satisfaction of any conditions precedent to the commencement of such Grace Period), the **failure by the Reference Entity to make, when and where due, any payments** in an aggregate amount of not less than the Payment Requirement under one or more Obligations, in accordance with the terms of such Obligations at the time of such failure.

We think this definition is fairly straightforward and means that any missed interest or principal payment that is not cured by the end of an applicable grace period, regardless of the circumstances, will result in an FTP credit event. This applied in the case of Codere, which made an interest payment two days after the end of the applicable grace period, and in the case of iHeart, which withheld a principal payment to an affiliate but paid outside investors. In both cases, the missed payment was not the result of credit distress and did not result in acceleration of the issuers' other obligations.

NTCE Supplement – Changes to FTP

The NTCE supplement maintains the 2014 definition of FTP but adds the following sentence:

> If "Credit Deterioration Requirement" is specified as applicable in the related Confirmation, then, notwithstanding the foregoing, it shall not constitute a Failure to Pay if such failure does not directly or indirectly either result from, or result in, a deterioration in the creditworthiness or financial condition of the Reference Entity.

Under the NTCE supplement, "Credit Deterioration Requirement" will be applicable for corporate and financial transactions, and as a result, a missed payment alone will not be sufficient to trigger a failure-to-pay credit event. The missed payment must result from (or in) credit deterioration. The supplement provides extensive interpretive guidance for the DC to assist in the determination of whether an event should be considered an FTP credit event. In particular, the guidance outlines eligible information that could indicate that the credit deterioration requirement is not satisfied, including:

- There are arrangements between the reference entity and one or more parties to trigger CDS intentionally (with exceptions).
- There are arrangements to create a new cheapest to deliver obligation that trades below other deliverables, or to issue a material amount of new debt.
- The missed payment does not result in acceleration.
- The reference entity has enough liquidity to make the payment and there is no technical, administrative, or operational cause for it to be missed.
- The missed payment is quickly cured following the expiration of the grace period.
- The missed payment is related only to obligations held by affiliates or parties that are not likely to accelerate.

With regard to the first point, the guidance makes exceptions for certain arrangements, including typical distressed forbearance and standstill agreements, as well as situations where basis holders would likely reject a restructuring without a credit event trigger and, therefore, such a trigger increases the likelihood that the restructuring will be successful, without which the reference entity would likely enter bankruptcy.

The guidance also outlines indications that credit deterioration has occurred, including:

- The reference entity announced that it was in financial distress or seeking to restructure.
- The reference entity hired restructuring (or similar) advisors.
- The missed payment happened as part of a court-approved (or similar) credit process.
- The missed payment was for obligations that were held by a number of parties.
- The missed payment occurred because the reference entity was unable to refinance.
- The payment date for the payment that was missed was either the original scheduled date under the terms of the obligation or was amended well before the missed payment occurred.
- To determine whether the missed payment results in deterioration of the reference entity, any of the following occur: other obligations are accelerated or are capable of acceleration, the reference entity fails to pay other obligations, or the reference entity files for bankruptcy.

Applying the Guidance to Past Credit Events

Under the credit deterioration requirement, we do not think that Codere CDS would have been triggered, as there was an arrangement with another party to trigger CDS intentionally by missing an interest payment, the missed payment did not result in acceleration, and the missed payment was quickly cured following the grace period.

We also do not believe that iHeart CDS would have triggered, as the missed payment was only for an obligation held by an affiliate, there was no acceleration, and the company had sufficient liquidity to make the payment.

While Hovnanian CDS ultimately did not trigger, it would have checked all of the “non-credit deterioration” boxes, which is not surprising since that potential credit event was the likely impetus for the drafting of the NTCE supplement.

An Important Step Forward, but Regulatory Scrutiny and a More Outcome-Focused DC Should Also Help

The NTCE supplement is an important step forward in terms of protecting the integrity of the CDS product, but as history has shown, it is unlikely that it will perfectly foresee all possible scenarios. However, the changes to the definitions of OPB and FTP make them more nebulous than in the past, which we think is an intentional shift away from a literal interpretation of the rules and toward a more flexible approach that allows the DC to focus on intent.

Our impression is that there has already been a gradual change in the stance of the DC away from a literal reading of the rules toward a more outcome-focused approach. We think part of this shift has been driven by situations such as the Abengoa SA credit event in Europe in 2015. A literal interpretation of the differences between the 2003 and 2014 bankruptcy definitions led to a bankruptcy credit event being triggered under the 2003 definitions, but not under the 2014 ones.

This is in sharp contrast to the case of Ziggo in January 2019 when the DC ruled that a succession event had occurred. While we believe this was the right outcome for the market, a literal read of the definitions could arguably have resulted in an orphaning of CDS (in fact the previous CDS entity was ultimately dissolved). Instead, the DC employed a more pragmatic approach, ruling that outstanding tax and expenses payable were "immaterial," and, as such, should be ignored for the purpose of interpreting the "all obligations" criteria of the universal successor language.

At a general level, we welcome such a pragmatic approach. Taking a step back, the 2014 CDS definitions are an approximately 90-page legal document meant to cover both the triggering and the settlement of corporate and sovereign CDS, whereas a legal document for just a single high yield bond could easily be 400 pages. Without a willingness to take a pragmatic stance, it is unlikely that a 90-page document could ensure sensible economic outcomes in all cases.

This more pragmatic approach will inherently make credit event determinations less cut and dried and could result in more determinations being sent to an external review panel, which would occur for any DC votes that do not achieve a supermajority (80%). However, the expectation is that with more flexibility, the DC should be able to address unintended flaws in the definitions to achieve economically sensible outcomes.

A potentially greater deterrent to NTCEs is increased regulatory scrutiny of the CDS market. Regulators have been fairly vocal about their concerns. In April 2018, the US Commodity Futures Trading Commission (CFTC) released a statement[4] saying that "Market participants and their advisors are advised that in instances of manufactured credit events, the Divisions will carefully consider all available actions to help ensure market integrity and combat manipulation or fraud involving CDS, in coordination with our regulatory counterparts, when appropriate." In December 2018, the FCA published a similar statement[5] saying that "Manufactured credit events may in certain circumstances constitute market abuse by the involved parties – both the CDS counterparty and the firm referenced in the CDS." More recently, in June 2019, the US Securities and Exchange Commission (SEC), CFTC, and FCA issued the following joint statement[6] regarding the CDS market:

> The continued pursuit of various opportunistic strategies in the credit derivatives markets, including but not limited to those that have been referred to as 'manufactured credit events,' may adversely affect the integrity, confidence and reputation of the credit derivatives markets, as well as markets more generally. These opportunistic strategies raise various issues under securities, derivatives, conduct and antifraud laws, as well as public policy concerns.
>
> As a result, today the Chairmen and Chief Executive of our respective agencies announce that the agencies will make collaborative efforts to prioritize the exploration of avenues, including industry input which will address these concerns and foster transparency, accountability, integrity, good conduct and investor protection in these markets. These collaborative efforts would not, of course, preclude other appropriate actions by our respective agencies or authority.

The SEC, CFTC, and FCA issued a follow-up statement[7] on September 19, 2019 in which they welcomed ISDA's efforts to address NTCEs but said that more needs to be done to address strategies that do not involve NTCEs. In particular, they said that "we look forward to further industry efforts to improve the functioning of the credit derivative markets and welcome continuing engagement with market participants."

We think the comments from the regulators should serve as a strong deterrent to future NTCEs because of the potential regulatory, legal, and reputational ramifications.

4 https://www.cftc.gov/PressRoom/SpeechesTestimony/divisionsstatement042418
5 https://www.fca.org.uk/publication/newsletters/market-watch-58.pdf
6 https://www.sec.gov/news/press-release/2019-106
7 https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement091919

Implementing the NTCE Supplement

In order for the supplement to be effective for existing, uncleared CDS trades under the 2014 ISDA Credit Derivatives Definitions, investors need to adhere to the ISDA 2019 NTCE Protocol.[8] The protocol was opened for public adherence on September 16, 2019, and will remain open until October 14, 2019, at 5pm New York time.

The protocol incorporates the terms of the NTCE supplement for legacy in-scope transactions in order to match the new trading standard (ie, 2014 definitions plus NTCE supplement) that is expected to go live on January 13, 2020. The protocol will make “Fallback Discounting” (for Outstanding Principal Balance) and “Credit Deterioration Requirement” (for Failure to Pay) applicable for these transactions. Note that transactions under the 2003 definitions and sovereigns are not in scope for the protocol.

For market participants that have only cleared trades, adherence to the protocol is not required, as the central counterparties (CCPs) are expected to apply the protocol changes to cleared transactions through an amendment to their clearing rules. We expect the CCPs to communicate these changes directly to clearing participants.

Investors that choose not to adhere to the protocol would end up having risk in a non-standard contract come January 13, likely leading to reduced liquidity and increased transaction costs. The SEC, CFTC, and FCA also commented on the protocol in their joint statement on September 19, 2019. In particular, they said that “firms should also consider the risks to which they may be exposing themselves by trading with counterparties who do not adhere to the proposed ISDA protocol.”

Note that the protocol covers single-name CDS, as well as index and options. So this also affects investors with non-cleared index/option risk who have no direct single-name exposure.

The NTCE supplement will be incorporated for new trades starting on January 13 by updating the ISDA Credit Derivatives Physical Settlement Matrix[9].

The Risk of Manufactured Orphaning Events

While the changes implemented by the NTCE supplement should be positive for the CDS market, there are still potential pitfalls for CDS users, including manufactured orphaning events. We consider manufactured orphaning events to be those where an investor works with a reference entity to restructure its debt obligations by effectively moving them to another entity without triggering a succession event. In such a scenario, the movement of debt serves no economic purpose for the reference entity outside of any incentive provided by the investor for agreeing to structure the refinancing transaction in that way.

Probably the most recent example of a potential manufacturing orphaning event is McClatchy. We discussed the McClatchy situation in detail in a previous *report*, but to recap, McClatchy entered into an agreement with an investor whereby the investor would make a loan to a new wholly owned subsidiary of McClatchy. McClatchy would then use the proceeds of the loan to repurchase bonds that the investor held. Since the transactions were not structured as an exchange (even though they involved the same investor), the expectation was that it would not result in a succession event and that the McClatchy CDS contract would effectively be orphaned. This was because the DC has historically utilized a literal interpretation of the succession rules and looked for evidence that debt has either been assumed or exchanged. The CDS market certainly appeared to expect that the contract would be orphaned, as 5y CDS tightened 20pts once news of the agreement became public.

[8] https://www.isda.org/protocol/isda-2019-ntce-protocol/
[9] https://www.isda.org/2011/01/20/credit-derivatives-physical-settlement-matrix-3/

Ultimately, the transaction did not go through as originally proposed because some potential buyers of a secured bond that the company was marketing apparently[10] balked at the previously announced plan to move its debt obligations to a subsidiary. The subsidiary was not created, and all of the debt continues to reside at the McClatchy entity, but for investors that were long CDS protection when the original transaction was announced and proceeded to unwind their positions, the damage was done.

One potential way to deal with such situations is to give the DCs more discretion in deciding whether a succession event has occurred. The definitions could provide some interpretive guidance (similar to what the NTCE supplement does for FTP) in order to arrive at an economically sensible outcome.

Another type of manufactured orphaning event is a restructuring event in Europe where all bonds in the front bucket (for example) have their maturities extended beyond 10 years, such that they cannot be delivered into a front-bucket, protection-buyer triggered trade. This leaves no deliverables in the front bucket, making short-dated CDS lose its value. Although in a restructuring event the protection buyer can elect not to trigger CDS, such an outcome is still detrimental to the intent of the product.

We believe that the most efficient way to prevent such outcomes, beyond changing the definitions, is regulatory scrutiny of such events in general.

Corporate CDS – More "Definition" Wood to Chop

While the effort to address NTCEs is a positive development, it appears to more focused on the US market. In Europe, the focus has not been on NTCEs but rather, on several deficiencies in the 2014 definitions that have come to light in recent situations.

In particular, we think that the European market would benefit from efforts to address the following three issues:

1. Lack of asset package delivery for corporates
2. Loan deliverability concerns
3. "Orphaning by refi" events

Lack of Asset Package Delivery for European Corporates

"Asset Package Delivery" (APD) is the ability to deliver into a CDS auction bonds/other assets that were given to investors as part of a restructuring credit event, as if the bonds had their original principal/maturity etc. This change was viewed as critical for European banks (and sovereigns) given the credit events experienced during the European sovereign crisis and the difficulty that the 2003 CDS definitions had dealing with the unprecedented level of state involvement.

APD has worked well for European banks. Banca Monte dei Paschi triggered a governmental intervention credit event in 2017 when its LT2 bonds were converted into equity. Under the 2003 CDS definitions, this would have prevented proper settlement, and recovery could have been 100%. But the CDS settled effortlessly with a final auction price equal to "share price" x "amount of shares given in conversion." For negative basis package holders who owned €10mn of bonds and €10mn of CDS prior to the event, this allowed them to settle the CDS and sell shares into the auction for a combined payout of par, as expected.

[10] https://www.bloomberg.com/news/articles/2018-06-27/mcclatchy-hands-win-to-cds-buyers-as-it-tweaks-refinancing-deal

We believe that APD is needed for European non-financials as well. As evidenced by the current Thomas Cook situation, there are meaningful concerns about the ability to settle CDS properly, largely deriving from the "chicken and egg" dilemma for restructuring events and settlement: the very action that causes a restructuring event is the same event that renders the bonds incapable of being properly delivered if the notional has been reduced or outright converted into equity.

This could also address some of the issues with restructured bonds' having a maturity of greater than 10 years (and, hence, currently not being able to settle in their "original" bucket), thereby removing some of the manufactured orphaning event concerns.

APD in restructuring events for banks is only for the reference obligation, in order to limit the likelihood that investors seek to create a "sub-optimal" asset package for a small bond. There is an argument to be made that with the NTCE supplement, restricting APD to just the reference obligation for corporates may not be necessary as tailored asset packages would see their effective notional reduced as a result of the changes to Outstanding Principle Balance. Making APD apply to all bonds also avoids the scenario where there are hold-outs in an exchange offer for the reference obligation, so no asset package to which APD can apply, but other bonds are exchanged. In this scenario, some bond holders could experience an economic loss which the set of deliverables may not be able to reflect.

Loan Deliverability Concerns

On the surface, loans are deliverable into corporate CDS. However, in practice, there are two principal obstacles in Europe: i) the ability to prove deliverability/transferability and ii) practical problems in delivering loans within the physical settlement period given the long settlement times for European loans.

The reality is that in Europe many loans are private, with the terms available only to (prospective) owners. This makes it difficult, if not impossible, to provide information to the DC to prove that loans satisfy deliverability criteria, let alone prove that a failure-to-pay credit event has occurred.

Without pretending to have a cut-and-dried solution, we would welcome an easing of the "burden of proof," at least in terms of the deliverability of loans, or a mechanism for providing such information.

This issue is becoming more relevant, as loan financing remains attractive for issuers given the general demand for loans from CLOs, with some European capital structures becoming loan-only. Note, however, that loan deliverability has been less of an issue in the US as investors are not typically looking to deliver loans to settle CDS, and there are fewer complications in the US in general.

A separate but related issue is that of bonds subject to lock-up agreements during creditor negotiations. This, in general, has the potential to hinder transferability. While this could be alleviated by having APD (and, as such, no rush in settling CDS while the bonds may be subject to a lock-up), it is still relevant in situations where, for example, a company fails to pay coupons, thereby triggering an FTP, but the bonds are unavailable for settlement.

"Orphaning by Refi" Events

With the 2014 definitions, there were two key changes to succession events: The introduction of the concept of "Universal Successor" and the hard-wiring of the reliance on qualifying guarantees in the relevant obligation definition.

These changes have improved CDS functioning related to liability management exercises, but the definitions remain ill equipped to manage situations where i) bonds are tendered for/called and ii) loans/bonds are issued out of a separate entity that has no guarantee from the initial entity.

This "orphaning by refi" is a persistent concern for protection buyers and is often cited as a reason for not engaging in negative basis trades, thereby hindering price discovery in general.

One solution could be to introduce a tighter link between the "disappearance" of bonds/loans and the issuance of new bonds/loans, akin to the already existing "steps plan." Currently, bonds and loans are in scope for succession events if the existing obligor is removed either by change of issuer or by exchange. A third limb could be added, stipulating that if calls or tenders occur as part of a plan to issue new bonds or loans, then they should be considered in generating a succession event. This would also help address the potential for manufactured orphaning events previously discussed.

Not Just for the Benefit of CDS Investors

The proposed changes, primarily related to APD but also succession event improvements, would obviously be beneficial for CDS investors, but we think that they could also be helpful for bond investors and issuers.

The main reason is that, as we have seen previously and more recently with Thomas Cook,[11] while CDS investors may not be engaged in "narrowly tailored credit events," they can influence outcomes for bonds in order to ensure that (mainly negative-) CDS-cash basis packages have the expected economic outcome.

In a sense, deficiencies in the CDS contract reduce the flexibility afforded to issuers, owing to how investors in their bonds have hedged themselves. If corporate CDS in Europe had APD enabled, it is likely that the CDS holders of Thomas Cook bonds would be indifferent to the precise implementation of the restructuring.

At a broader level, if bond investors are comfortable that they can hedge their risk with CDS with no concerns about the CDS not "working," the liquidity of the bonds, particularly in more stressed situations, could improve as investors choose not to sell bonds but hedge with CDS, or there could be more buyers of bonds from basis-package investors.

[11] "Thomas Cook races to secure support for £900m rescue deal," *Financial Times*, September 15, 2019.

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