



LET'S TALK ABOUT...

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Default

(Part One) Debt restructuring, as discussed in the past articles, is a form of default in every respect, being the result of insolvency and failing to comply with the contractual obligations towards creditors-investors. In most cases it means not repaying principal at its due expiration date. It may be useful, after considering debt restructuring, to turn to the concept of default in more general terms, because some more features are of interest for both operators and investors. Firstly the debtor, that is the issuer of the instrument, may not repay it because is unable to do so, due to troubled financial conditions and poor cash flows, but it may also decide not to comply with its obligations still having the means – though such cases are much more uncommon in the financial markets – up to the most odd cases of “strategic” defaults, in which the missed payments may be motivated (in the issuer’s view) by legal, political or commercial reasons. If the event of a default is mostly associated with the fixed income market, that is bonds and notes, it also applies to other financial instruments, such as mortgage-related products, commercial paper and other similar investment vehicles, of old and new creation. In formal terms the case of default must not be confused with bankruptcy, first of all because not all debt issuers are subject to bankruptcy (as in the case of sovereign, supranational and public institutions and agencies), and secondly because the latter refers to a legal procedure which also imply a sort of protection and judicial supervision for the defaulted subject, normally a corporation. Within the financial markets typical defaults concern the missed payments of periodical interests (coupons) or the failed reimbursement do principal at the date of expiration. In such case the debt’s terms become relevant, as they are mentioned in the issue prospectus: for instance the debt class, primary or subordinate, the future recovery of unpaid coupons together with the next ones, the presence of specific collateral (corporate assets) or the explicit mention of private or public institution which guarantee payments should the issuer default. We remind that issuers’ financial reliabilities may be assessed by considering the debtors’ ratings – although such tool is no longer so valid indeed and pretty controversial – and the level of CDS’s, credit default swaps, that are the percent premiums investors should pay in order to assure due repayments. If a private (corporate) issuer’s default almost usually end up in an ordinary bankruptcy or other judicial procedure, in different terms according to different jurisdictions, if the case of a sovereign (or supranational institutional) default, no bankruptcy path is obviously applicable (states do not go bankrupt by definition), so that legal and practical consequences and outcomes are usually lighter for them. That is a pretty interesting point, which will be considered next. *(to be continued)- GLT*

The views expressed are not necessarily those of the Swiss Association of Asset Managers
