Fallen from grace

Executive summary

- CDS contracts are no longer seen as improving the overall stability and security of the financial system but as actually creating additional risks. The rapid growth of the CDS market, coupled with a lack of regulation, makes it unclear how deep the recently uncovered problems go. Already, a number of financial institutions have revealed heavy losses.

Credit risk products have plummeted from favour since the onset of the credit crunch. Among those suffering a sharp reversal of fortune are credit default swaps (CDS), which featured on the agenda at last year's ACT conference when treasurers were told that the CDS market had grown too big to ignore.

Indeed, CDS were recommended by Alan Greenspan himself. Less than two years ago, the former Chairman of the US Federal Reserve described this particular form of derivatives contract as "probably the most important instrument in finance" because they "lay off all the risk of highly leveraged institutions (and that's what banks are, highly leveraged) on stable American and international institutions".

Since the first CDS and collateralised debt obligations (CDOs: complex instruments that bundle debt of various kinds together) were developed in 1995, the market for them has ballooned. At the beginning of this decade, the estimated value of the CDS market was $900bn; by the end of last year the figure hit $45,500bn while bond turnover dwindled.

Not everyone was convinced of the worth of CDS. Heading the sceptics has been legendary investor Warren Buffett, who coined the term "financial weapons of mass destruction" for all derivatives bought speculatively. When Buffett's group Berkshire Hathaway bought reinsurance giant Gen Re in the late 1990s, one of his early moves was to reduce its CDS exposure.

SECRET DRIVERS Despite the Sage of Omaha's disapproval, until last summer CDS were one of the most liquid areas of the derivatives market. They offered a form of insurance against the non-payment of debt, while allowing investors to make bets on the creditworthiness of a particular company. As the *New York Times* put it: "Like a homeowner's policy that insures against a fire or flood, these instruments are intended to cover losses to banks and bondholders when companies fail to pay their debts."

Banks, bondholders and other buyers of protection (the insured) used CDS to transfer the risk of borrowers defaulting to a protection seller (the insurer), gaining indemnification against any resulting loss in return for a premium. The premium required reflects the risk of insurance, thus allowing arbitrage trades and the trading of differing spreads and ratings on bonds.

CDS have also proved useful for reducing exposure to credit market conditions becoming more adverse, enhancing the performance of a basket of bonds, and for trading on events that may happen to bonds that the insured doesn't actually own.

Hedge funds, insurance funds and pension funds also moved to CDS. Initially used to provide protection for banks on their loan book, CDS have more recently been used for funding rather than hedging.

John Jackson, Director of Group Financial Services at Scottish & Newcastle, says that while his own group hasn't utilised CDS their spreads have proved very useful in giving a ready benchmark for pricing a bond issue – and one independent of the investment banks. "It's one that just wasn't available a few years ago and gives you an up-to-date picture of how you compare with your peers," he says.

Over this period, CDS have become increasingly relevant to treasurers as a hidden driver of investor behaviour for companies planning a bond issue or corporate restructure. They offered the opportunity to create a balanced bond portfolio for investors by going long of the CDS, effectively selling protection and giving the margin equivalent to investing in the bond. When combined with investment in a government security, investors have been able to hold a position in bonds that were otherwise illiquid or virtually unavailable.

WARNING SIGNS There have been other changes in the CDS market since the very first transactions. In the early years, if a default occurred, the insured delivered a defaulted bond or loan (known as the deliverable obligation) to the insurer, who provided a "physical

A YEAR AGO, TREASURERS WERE BEING TOLD THAT THE CREDIT DEFAULT SWAP MARKET WAS TOO BIG FOR TREASURERS TO IGNORE. NOW ITS VERY REPUTATION IS IN SERIOUS DOUBT. **GRAHAM BUCK** REPORTS.

"LIKE A HOMEOWNER'S POLICY THAT INSURES AGAINST A FIRE OR FLOOD, THESE INSTRUMENTS ARE INTENDED TO COVER LOSSES TO BANKS AND BONDHOLDERS WHEN COMPANIES FAIL TO PAY THEIR DEBTS."

settlement", or indemnification, that represented the face value of the deliverable obligation. However, the market has experimented with forms of netting arrangement or auctions, so that if a default occurs, the process of unwinding CDS contracts is simplified, and the potential lessened for situations where numerous investors are simultaneously attempting to get hold of bonds.

The market developed its own indices (the main ones are iTraxx in Europe and CDX in the US) used by investors to trade baskets of different companies' debt. Both indices are now suffering from the increasingly illiquid conditions.

Growth has also produced a number of hazards. The most obvious is overexposure to a particular event by the insurers and insufficient coverage for bonds held by the insured. If the cover purchased exceeds the amount of bonds issued, then the insured either has to buy more bonds or pay cash to the market value of the outstanding bonds for delivery to the insurer. Possibly the most famous example was provided by US car parts maker Delphi, which filed for bankruptcy in October 2005. The CDS outstanding on the its debt was $28bn, while the value of underlying bonds and loans was only $5.2bn. Bond prices rose after Delphi sought Chapter 11 protection.

Another recent trend has been for the banks to sell rather than buy CDS protection, thereby increasing their risk taking instead of reducing it. A CDS can be sold by the insurer or the insured and because trades are not regulated, in the same way that the sub-prime mortgage securities market was unregulated, there is no obligation to inform the other parties to the contract of the sale.

As the *New York Times* noted, CDS "form a large but obscure market that will be put to its first big test as a looming economic downturn strains companies' finances".

SHORT-LIVED ENTHUSIASM That big test was temporarily delayed, as the first bout of volatility in the financial markets last summer saw demand for CDS accelerate. As the cash bond market froze up investors piled into CDS, using them to bet on credit deterioration in the early stages of the US sub-prime mortgage crisis. This burst of enthusiasm proved short-lived. As contagion from sub-prime spread wider, banks, hedge funds and asset managers grew increasingly reluctant to take on risk in the second half of 2008; liquidity dried up and the market for smaller single-name CDS ground to a halt in Europe although the US remained more active. Since then, the economic outlook has steadily deteriorated and CDS spreads have reached historically high levels, partly driven by the impact of financial companies on iTraxx and CDX.

This has made life even more difficult for a number of banks, such as Iceland's big three of Glitnir, Landsbanki and Kaupthing. Their cost of protection rocketed as, like the ill-fated Northern Rock, they borrowed heavily from the capital markets to fuel their expansion and have been hard hit by tightening credit conditions.

So far, there have been only a limited number of corporate defaults and relatively few CDS contracts have actually been triggered. But ratings agency Moody's predicts the worldwide default rate for junk-rated firms will rise this year from 0.9% to nearly 5% as economies weaken on both sides of the Atlantic. That would move the overall corporate insolvency rate back to its historically typical rate of 1.25%, triggering many more payments.

With reports suggesting that the CDS market has practically closed down and that banks are lining up to report massive CDS-related losses, Buffett's scepticism is beginning to look prescient. CDS contracts are no longer seen as improving the overall stability and security of the financial system but as creating additional risks.

The rapid growth of the CDS market coupled with the lack of regulation makes it unclear how deep the problems that have recently developed actually go. Already, a number of financial institutions have revealed heavy losses incurred from CDS, or sharply revised their initial estimates.

The CDS market may be resilient enough to cope with a further increase in corporate defaults, but there is also a risk of much greater tightening if more nasty surprises are in store. And as Wolfgang Munchau of the *Financial Times* recently suggested, if, instead of a short, sharp recession, the US economy faces a prolonged downturn, more firms will default and so might insurers and insureds. There is potential for the CDS market to cause "serious financial contagion".

Despite the steadily worsening situation of the past six months, S&N's Jackson still believes that the market's current liquidity problems will eventually correct themselves. However, with Lehman Brothers – a major name in the bond market – forced to reassure customers about its financial stability, potential liquidity is likely to be adversely affected for some time to come.

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