

## Credit Default Swaps: A Hedge Gone Haywire

By Elaine Floyd, CFP

**Subprime mortgages might have been the catalyst, but credit default swaps are ravaging banks and other financial players. Here's a primer on how this unregulated shadow market is intensifying the crisis.**

We are only now learning of the potential devastation of credit default swaps, a derivative that has allowed speculators to place such highly leveraged bets on debt instruments that the solvency of our entire financial system has been threatened.

Most people think the credit crisis traces to subprime loans, the fall in housing prices, and the rising default rates on mortgages that left bad assets on financial companies' balance sheets. All this is true, but it doesn't tell the whole story.

Many companies' balance sheets are a mess because of credit default swaps (CDSs) that are so convoluted they are almost impossible to unwind. Their CDSs have been bought and sold so many times and involve so many different borrowers that no one even knows who owes what to whom.

One financial commentator noted that the reason the government wanted JPMorgan to take over Bear Stearns was that (1) it didn't want the many financial institutions wrapped up in Bear's CDS deals to become insolvent, and (2) it didn't want the horrid job of trying to unwind all of Bear's credit default swaps. By taking over \$30 billion worth of bad assets, the government essentially deputized JPMorgan, the largest dealer in credit default swaps, to clean up the mess.

The government's decisions not to bail out Lehman but to rescue AIG were both related to CDS exposure. It was believed that Lehman's CDSs would mostly net out and that the damage beyond Lehman would be contained.

AIG, on the other hand, was the world's largest issuer of credit protection, guaranteeing some \$587 billion in collateralized debt obligations (CDOs) and other loans via credit default swaps. Purchasers were mainly banks, which took advantage of AIG's once AAA credit rating to show regulators and auditors that the risk of an underlying asset was protected. This allowed banks to hold less cash in reserve.

When marked-to-market losses on AIG's CDS portfolio triggered a credit rating downgrade and demand for \$14 billion in collateral, the potential canceling of all the debt insurance that AIG has provided would have triggered emergency capital raisings from banks around the world. This is why the government rescued AIG with an \$85 billion loan.

But the terms are punishing: 8.5% above LIBOR. The rescue package has been delicately crafted to avoid any of the terms that might trip a credit default swap, which should allow these five-year instruments to unwind naturally. (The takeover of Fannie Mae and Freddie Mac, on the other hand, did constitute a credit event, which CDS parties are having to deal with.)

### **What is a credit default swap?**

In its simplest form, a credit default swap is a five-year contract between two parties wherein one party guarantees that a debt owed to the other party will be paid.

Let's say ABC Bank wants to lend XYZ Corporation \$10 million, but it doesn't want to take on the full risk of default. So another firm—let's call it AIG—will guarantee the loan in exchange for ongoing payments over the next five years. If XYZ defaults, declares bankruptcy, or even has its credit rating downgraded, AIG would pay the face value of the loan to ABC Bank. AIG would then assume the debt obligation and try to collect from XYZ.

What used to be a simple, useful hedging tool has now become enormously complicated. For one, some of the debt obligations covered by CDSs are not owed by a single borrower but by multiple borrowers, as with CDOs.

For another, there is no assurance that the party guaranteeing the loan is in fact qualified to do so. Lots of players entered the CDS market, and some have taken on far more obligations than they could possibly meet.

Further complicating matters is that credit default swaps themselves are actively traded in the marketplace as a way for traders and investors to make a bond play without putting up substantial amounts of capital. Speculators have taken this to the extreme, using huge leverage and controlling trillions of dollars in outstanding debt. The \$62 trillion in outstanding CDSs far exceeds the total dollar value of the debt on which CDSs are written.

When times are good and borrowers are making their payments, no one ever thinks about having to settle a contract. But when the house of cards starts to topple with the first missed mortgage payment or credit downgrade, the nightmare of unwinding these contracts begins. Then the question of who owes what to whom becomes difficult or impossible to answer.

And it's still not clear how all these outstanding contracts will settle as more and more parties—such as undercapitalized banks and teetering corporations—face credit downgrades or bankruptcy in the months and years ahead. Speculators and hedge funds that never dreamed of having to settle a contract will find themselves on the hook for guaranteeing billions of dollars in loans.

### **What's next?**

The alarm has been sounding for some time now. In January 2008, *The Wall Street Journal* reported that struggling bond insurer ACA Financial Guaranty Corp., with just \$425 million capital, needed more time to unwind more than \$60 billion of insurance contracts it sold to financial firms but couldn't fully pay off. The article quoted Warren Buffett as saying, "You are essentially counting on the reliability of strangers" to pay up on their contracts. ACA Financial recently settled up in a work-out that may prove to be a model for distressed bond insurers.

In March, *Time* magazine called out, "Credit Default Swaps: The Next Crisis?" It reported AIG's \$11 billion writedown on its CDS portfolio and noted that the situation is exacerbated by the heavy trading volume of the instruments, the secrecy surrounding the trades, and—most important—the lack of regulation. "An original CDS can go through 15 or 20 trades," said one observer, "so when a default occurs, the so-called insured party or hedged party doesn't know who's responsible for making up the default and if that end player has the resources to cure the default."

Time also noted that a meltdown in the CDS market has potentially even wider ramifications nationwide than the subprime crisis. If bond insurance disappears or becomes too costly, lenders will become even more cautious about making loans, and this could impact everyone from mortgage-seekers to municipalities that need money to fix roads and build schools.

In June, market author F. William Engdahl said subprime collateralized mortgage obligations are just the tip of a colossal iceberg of dodgy credits that are beginning to go sour and that a chain reaction of failures in the CDS market could trigger the next global financial crisis. A surge in corporate defaults will leave swap buyers trying to collect hundreds of billions of dollars from their counterparties.

Nouriel Roubini wrote in the Sept. 22 *Financial Times* that the next stage in the financial crisis will be a run on thousands of highly leveraged hedge funds. "We are observing an accelerated run on the shadow banking system that is leading to its unraveling," he wrote. "The real economic side of this financial crisis will be a severe U.S. recession."

Another article in the *Financial Times* the same day noted with regard to the CDS market, "the whole system could seize up—a bonanza for lawyers, no doubt, but another kind of reduction in liquidity."

More recently, the pressure to hedge has led the most liquid contracts to overshoot, in effect pricing in absurd default risks and recovery rates. These same prices are then used as supposedly objective indicators to value the securities the CDS contracts were designed to hedge. The result has been a spiral of overhedging and overstated marked-to-market losses.

On the bright side, New York state announced on Sept. 22 that it will begin to regulate some credit default swaps as of January 2009. The next day, SEC chairman Christopher Cox told the Senate Banking Committee that lawmakers need to "provide in statute the authority to regulate these products to enhance investor protection and ensure the operation of fair and

orderly markets." Following that announcement, 17 banks that handle about 90% of the CDS trades agreed to initiatives to curb market risk, including tearing up trades that cancel each other out. Reducing open interest reduces risk and lowers the amount of regulatory capital banks are required to hold against trades on their books.

### **What to do now**

Some of the largest bond funds are CDS traders. This isn't necessarily bad, but you may want to decide for yourself if you want clients in funds with CDS exposure. Otherwise, just be aware that a financial tsunami may be building and could spill over into the entire economy unless efforts are made to curb the abuse. You may wish to revise your worst-case scenario to include the fallout from a cascade of billions of dollars in credit default swaps going bad. And hope the damage won't be as bad as many predict.

### **Further reading**

["Arcane Market Is Next to Face Big Credit Test," \*New York Times\*](#)

["NY State to Regulate Some Credit Default Swaps," Reuters](#)

["Credit Derivatives: An Overview," Federal Reserve Bank of Atlanta](#)

[International Swaps and Derivatives Association, Inc.](#)

["Credit Default Swap," Wikipedia](#)

["Credit Default Swaps: An Introduction," Investopedia](#)

["Merrill's AIG Problem," \*BusinessWeek\*](#)

["Corporate Bond Risk Rises to Record on AIG Counterparty Concern," Bloomberg](#)

["Credit Default Swaps and Bank Leverage," Naked Capitalism](#)

["The Pricing of Credit Default Swaps During Distress," International Monetary Fund](#)

["OCC's Quarterly Report on Bank Trading and Derivatives Activities First Quarter 2008," Comptroller of the Currency](#)