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Greece Default Swaps Failure to Trigger Casts Doubt on Contracts as Hedge

By John Glover - Oct 27, 2011

The European Union's ability to write down 50 percent of banks' Greek bond holdings without triggering $3.7 billion in debt insurance contracts threatens to undermine confidence in credit-default swaps as a hedge and force up borrowing costs.

As part of today's accord aimed at resolving the euro region's sovereign debt crisis, politicians and central bankers said they "invite Greece, private investors and all parties concerned to develop a voluntary bond exchange" into new securities. If the International Swaps & Derivatives Associationagrees the exchange isn't compulsory, credit-default swaps tied to the nation's debt shouldn't pay out.

"It will raise some very serious question marks over the value of CDS contracts," said Harpreet Parhar, a strategist at Credit Agricole SA in London. "For euro sovereigns in particular, the CDS market is likely to remain wary."

Politicians and central bankers came to a last-minute agreement after banks, the biggest private holders of Greece'sgovernment bonds, were threatened with a full default on their debt, according to Luxembourg Prime Minister Jean-Claude Juncker. ISDA General Counsel David Geen said his organization considered the agreement to be voluntary, even if there may have been "a lot of arm twisting."

Stopping Contagion

Leaders in Brussels agreed to boost Europe's rescue fund to 1 trillion euros ($1.4 trillion), to recapitalize banks and get a commitment from Italy to do more to reduce debt.

The talks were regarded by many investors as a last-ditch attempt to stem the sovereign crisis, while preventing the contagion to Spain, Italy and Portugal that they feared a default-swaps trigger would cause. The involvement of theInstitute of International Finance, which represents lenders, helped progress toward an accord that the EU could portray as non-mandatory.

This approach threatens to affect banks that use credit-default swaps to hedge their holdings of government bonds, forcing them to look at other ways of laying off risk.

"It punishes the banks that were well-hedged and managed, and I think it's just starting to sink in as to what this might mean," said Peter Tchir, the founder of hedge fund TF Market Advisors in New York. "Bank hedging desks are definitely now trying to re-evaluate" their use of default swaps, he said.

Deutsche's Hedges

Deutsche Bank AG (DBK), Germany's biggest lender, used credit-default swaps to help cut its net sovereign risk related to Italy to 996 million euros ($1.4 billion) as of June 30, from 8.01 billion euros six months earlier, Chief Financial Officer Stefan Krause said July 26. The Frankfurt-based lender said this week it has since increased its risk associated with the nation's debt as it stepped up market making.

"If they find a way to avoid a trigger event in the CDS, then people will doubt the value of credit -default swaps in general, leading to more dislocations in the market," said Pilar Gomez-Bravo, the senior adviser at Negentropy Capital in London, which oversees about 200 million euros.

Credit-default swaps pay the buyer face value in exchange for the underlying securities or the cash equivalent should a borrower fail to adhere to its debt agreements.

Schaeuble, Speculators

German Finance Minister Wolfgang Schaeuble is among European politicians who have expressed concern that the contracts have worsened the euro region's troubles. Speculators can use them to benefit as a nation's creditworthiness declines because the price of the insurance they offer rises.

ISDA's Geen, speaking today on Bloomberg Television's"InsideTrack" with Erik Schatzker, said that the agreement probably won't trigger the swaps because it's voluntary, despite the possibility of some "coercion."

The matter "is borderline," he said, adding that whether to trigger credit-default swaps on Greece is a matter for ISDA's Determinations Committee.

Default swaps still rallied on optimism the agreement means the euro region is a step closer to resolving its crisis.

The Markit iTraxx SovX Western Europe Index of contracts on 15 governments declined 46 basis points to 288 as of 2 p.m. inNew York, the lowest since Aug. 31. That's still almost 100 basis points higher than at the end of last year. The Markit iTraxx Financial Index linked to the senior debt of 25 European banks and insurers plunged 37.5 basis points to 204, JPMorgan Chase & Co. prices show.

Greek Swaps Rally

The cost of insuring Greek debt fell. Credit-default swaps backing $10 million of the nation's bonds for five years cost $5.6 million in advance and $100,000 annually, according to CMA, which is owned by CME Group Inc. and compiles prices quoted by dealers in the privately negotiated market. That implies an 85 percent chance of default assuming investors recover 32 percent of their holdings. The probability is down from 90 percent yesterday, when the upfront cost was $6 million.

The net notional value of default swaps outstanding on Greece has fallen from $5.3 billion at the start of the year, according to the Depositary Trust & Clearing Co., which maintains a warehouse of trading data. The total is a fraction of the $390 billion Greek bond market.

Greek bonds soared and the euro strengthened. The yield on the 10-year note dropped to 23.35 percent, from 25.32 percent yesterday and compared with 12.5 percent at the end of last year. The 17-nation common currency gained to a 1 1/2-month high of $1.4232 from $1.3906 yesterday, adding to its 6 percent advance this year.

Hedging Tool

Tchir of TF Market Advisors said be doubts whether the Greek debt exchange's likely failure to trigger credit-default swaps means the contracts have become useless as a hedging tool.

"Whoever agrees to this is making a business decision that it's worth doing," he said. "They're clearly being coerced into it and, I'm sure, threatened with all sorts of regulatory actions just to make their life difficult if they don't agree. But there's really nothing to stop them from saying no."

ISDA too rebuts suggestions that the swaps not paying out means they don't work as a hedge in a statement on its website.

"It has always been understood that the restructuring definition cannot catch all possible events," according to the statement. "If a creditor is hedging using CDS, and declines to participate in a voluntary restructuring, then the creditor would still hold its original debt claim and its CDS hedge."

Exchange Terms

Much still needs to be resolved after the 10-hour Brussels talks, including how to strengthen the euro region's 440 billion-euro bailout fund and what banks will get in return for accepting the writedown on their Greek bonds. This includes the collateral they'll be given and whether future bank debt is backed by a national or European guarantee. Either way, the deal will likely be structured as a voluntary agreement to avoid a default-swap trigger.

"It is symptomatic of the regulatory and legal goalposts being constantly shifted either randomly or to suit political interests," said Marc Ostwald, a fixed-income strategist at Monument Securities Ltd. in London. "For genuine long-term investors, either financial or non-financial, it's a major liability."

To contact the reporter on this story: John Glover in London at johnglover@bloomberg.net

To contact the editor responsible for this story:Paul Armstrong at parmstrong10@bloomberg.net