

FINANCIAL TIMES

Credit default swaps

Credit default swaps: a \$10tn market that leaves few happy

Owners of contracts designed to insure against default frequently find themselves stymied



© Bloomberg
Robert Smith
JULY 24, 2017

If your house were burgled, you would expect your insurance to pay out for the stolen items in full.

Imagine your dismay if the company providing the cover said you could — in theory — sue the burglar, so it was not sure whether you deserved full compensation.

If you had no intention of launching a lawsuit, the insurer might assess how much your right to take legal action was worth, and deduct this from your payment.

The scenario may seem far fetched, but this is precisely the predicament Banco Popular credit-default swap holders [find themselves in](#).

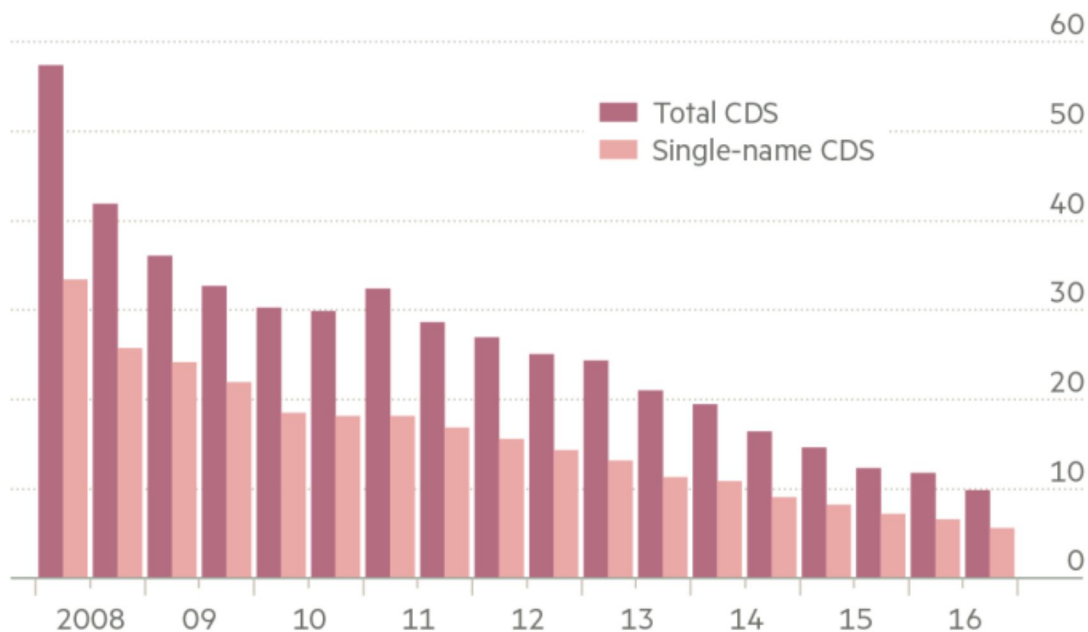
A committee from the International Swaps and Derivatives Association (Isda) is gathering feedback on whether bondholders' right to pursue litigation over the Spanish bank's collapse could be viewed as an asset that would ultimately limit any payout to owners of the CDS.

While use of credit derivatives has declined since the financial crisis, it is still a \$10tn market. And the Popular episode highlights that despite recent overhauls, the instrument still has handicaps when it comes to its intended purpose — insuring bonds against default.

“CDS is definitely good for trading strategies and tagging along to the market sentiment around a particular story, but when it comes to insuring against a default it's never a perfect proxy,” said Gildas Surry, a partner at Axiom Alternative Investment.

Shrinking market: CDS contracts outstanding

\$bn



Source: Bank for International Settlements

FT

The paradox of CDS is that the so-called credit insurance market is not actually insurance at all. This central tenet of the market was enshrined in law 20 years ago, through a legal opinion Robin Potts QC provided to Isda in 1997, which market practitioners said was necessary to ensure CDS remained tradable instruments.

Cynics argue that this has allowed the market to escape more stringent regulation, however. After all, while you cannot legally buy insurance on someone else's car, for fear of foul play, investors frequently buy CDS contracts on bonds they do not own.

Concerns around foul play often dog the CDS market, given that the funds that buy and sell CDS can also change the fate of the companies involved by offering or withholding finance.

A group of hedge funds that sold CDS on UK retailer Matalan recently offered [to fully support a new bond issue](#) from the company, so long as the company issues the debt out of a new entity. This process would "orphan" existing CDS contracts written against the old entity, making them essentially worthless as they no longer reference any debt, and hand the funds a profit.

Sources with knowledge of the matter said that Matalan was unlikely to accept the deal, but noted that concerns around orphaning had still contributed to a collapse in value of CDS contracts linked to its debt.

"If you're shorting through the CDS market you should've learnt by now that you can get the credit trajectory correct, but still lose money due to the nature of the instrument," said a bond portfolio manager.

Some market practitioners fear that these attempts to exploit contractual quirks have undermined liquidity in the so-called single-name CDS market, where investors buy insurance on a single company, rather than a broad basket of companies through an index.

"All the legal complexities of CDS create a nice playground for hedgies, but we need to have more

and more investors involved,” said Jochen Felsenheimer, a managing director at XAIA Investment. “Real-money investors are happy using the indices, but as long as they see tricky goings on in single-name CDS, they simply won’t touch it.”

Cost of Matalan’s CDS falls

Upfront cost of buying five-year CDS (%)



Source: Thomson Reuters Datastream

FT

The potential for a messy outcome on Banco Popular has caused particular consternation because the CDS market’s rules were rewritten in 2014 ostensibly to iron out major flaws in the auction process. These auctions see traders bid on defaulted bonds and other assets to determine their value, deciding the level of payout that CDS buyers receive.

“It’s the biggest problem in CDS and it’d be much neater if you always had a payout at 100 [per cent],” said an analyst at a credit hedge fund. “You just don’t know what you’re going to get back in the auction. It’s needlessly complex, but it suits a load of different people, unfortunately.”

Isda has made efforts in recent years to make the determinations committees, which decide on the outcomes and auction processes in the CDS market, more independent and transparent. But many in the market argue that the scope for conflicts of interest is still rife.

Asset manager Pimco sits on the Isda committee deciding whether legal claims should be included in the Banco Popular auction, for example, but is also part of the bondholder group that has hired lawyers to explore litigation options. Pimco declined to comment.

This widespread distrust of the auction process is yet another drag on the market.

“When you have guys trying to find a clause which could be interpreted in a certain way to trigger a fancy outcome in the auction — sure they will make a nice one-time profit, but step by step they will destroy a very useful market that needs to be kept alive,” said Dr Felsenheimer.