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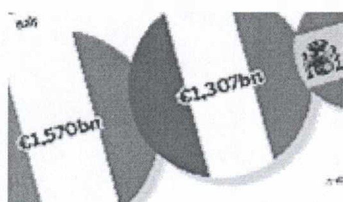
Bankers fear political moves will kill off CDS

By David Oakley and Tracy Alloway

It has been blamed by politicians for causing the eurozone debt crisis and attacked as the favoured asset of "evil speculators".

Now, politicians are seeking to take their revenge: not just with the recent introduction of bans on some trading of credit default swaps but also in their attempts to ensure that any haircut on Greek government bonds does not trigger a credit event.



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Combined, these two events could spell the end of the credit default swaps market, say bankers.

Sovereign CDS – used to protect creditors against defaults – have been bought by hedge funds and other investors as protection against possible default. But concerns over this market are rising following the latest plans to hit holders of Greek debt with punitive haircuts of 60 per cent and the European Union wide ban on naked trading, or the buying or selling the assets without owning underlying bonds.

Bankers fear the market could be "killed stone dead", in the words of one, if politicians put pressure on banks to accept big haircuts without triggering a CDS payout, while a ban on naked trading could hit liquidity.

The EU wants to prevent speculation in this market as it believes this could drive up government borrowing costs. Policymakers are also keen to avoid a credit event on Greek CDS, fearing this could put further pressure on those banks having to pay out.

But these aims could backfire. Some bankers believe, rather than lowering borrowing costs, these moves will have the reverse effect and also restrict lending to their banks and companies.

In the wake of the CDS ban, some banks are already pushing alternative strategies that risk driving up government bond yields even further. Last week Citigroup, the leading US bank, recommended selling the bonds of France, Italy and Spain because of the trading ban while other banks have warned they could unload peripheral bonds if CDS payouts are ruled out on Greece.

Last week Spanish and Italian CDS prices fell, while yields on the debt of these countries rose, a possible indication, according to some market participants, that some funds and banks may be closing out their positions in CDS while selling bonds.

Michael Hampden-Turner, fixed income strategist at Citigroup, says: "We have recommended selling French, Italian and Spanish bonds against CDS because fast money banned from taking shorts in CDS will likely try and reset those shorts in the bond market. There is a danger that politicians will drive up bond yields and borrowing costs because of the ban, which is an unintended consequence that could hit the peripheral economies."

Another banker, who is responsible for managing risk at a big European institution, adds: "If there are not going to be payouts [from CDS] and liquidity dries up because of the trading ban, then we will not be able to use CDS as a hedge. That means not only selling bonds of countries like Italy and pushing up their borrowing costs, but telling our country managers there they will have to restrict loans to companies and businesses."

The International Monetary Fund warned in a recent report that investors seeking hedges other than CDS, could include shorting government bonds, bank equity or simply cutting their exposure. Shorting government bonds is "one option", says Seamus MacGorain, at JPMorgan.

The European Commission, which announced the naked trading ban earlier this month, insists the move will ensure sovereign CDS is used for hedging risk only, the purpose it was designed for.

Other policymakers insist CDS can cause selling pressure in the bond markets and equities, too, because they move more quickly and sharply. Michel Barnier, EU commissioner for the single market, said this month that short selling, or naked trading, did not cause the eurozone debt crisis, but can aggravate price declines in distressed markets.

Even market participants admit the small size of the CDS markets, which are about 20 per cent the size of the government bond markets, can mean they are easier to manipulate. Certain hedge funds are believed to have squeezed prices higher in the CDS market so they can then sell protection later for profit.

However, there is still a worry in the markets over the changing position of the EU commission as the eurozone crisis has deepened. A Commission report last year found no evidence that CDS prices influenced other markets, yet now they propose there could be a link. Some bankers say this change is because of pressure heaped on them as Italy has been sucked into the debt crisis.

On the Greek credit event, it is still unclear what will happen. The International Swaps and Derivatives Association, the derivatives trade body, is likely to rule that there is no credit event, regardless of the size of haircuts, so long as it is deemed voluntary.

But as the haircut increases, the risks rise that investors ,will no longer agree to a voluntary deal. Bankers say few serious investors would agree to losses of 60 per cent voluntarily.

Opinions are divided over how damaging a non payment scenario would be on CDS. Some bankers say Greece is a one-off and may have little effect, while others insist it could undermine the market and usher in a worrying precedent for CDS payouts.

However, one thing is certain, say bankers: there is a risk that political interference in the CDS markets may end up hurting the peripheral and other economies by forcing borrowing costs higher and ushering in tighter lending conditions for banks and companies rather than helping to navigate the continent's debt crisis.

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