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Fitch backs calls for sovereign CDS reform

By Michael Mackenzie in New York

Calls to reform the market for insuring against the default of sovereign debt have been backed by a leading credit rating agency following the voluntary deal for exchanging Greek bonds proposed last month.

The usefulness of so-called credit default swaps to act as insurance on sovereign debt for investors has been increasingly called into question by market participants following the Greek deal.

As it is a voluntary agreement, the proposal would not trigger a pay-out on CDS as the deal would not constitute a "credit event" by the International Swaps and Derivatives Association, the industry body. Fitch Ratings says that, as a result, the settlement of CDS on sovereign countries requires clarification.

"It would seem that the use of the restructuring credit event generally and the nature of the language employed should probably be revisited," the agency says in a report to be released on Monday.

James Batterman, managing director in Fitch's credit policy group and one of the report's authors said that while the Greek debt example would not trigger a pay-out under the language of the standardised ISDA contracts for the CDS, "creditors have taken possibly a very significant hit on their holdings that they will never get back".

"Permanent impairment [of the value of their assets] has been suffered."

The use of credit default swaps on debt-laden eurozone countries has expanded greatly in recent years, with holders of government bonds buying CDS in order to protect their portfolios from a future debt default.

When a country or company defaults, investors who have paid a premium for credit protection are compensated for their losses on bonds by another party who sold the CDS and received the initial premium.

The greater use of CDS on eurozone sovereigns has coincided with growing concern about sovereign debt markets, which have pushed government bond yields for Greece, Italy, Spain, Ireland, Portugal and France sharply higher.

Fitch's report notes that more than half of the approximately $85bn increase in net CDS exposure since the end of 2008 is attributable to European countries, with more than 60 per cent of all sovereign notional exposure currently referencing European entities.

"Doubts about the restructuring credit event as well as any restrictions placed on trading are not plusses as far as the sovereign CDS market is concerned," said Mr Batterman.

"All CDS language needs to avoid subjectivity and excessive complexity, which makes formulating restructuring event language more difficult than for other types of credit events."

In response to mounting criticism, the ISDA last week wrote in the Financial Times: "The CDS definitions clearly provide that restructuring of bonds will trigger a credit event if the restructuring plan binds all holders."

While the Greek CDS market is small, it has cast a cloud over the usefulness of buying protection against other debt-laden countries in the eurozone. Indeed, net notional exposure to eurozone CDS has been gradually declining, suggesting that some investors are cutting their trades.

"The absence of a CDS "credit event" in Greece – while entirely within the ISDA rules – in practice has undermined banks' confidence in their ability to rely on CDS protection for any sovereign debt," said analysts at Barclays Capital.

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