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Questions over CDS amid pay-out wrangle

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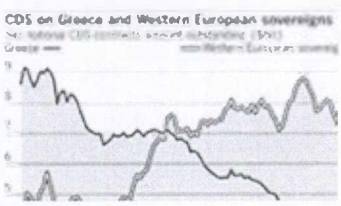
Sovereign debt fears shine the spotlight on insurance against default

Since their creation in the 1990s, credit default swaps, a form of insurance against defaults of loans and bonds, have emerged as a vital component of the global financial system, with about $28,000bn of contracts currently outstanding.

However, the market has long been contentious due to its sheer size and opacity. Transparency has improved markedly in recent years but some investors and bankers are becoming increasingly concerned that CDS may not always work as hoped.



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Those fears have revolved primarily around CDS on sovereign debt. Brevan Howard, Europe's second-largest hedge fund manager, warned as far back as January 2010 that it had significant concerns about regulatory or political interference in CDS markets.

"The fund [has] continued its approach of not taking short positions in peripheral European debt markets either through government bonds or sovereign CDS," Brevan reiterated to clients two months ago.

More recently, some fund managers have expressed concerns that the integrity of CDS on corporate debt may also be subject to interference – by the very industry body set up to regulate the market.

After three deferments, the "determinations committee" of the International Swaps and Derivatives Association on Monday referred a decision on whether Seat Pagine Gialle, the Italian directory company, has defaulted on its debts to external review.

Referral to an external panel of three independent experts is a fail-safe mechanism for when the committee cannot reach a required super-majority of nine out of 15 votes. It has only happened once before, with Cemex, the Mexican cement maker, in 2009. In that case, the external panel ruled that a default had taken place.

Despite the referral to external experts, some bankers and fund managers are still concerned by the fact that members of the determinations committee are made up of institutions that buy and sell CDS – banks, hedge funds and some of the world's largest investors. This means that many of the committee members could have a conflict of interest.

"It's a multitrillion-dollar insurance market where the people who rule on the pay-outs are market participants and can be conflicted," argues one hedge fund executive who has bought Seat Pagine CDS. "What's the point of buying insurance if the process can be delayed so long that the contracts never pay out?"

Part of Seat Pagine's current restructuring proposal involves turning nearly all of the junior debt into equity. It is the more junior debt that most of the CDS contracts reference.

If the panel of external experts finds that there has been a credit event but the junior debt has been "equitised", the pay-out to CDS holders will be much lower. Settlement mechanics on the contracts require the existence of debt at the same level of seniority.

The cost of insuring €10m of Seat Pagine's relevant debt against default cost as much as €8m upfront earlier this week, but the cost fell to about €7.5m on Tuesday, implying increasing uncertainty as to whether the CDS will be triggered and holders will receive a full pay-out.

In the case of Greece, CDS pay-outs will not be triggered as long as the bond swap is voluntary, according to Isda definitions. The amount of engineering by politicians and their banker advisers to ensure this – seemingly expressly to avoid a formal default – has rattled the market.

These cases highlight how a quest to standardise and nurture the CDS market through Isda's rulebook-based approach can clash with the reality of often complex debt structuring and documentation, and the relationship between borrower and lender, particularly in restructurings.

However, many bankers and some investors argue that CDS still work as advertised in the vast majority of cases.

"There have been situations where the contracts haven't worked as expected," says a banker familiar with the Isda determination committee's thinking, "but that is not a reason to discount the efficiency of the entire market."

Many experts also doubt that Isda's determination committee would collude in protecting members from losses.

If there are enough aggrieved holders of CDS that are not triggered, they can also lobby Isda to change the definitions. The rulebook has already gone through several rewrites. For example, a standard clause for CDS that references European corporate debt is called "modified modified restructuring", a testament to the changes through which it has gone.

Nonetheless, it is clear that the CDS market will continue to be tested in the coming years, given the limp economic outlook and likelihood of further defaults by companies – and governments.

Additional reporting by Sam Jones