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Germany set to overtake Italy in CDS protection

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Germany is on course to overtake Italy and France as the most insured sovereign in the global credit default swap market, where investors buy protection against default, analysts say.

"The fact that net notional CDS outstanding on Germany is looking set to overtake Italy at $20bn [last week] may raise some eyebrows," particularly after last week's "failed" auction of German government debt, JPMorgan analysts wrote in a note to their clients. They added that, if current CDS trends continued, Germany would overtake France as the most insured country by mid-January.

The analysts expect the net notional amount of CDS, or the maximum amount that would have to be paid out in the event of a default, written on German government debt to have swelled to $20bn as of last week. Data for the most recent week, ending November 25, are due to be released late on Tuesday by the Depository Trust & Clearing Corporation, which compiles global CDS figures.

Sovereign CDSs can act as an insurance-like product, used to protect an investor's government bond holdings, or as an outright bet on the creditworthiness of a sovereign.

However, market participants say the Germany's move into second place may have more to do with a decrease in the amount of CDS written on Italian and French government debt, than increased demand for protection on German bonds or a bet on its financial health. Brokers and traders say Italian and French CDS have dropped because Rome, in particular, is seen as a default risk.

That may seem perverse in a market that is supposed to offer default protection. But, in such a scenario, institutional investors and banks say they would seek to simply exit the markets rather than purchase more protection.

"Buying CDS may not help you in a default situation," said one trader at a US bank. "In a default situation, you simply want no exposure to that country or credit, which means selling the bonds, not shorting them through CDS."

France rose above Italy to the top spot in August this year, according to JPMorgan. The DTCC began collecting the data in October 2008, the month after the onset of the crisis triggered by the collapse of Lehman Brothers.

CDS written on Italy's debt amounted to $20.1bn as of November 18, the latest available data. CDS on France was $22.6bn and swaps on Germany stood at $19.9bn.

Additional reporting by Lisa Pollack

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