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Fears for CDS market after Greek decision

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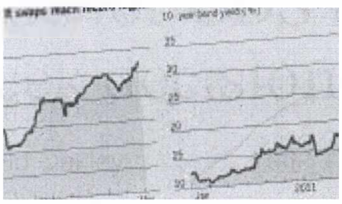
It might be a non-event, not a credit event. But Thursday's decision that insurance-like instruments should not pay out on Greek bonds has potentially huge repercussions for the eurozone debt markets.

Investors and traders fear the decision by the International Swaps and Derivatives Association not to trigger a credit event in Greek credit default swaps will undermine the entire multitrillion-dollar CDS market.



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It is yet another twist in the long-running saga over Greece and sovereign CDS – relatively new instruments that are used by banks and investors to hedge risk or bet on the creditworthiness of countries.

The crux of the matter is the timing of a decision over whether a pay-out will be made. Crucially, Thursday's "no vote" by the determination committee of Isda, the trade body that represents the derivatives industry, means investors holding CDS may be paid less than they had hoped.

This could, therefore, deter bankers and investors from buying the instruments, jeopardising the future of the product, say traders. It could also prompt some funds and banks to sell peripheral eurozone bonds as they can no longer be sure of the instruments used to hedge the risk of holding the debt.

Paul Griffiths, global head of fixed income at Aberdeen Asset Managers, says: "If CDS has been used to measure the perceived creditworthiness of a country or as a bet on the direction on the market, it still has value. But if it has been used to hedge against risk, then its intrinsic value has been hurt because you are not necessarily going to get back the amount of money you had hoped you would."

The market still believes a credit event will be activated next week when Greece is finally expected to announce it will use collective action clauses to force creditors to accept about 70 per cent in losses in a debt swap.

But this means the debt used to set the level of the pay-out will be new bonds, issued as part of the exchange, instead of existing ones, which would have been used had the credit event been triggered on Thursday. As these new bonds are expected to trade at a higher par value than the old bonds, any CDS pay-out would be less.

A rough estimate by traders is that the new bonds, which have long maturities and low coupons, will trade at about 50 per cent of par compared with the old bonds, which mostly trade at about 24 per cent.

This means instead of receiving 76 per cent of the par value, or the amount needed to make a par value of 100, a buyer of CDS protection will receive only 50 per cent.

The timing of an announcement over a pay-out explains why there has been a rush by some investors to try to have a credit event declared ahead of the completion of the debt swap.

One request for a credit event said the de facto seniority of the European Central Bank in the deal meant private creditors had been subordinated. The second said pay-outs should be triggered because the mere existence of collective action clauses signified a credit event. These clauses will allow Greece retroactively to force recalcitrant creditors to take part in any deal as long as two-thirds of investors support the swap.

Isda's determinations committee disagreed. But people familiar with the situation said that if Greece finally used them, as expected next week, then a credit event would be activated.

Some, such as Pimco's Bill Gross, have criticised Thursday's decision, saying it sets a dangerous precedent.

However, some market participants say it is unlikely to harm sovereign CDS. They say global banks, which are the biggest users for hedging purposes, are aware they should not be used as a guaranteed insurance against a default.

Others say it still unclear exactly what the pay-out will be and warn against second-guessing the amount set in an auction process that will decide this, which might take another three weeks to complete.

One senior risk manager at a US bank says: "The fact is, CDS is useful. But it is not a perfect hedge. We know that. One non-decision will not bring the market to a shuddering halt. It will just mean that people will be more careful when they decide whether to use them, which is a good thing for CDS and the debt markets."