Payments ruled out on Greek debt swaps

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Industry arbiter decides that bailout did not activate default protection

BY PETER EAVIS

A trade group and arbiter for the derivatives industry said Thursday that based on current evidence, the Greek bailout would not prompt payments on the credit-default swaps linked to the country's bonds.

But the organization, the International Swaps and Derivatives Association, warned that the situation in Greece was "still evolving" and such payouts might be necessary in the future "as further facts come to light."

In the midst of the Greek drama, credit-default swaps, insurancelike instruments intended to protect against losses on debt, have once again raised worries.

During the financial crisis of 2008, derivatives contributed to the mess. Banks feared that their trading partners might not make good on their obligations, a situation that panicked the markets and nearly brought the financial systems to its knees.

As part of Greece's restructuring, bondholders will be required to take a loss of more than 70 percent on their holdings. When first announced, the deal was proposed as a voluntary exchange, which would not have activated the credit-default swaps. But in recent weeks, Greece has prepared to require all private bondholders to accept the losses through legal means. This would make the exchange involuntary and almost certainly set off the swaps.

This week, two undisclosed parties asked the derivatives group to rule on whether various aspects of the Greek debt exchange would necessitate swap payments.

One party raised a specific issue, related to the European Central Bank. While private bondholders will take a loss on their holdings, the E.C.B. was able to avoid those losses by striking a separate deal w[illegible] Greece. The party wondered if that qualified as "subordination" and would prompt swap payments.

Another party took a broader approach, asking if any part of the proposed Greek debt exchange — and the resulting losses — would activate the swaps.

But so far the trade group has not been swayed. On Thursday, the organization said a committee had "unanimously determined" in both cases that a credit event did not occur.

The 15-member committee behind the decision includes 10 banks that deal in derivatives and five asset management firms. For a decision to be approved, it has to have the backing of at least 12 members. The organization says this prevents a situation where the banks alone can sway a vote. In the most recent Greek votes, all 15 members voted against activating the swaps.

One question the process faces is whether committee members will vote according to their economic interest. Many of the banks on the committee have recently reported substan[illegible] exposure to swaps on Greek gover[illegible]ent bonds. For instance, Barclays, which voted against swaps activation on Thursday, had sold default protection on $5.92 billion of swaps on Greek debt, and bought $5.81 billion of protection, as of Sept. 30 last year, according to the European Banking Authority.

Despite the unanimous vote, the organization did not shut the door entirely on the possibility of a payout. Market participants, the group said, can still submit questions on the deal. And given that Greece could use legal means to require all private bondholders to accept losses, the action could still set off the swaps.

Even so, the ruling — and the prospect that Greece could default without activating the swaps — could reignite the debate about the usefulness of the financial instruments. If borrowers can structure defaults to circumvent swaps payouts, investors may see the swaps as unreliable.

"The market has been harmed by people playing games to avoid events that would be covered by the insurance," said John B. Sprow, chief risk officer at Smith Breeden Associates, a fund management firm.