

# Mammoth Financial Losses: Credit Default Swaps - Exercises in Surrealism

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At the quantum level, the laws of classical physics alter in intriguing ways. In financial markets, at the derivative level, the rules of finance also operate differently.

The derivative industry's indefatigable advocacy of credit default swaps ("CDS") centers on the fact that contracts related to recent defaults settled and the overall net settlement amounts were small. Closer scrutiny suggests causes for caution.

The CDS contract is triggered by a "credit event"; broadly, default by the reference entity. CDS contracts on Freddie and Fannie were 'technically' triggered as a result of the conservatorship necessitating settlement of around \$500 billion in CDS contracts with losses totaling \$25 to \$40 billion. Government actions were specifically designed to allow the firms to continue fully honouring their obligations. Triggering of these contracts poses questions on the effectiveness of CDS contracts in transferring risk of default.

Practical restrictions on settling CDS contracts has forced the use of "protocols" - where counterparties may substitute cash settlement for physical delivery. In cash settlement, the seller makes a payment to the buyer of protection to cover the loss suffered by the protection buyer based on the market price of defaulted bonds established through an "auction" system.

For the GSEs, the auction prices resulted in the following settlements by sellers of protection: Fannie Mae - around 8.49% for senior debt and 0.01% for subordinated debt. Freddie Mac - around 6.00% for senior debt and 2.00 % for subordinated debt.

Subordinated debt ranks behind senior debt and is expected to suffer larger losses in bankruptcy. The lower payout on subordinated debt probably resulted from subordinated protection buyers suffering in a short squeeze resulting in their contracts expiring virtually worthless. Differences in the payouts between the two entities are also puzzling given that they are both under identical "conservatorship" arrangements and the ultimate risk in both cases is the US government.

In other CDS settlements in 2008 and 2009, the payouts required from sellers of protection have been highly variable and large relative to historical default loss statistics. This may reflect poor economic conditions but are more likely driven by technical issues related to the CDS market.

For example, the Washington Mutual payout (around 43%) may have been affected by

capital remaining at the holding company, Washington Mutual Inc. (estimated at \$2.8 billion). More recently, the auction settlement of Lyondell (around 80-85%) reflected complication from the role of debtor in possession financing and complex collateral allocation mechanisms.

Skewed payouts do not assist confidence in CDS contracts as a mechanism for hedging. In addition, the large payouts are placing a material pressure on the price of underlying bonds and loans exacerbating broader credit problems.

Low overall net settlement amounts may also be misleading. In practice, there are actually two settlements. The 'real' settlement where genuine hedgers and investors deliver bonds under the physical settlement rules (i.e. those who actually own bonds and were hedging). The 'auction' where dealers who have both bought and sold protection and have small net positions settled via the auction.

In the case of Lehman Brothers, the net settlement figure of \$6 billion that was quoted refers to the auction. Some banks and investors that had sold protection on Lehmans did not participate in the auction choosing to take delivery of defaulted Lehman debt resulting in losses of almost the entire face value.

CDS contracts can amplify losses in credit market. Lehman Brothers defaulted with around \$600 billion in debt implying a maximum loss to creditors of that amount. In addition, according to market estimates, there were CDS contracts of around \$400-500 billion where Lehmans was the reference entity.

Market estimates suggest that only around \$150 billion of the CDS contracts were hedges. The remaining \$250-350 billion of CDS contracts were not hedging underlying debt. The losses on these CDS contracts (in excess of \$200-300 billion) are additional to the \$600 billion. The CDS contracts amplified the losses as a result of the bankruptcy of Lehmans by (up to) approximately 50%.

The CDS market is also complicating restructuring of distressed loans as all lenders do not have the same interest in ensuring the survival of the firm. A lender with purchased protection may seek to use the restructuring to trigger its CDS contracts.

As the global economy slows and the risk of corporate default increases sharply, the identified issues with CDS contracts are likely to complicate the problems of credit markets and banks generally.

In October 2008, Alan Greenspan, the former Chairman of the Fed, acknowledged he was "partially" wrong to oppose regulation of CDS. "Credit default swaps, I think, have serious problems associated with them," he admitted to a Congressional hearing.

Ludwig von Mises, the Austrian economist from the early part of the twentieth century, once noted: "It may be expedient for a man to heat the stove with his furniture; but he should not delude himself by believing that he has discovered a wonderful new method of heating his premises".

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