

The Next Derivatives Bloodbath: Insurance Companies and Auto Makers

By [George Washington's Blog](#)

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This essay is about future derivatives problems. But before we look to the future, let's recap what happened yesterday, to gain some perspective.

Post-Game Analysis on Lehman

As the Washington Post [writes](#) today about yesterday's auction of some \$400 billion dollars in credit default swaps for Lehman:

'If we see defaults from the standpoint that protection sellers don't pay up, then we're going to have a huge problem in the market,' Telpner said. 'But we don't have any explicit evidence indicating that sellers ultimately are not going to be able to pay the amounts owed to buyers.'

And the Sunday Times [writes](#) today:

"The valuation leaves the insurers of the debt a bill of about \$365 billion. It is not clear whether the insurers, which are required to settle the bill in the next two weeks, will be able to pay - a development that could further undermine increasingly stressed capital markets."

Will the insurers" of Lehman's CDS be able to pay up? The big bank [insurers](#) to the Lehman swaps have been [hoarding cash](#), and so can presumably pay.

The bigger question is whether the [hedge funds](#) - such as Citadel - will be able to pay up or will go belly up. The next couple of weeks will tell.

But even if no companies are wiped out by their Lehman CDS obligations, it is clear that yesterday was, indeed, a traumatic day for the world economy. As today's Sunday Times article put it:

"Lehman's corporate debt default promises to increase the stress across global credit markets. Sean Egan, of the Egan-Jones ratings agency, said: 'This is a killer. Lehman said a month ago that it was in terrific shape and now you can't even get ten cents on the dollar for its debt.'

'It underscores the deep structural flaws in our financial system, knocks confidence in the financial markets and raises the cost of capital. It also

demonstrates that we are experiencing not only a crisis of confidence, but a crisis.”

Next Up: Automakers

The next phase of the derivatives wipeout will hit insurance companies and auto makers.

Initially, Standard and Poor’s is [saying](#) that GM and Ford may very well go bankrupt.

As of 2004, “[GM was among the five companies most frequently included in credit-derivatives contracts in 2004, along with Ford Motor Co.](#), France Telecom SA, DaimlerChrysler AG and Deutsche Telekom AG, Fitch said. Investors bought more contracts protecting payments from Korea, Italy and Russia than any other governments.”

Indeed, according to [Fitch’s](#), as of 2004 and 2005, there were perhaps billions of dollars in GM credit default swaps traded per day. Fitch’s noted that “GM CDS are the second most included named in synthetic collateralized debt obligations (CDOs), behind Ford, as disclosed in several Fitch analyses of the CDS market.”

On October 3rd, Bloomberg [wrote](#):

General Motors Corp. saw its credit default swaps rise to a record after the automaker said Sept. 19 it was going to draw down the remainder of a \$4.5 billion revolving credit line to preserve cash because of the instability in the financial markets. Detroit-based GM, the largest U.S. carmaker, has lost almost \$70 billion since 2004.

As of June of this year, “[The cost to insure GM’s debt with credit default swaps rose to 33.5 percent upfront . . . plus annual payments of 500 basis points](#)” and “[Ford saw its credit default swap spread increased to 30.5 percent upfront, plus 500 basis points annually](#)”.

According to financial advisor Mike “Mish” Shedlock, there are approximately [one trillion dollars](#) of credit default swaps for GM.

If GM went bust, there would be huge credit default swap liability. While I have seen no estimates of the current amount of Ford CDS, it is probably also quite high, given that it was one of the most common CDS issued in 2004.

Insurance

The insurance companies are also getting hit hard by CDS.

The October 3rd Bloomberg article goes on to state:

“The cost to protect against default by Hartford, Prudential Financial Inc. and MetLife Inc. soared to records and shares fell yesterday on speculation that turmoil in financial markets may be spreading to insurance companies.”

As an [article](#) at Naked Capitalism explains:

First it was banks and securities firms, and now the focus of worry has widened to include insurance companies. Reader John referred us to a Reuters article that MetLife credit default swaps are now trading on an upfront basis, which means buyers of protection against the default of MetLife bonds must make an upfront payment as well as agreeing to periodic fees. Only companies seen as being in serious risk of failure trade on an upfront basis. Another story shows similar pricing of XL Capital CDS.

Concerns about MetLife became serious when the company [announced it was writing down its investment portfolio and withdrew its 2008 earnings forecast](#).

From [Reuters](#):

Metlife Inc's credit default swaps on began trading on an upfront basis on Thursday, indicating perceptions that its credit quality is considered distressed.

The cost to insure Metlife's debt rose to around 10.5 percent the sum insured as an upfront sum, or \$1.05 million to insure \$10 million in debt for five years, in addition to annual premiums of 5 percent, according to Markit Intraday.

The swaps had closed on Wednesday at a spread of around 717 basis points, or \$717,00 per year for five years to insure \$10 million in debt, according to Markit.

The second [Reuters story](#):

Credit default swaps on XL Capital Ltd (XL.N: Quote, Profile, Research) began trading on an upfront basis on Thursday, and its stock price plunged more than 37 percent.

The cost to insure XL's debt rose to around 12.5 percent the sum insured as an upfront sum, or \$1.25 million to insure \$10 million in debt for five years, in addition to annual premiums of 5 percent, according to Phoenix Partners Group....

The swaps had opened at a spread of around 750 basis points, or \$750,00 per year for five years to insure \$10 million in debt, according to Phoenix.

Instead of being the end of the derivatives bloodbath, Lehman was probably just the beginning.

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