Credit Default Swaps: The Next Crisis?

By Janet Morrissey Monday, Mar. 17, 2008

Traders work on the floor of the New York Stock Exchange.
Richard Drew / AP

As Bear Stearns careened toward its eventual fire sale to JPMorgan Chase last weekend, the cost of protecting its debt, through an instrument called a credit default swap, began to rise rapidly as investors feared that Bear would not be good for the money it promised on its bonds. Not familiar with credit default swaps? Well, we didn't know much about collateralized debt obligations (CDOs) either — until they began to undermine the economy. Credit default swaps, once an obscure financial instrument for banks and bondholders, could soon become the eye of the credit hurricane. Fun, huh?

The CDS market exploded over the past decade to more than $45 trillion in mid-2007, according to the International Swaps and Derivatives Association. This is roughly twice the size of the U.S. stock market (which is valued at about $22 trillion and falling) and far exceeds the $7.1 trillion mortgage market and $4.4 trillion U.S. treasuries market, notes Harvey Miller, senior partner at Weil, Gotshal & Manges. "It could be another — I hate to use the expression — nail in the coffin," said Miller, when referring to how this troubled CDS market could impact the country's credit crisis.

Credit default swaps are insurance-like contracts that promise to cover losses on certain securities in the event of a default. They typically apply to municipal bonds, corporate debt and mortgage securities and are sold by banks, hedge funds and others. The buyer of the credit default insurance pays premiums over a period of time in return for peace of mind, knowing that losses will be covered if a default happens. It's supposed to work similarly to someone taking out home insurance to protect against losses from fire and theft.

Except that it doesn't. Banks and insurance companies are regulated; the credit swaps market is not. As a result, contracts can be traded — or swapped — from investor to investor without anyone overseeing the trades to ensure the buyer has the resources to cover the losses if the security defaults. The instruments can be bought and sold from both ends — the insured and the insurer.

All of this makes it tough for banks to value the insurance contracts and the securities on their books. And it comes at a time when banks are already reeling from write-downs on mortgage-related securities. "These are the same institutions that themselves have either directly or through subsidiaries invested in the subprime market," said Andrea Pincus, partner at Reed Smith LLP. "They're suffering losses all over the place," and now they face potentially more losses from the CDS market.

Indeed, commercial banks are among the most active in this market, with the top 25 banks holding more than $13 trillion in credit default swaps — where they acted as either the insured or insurer — at the end of the third quarter of 2007, according to the Comptroller of the Currency, a federal banking regulator. JP Morgan Chase, Citibank, Bank of America and Wachovia were ranked among the top four most active, it said.

Credit default swaps were seen as easy money for banks when they were first launched more than a decade ago. Reason? The economy was booming and corporate defaults were few back then, making the swaps a low-risk way to collect premiums and earn extra cash. The swaps focused primarily on municipal bonds and corporate debt in the 1990s, not on structured finance securities. Investors flocked to the swaps in the belief that big corporations would seldom go bust in such flourishing economic times.

The CDS market then expanded into structured finance, such as CDOs, that contained pools of mortgages. It also exploded into the secondary market, where speculative investors, hedge funds and others would buy and sell CDS instruments from the sidelines without having any direct relationship with the underlying investment. "They're betting on whether the investments will succeed or fail," said Pincus. "It's like betting on a sports event. The game is being played and you're not playing in the game, but people all over the country are betting on the outcome."

But as the economy soured and the subprime credit crunch began expanding into other credit areas over the past year, CDS investors became jittery. They wondered if the parties holding the CDS insurance after multiple trades would have the financial wherewithal to pay up in the event of mass defaults. "In the past six to eight months, there's been a deterioration in market liquidity and the ability to get willing buyers for structured finance securities," causing the values of the securities to fall, said Glenn Arden, a partner at Jones Day who heads up the firm's worldwide securitization practice and New York derivative.

The situation is already taking a toll on insurers, who have been forced to write down the value of their CDS portfolios. American International Group, the world's largest insurer, recently reported the biggest loss in the company's history largely due to an $11 billion writedown on its CDS holdings. Even Swiss Reinsurance Co., the industry's largest reinsurer, took CDS writedowns in the fourth quarter and warned of more to come in the first quarter of 2008.

Monoline bond insurance companies, such as MBIA and Ambac Financial Group Inc., have been hit the hardest as they scramble to raise capital to cover possible defaults and to stave off a downgrade from the ratings agencies. It was this group's foray out of its traditional municipal bonds and into mortgage-backed securities that caused the turmoil. A rating downgrade of the monoline companies could be devastating for banks and others who bought insurance protection from them to cover their corporate bond exposure.

The situation is exacerbated by the heavy trading volume of the instruments, the secrecy surrounding the trades, and — most importantly — the lack of regulation in this insurance contract business. "An original CDS can go through 15 or 20 trades," said Miller. "So when a default occurs, the so-called insured party or hedged party doesn't know who's responsible for making up the default and if that end player has the resources to cure the default."

Prakash Shimpi, managing principal at Towers Perrin, downplays this risk, noting that contractual law requires both parties to inform and get approval from the other before selling the CDS policy to someone else. "These transactions don't take place on a handshake," he said. Still, being unregulated, there is no standard contract, no standard capital requirements, and no standard way of valuating securities in these transactions. As a result, Pincus said she wouldn't be surprised to see a surge in litigation as defaults start happening. "There's a lot of outcry right now for more regulation and more transparency," said Pincus.

A meltdown in the CDS market has potentially even wider ramifications nationwide than the subprime crisis. If bond insurance disappears or becomes too costly, lenders will become even more cautious about making loans, and this could impact everyone from mortgage-seekers to municipalities that need money to fix roads and build schools. "We're seeing players in all of those spaces being more circumspect about whose credit they're going to guarantee and what exactly the credit obligation is," said Ellen Marshall, partner at Manatt, Phelps & Phillips LLP.

Shimpi admits a meltdown or even a slowdown in the CDS market would affect the amount and cost of liquidity in the market. However, he dismisses concerns that municipalities and others seeking capital could be left in the dust. "Even if the U.S. takes a hit, there are other markets in the world that have different dynamics, and capital flows are international," he said.

Still, most agree the potential repercussions are far-reaching. "It's the ripple effects, the domino effects" that are worrisome, said Pincus. "I think it's [going to be] one of the next shoes to fall" in the credit crisis. Miller said the subprime debacle, rising unemployment, record-high oil prices, and now CDS market troubles "have all the makings of the perfect storm.... There are some economists who say this could be another 1929 — but I don't believe it," he said. "We have a lot of safeguards built into the system that did not exist in 1929 and 1930." None of them, though, are directly targeted at CDS. On Wall Street, innovators are always ahead of regulators. And that can sometimes have a very steep price.