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GREEK CREDIT DEFAULT SWAP

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The latest additions to the Greek debt saga and the Eurozone crisis are the Credit Default Swap holders and the ISDA. But who are they and what is their role?

WHAT IS A CREDIT DEFAULT SWAP (CDS)?

A CDS is most simply described as a type of insurance against the risk of a default on a debt issued by a third party (the reference obligor). Technically a CDS is a financial swap agreement whereby the seller of the CDS agrees to compensate (usually the face value of the underlying instrument) the buyer in the event of a (loan) default or other credit event in respect of an underlying instrument issued by a reference obligor. In exchange for this protection, the buyer pays the seller a fee or "spread" expressed as a percentage of the notional principal amount[1].

For example: if Country A has issued government bonds to B, then B could ask to buy a CDS from C to cover the risk of A not being able to repay the bond when it matures. Party B and Party C then enter into an agreement whereby B agrees to pay C a fee and C agrees to pay the value of the bond in the event that A goes bankrupt or doesn't repay the bond. A has nothing to do with the CDS itself.

It is also possible to purchase CDSs without owning a related underlying instrument. These types of CDSs are called Naked CDSs. A CDS buyer is then speculating on the default of the underlying instrument and betting he can buy it at a cheaper rate when it does default. The EU agreed to a ban on Naked CDSs in respect of sovereign debt at the end of 2011[2].

CDSs were first "invented" in the 1990´s and played a large part in the financial melt down in 2008 when large American insurance companies could not fulfil their payment obligations in respect of CDSs issued in connection with mortgages which had subsequently turned sour.

Oddly enough, although the current CDS market is estimated to be worth around USD 32 tn this year, CDSs are not traded on any official exchange and are unregulated by any (national or international) governmental body. The International Swaps and Derivatives Association (ISDA), which is made up of high profile banks, hedge funds and investment houses[3], acts as a governing body and publishes guidelines and standard documentation.

[1] As the principal amount does not change hands in a swap, the amount used to calculate the spread, which is based on the principal amount of the underlying instrument is fictitious or "notional" only.
[2] Regulation of the European Parliament and the Council on Short Selling and Credit Default Swaps – It was adopted by the European council on 12 February 2012 and is pending publication and entry into force.
[3] Including but not limited to: Barclays, Credit Suisse, Deutsche Bank, Goldman Sachs, JPMorgan Chase Bank, Morgan Stanley, UBS, BNP Paribas, Societe Generale, Citadel Investment Group and PIMCO.

HOW DOES IT WORK?

During the lifetime of a CDS (usually around 5 years), the buyer will pay the spread to the seller. A payment under a CDS is triggered by a so-called "Credit Event". These Credit Events are usually the direct insolvency of the entity or state issuing the relevant underlying instrument or a default in payments thereof[4]. When a Credit Event occurs, depending on the terms of the CDS, the buyer receives the agreed compensation payment (usually the face value of the underlying instrument) and ownership of the underlying instrument is transferred to the seller.

WHY IS THIS RELEVANT TO THE GREEK DEBT CRISIS?

When the private investors bought Greek sovereign (and other) debt, it is fair to assume that at least a large portion of them purchased CDSs to hedge their risk. However, on 24 February, the Greek PSI restructuring offer was launched which "invited" bond holders to swap their current bonds for new bonds which, among other things, included a 53.5% face value write down of their debt. The ECB (which is currently estimated to hold around EUR 177 bn of Greek debt) is also required to swap its bonds, but under the terms of the restructuring, it would not be subject to the debt write down.

This led Greek debt CDS holders to ask two questions. In summary:

1. whether the holders of Greek bonds had been subordinated to the ECB as a result of the fact that the ECB would not participate in the write down, which would constitute a Credit Event? and

2. whether the 53.5% debt write down – which could technically be deemed a failure to make payment on the underlying instrument – could itself constitute a Credit Event.

If either (or both) of these situations would constitute a Credit Event, then it would result in the payment of billions of Euro's to CDS holders, reminiscent of the 2008 CDS melt down. Some experts have speculated that an event like that could further destabilise the financial markets, others believe that it has already been "priced" into the Greek market.

If neither situation would constitute a Credit Event, then the role of the CDS, at least certainly with regard to securing sovereign debt, could be severely damaged. In addition, if bond holders can no longer hedge their risk sufficiently, this could, in turn, send government bond yields in the weaker Eurozone countries rocketing (again) as lenders pass on the additional cost of the risk.

On 1 March 2012, the ISDA's EMEA Determinations Committee unanimously ruled that neither of the two questions submitted constituted a Credit Event[5].

To view the full statement click here: http://www.isda.org/dc/docs/EMEA_DC_Statement_01032012.pdf

While the ISDA has not given a formal explanation for its ruling, most experts agree that it is based on the fact that the PSI restructuring is on a "voluntary" basis[6] - and this is an important distinction.

Greece has made it clear that it will not hesitate to use special Collective Action Clauses (CACs) which will force bond holders to participate in the PSI debt restructuring. If these CACs are triggered[7] participation will no longer be voluntary and it is very likely that the ISDA EMEA Determination Committee will find themselves, once again, looking at the Greek CDSs and being forced to take a decision which may, not only have consequences for the future of CDSs, but also have knock-on effects for Greece and the rest of the Eurozone.

[4] Although it should be noted that there are no limitations on what parties can agree to constitute a Credit Event
[5] Under the terms of the ISDA 2003 Definitions – see www.isda.org.
[6] Although the market has its own opinion on how "voluntary" the offer is when the alternative is a Greek disorderly default.
[7] The trigger is dependent on the percentage of uptake on the initial PSI restructuring offer.

It is important to note that the ISDA EMEA Determination Committee left the backdoor open for themselves. In their statement they say: "that the situation in the Hellenic Republic is still evolving" and that they reserve the right to change their minds if new facts come to light (i.e. the results of the PSI restructuring offer).

Officially the term of the PSI restructuring offer ends on 8 March. In the meantime, bondholders are prowling around, eyeing each other up. The terms of the offer mean that if there is less than 66% take up, then the CACs cannot be triggered and the PSI restructuring will not be able to take place – a key requirement for the bail-out funding. If Greece doesn't get the money it needs under the bail-out to pay the EUR 14.5 bn due this month, then default would seem imminent. The cost of a disorderly default of Greece is currently estimated at over EUR 1 tn and bond holders can whistle for their money with the rest of Greece's creditors. However, if over 90% take up on the deal, then it is likely that the remaining bondholders would get paid out fully anyway so many bondholders may prefer to sit tight and hope everyone else will accept the offer.