Opinion **FTfm**

Time to wipe out the absurd credit default swap market

Someone must deliver a coup de grâce to this global joke

JOHN DIZARD

The basilisks in a Harry Potter film. Dealing desks have been under the eye of regulators since CDS caused panic in 2008 © Alamy

John Dizard MAY 11, 2018

There was a time when the credit default swap market was a giant, incomprehensible and terrifying threat to the global economy. Think of the barely controlled panic in the phone calls between the US Treasury and the Federal Reserve Bank of New York in 2008.

Now it is a gigantic, incomprehensible global joke. Once it could be argued (by some) that the CDS market was a way to efficiently price and trade credit risk among institutions with illiquid instruments, such as corporate loans or infrequently traded sovereign bonds. And, of course, it was a way for dealing desks to make money in ways customers could not understand.

Since then, CDS documentation and market practice has been tweaked almost beyond recognition, like a series of poor plastic surgeries: there are more hazy conditions and exceptions in the paperwork, and more ways for participants to sleaze out of paying for the "protection" offered.

Under the basilisk gaze of compliance officers and regulators, those on the front line of the dealing desks cannot pull in the bonuses or cover the expense allowances that once came with the job. For that matter, their banks and dealers are more constrained by capital requirements and accounting guidelines than in the good old days.

At least back in 2008, dealing in CDS was sinister or arcane. Now it just seems pointless, what the American military calls a "self-licking ice-cream cone". Not evil, or feared, but boring and faintly ridiculous.

The CDS business is still big but at a time when most markets have been growing (or just inflating), it has been steadily shrinking in notional size. According to the Bank for International Settlements, the notional value of all CDS has declined from about $25tn at the start of 2013 to less than $10tn today.

Even a $10tn black hole could terrify editorialists, policymakers and conference attendees. It has become apparent, though, that most of that is helium in the balloon. Those trillions could only end life as we know it if someone (taxpayers, depositors, investors) had to pay them to someone else (foreign billionaires, Bond villains, New York and London socialites).

With ever-greater frequency, though, CDS participants are being told by the authorities or "determination committees" of market participants that we were just kidding, no one takes this seriously any more. I am inclined to agree with this de-escalation policy, but the problem is that some less knowing market participants may believe the "protection" offered by CDS represents a genuine hedge against risk, which could result in some significantly unbalanced books when there is another global financial crisis.

The swaps dealers came under intense scrutiny after 2008 but the real limits on the supposed power of CDS came after the Greece-eurozone kerfuffle in 2011. The eurocracy and politicians were shocked to find they did not have the absolute power to dictate the price of sovereign debt of their national issuers.

This led to controls on rating agencies' estimates of eurozone sovereign risk, and to heavy breathing over the shoulders of euro area CDS traders. Part of the reason for the eurocracy's concern over post-Brexit London-based derivatives clearing is the compulsion to retain control over euro-sovereign CDS pricing.

No one in the chancelleries of Europe wants geeks in London to decide whether a future Italian government is worthy of market access, so eurozone sovereign CDS will remain closely controlled.

How about CDS on bank risk? Well, we have the examples of Spain's Banco Popular and Portugal's Novo Banco. In both cases, the supervisory authorities and national governments ensured there was no "event of default" trigger that would lead to massive CDS payouts and a disruption of official bailout plans.

You could, for that matter, buy protection through the CDS market on Citibank or JPMorgan Chase

risk. Imagine getting paid by the seller in the chaotic circumstances of such an event of default, as specified in the fine print of the contracts. That is just science fiction.

Well there is still plain corporate risk, where the CDS protection buyer is looking to hedge against the risk of default on a single company, or an index of companies. That is also proving to be a less credible proposition.

In August, a "determination committee" of the International Swaps and Derivatives Association in Asia was unable to determine whether there had been an event of default by Singapore's Noble Group. Finally, in March, Noble said it would default on a bond issue, and the CDS process for that "event" is playing out.

In case you think Noble was a fetid outlier, Hovnanian, the US homebuilder, included a CDS event of default in its restructuring plan. The Commodity Futures Trading Commission tut-tutted but did not stop that process.

Can anyone find a way to bury this absurd pseudo-market?

Letter in response to this column:

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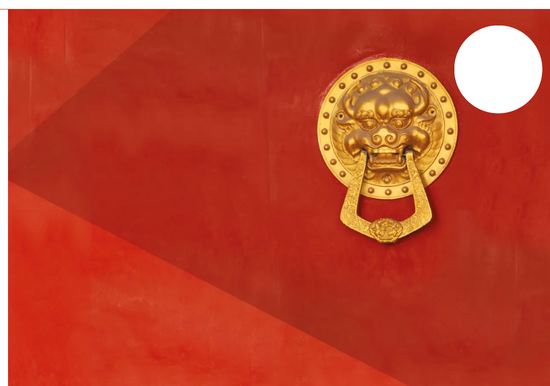

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