

Credit Default Swaps (AKA Insurance) - Useful Risk Management Tool or Financial WMD?

"Derivatives are financial weapons of mass destruction carrying dangers that, while now latent, are potentially lethal." - *Warren Buffett, Berkshire Hathaway 2002 Shareholder Letter*

"In 2008 we began to write credit default swaps on individual companies."
- *Warren Buffett, Berkshire Hathaway 2008 Shareholder Letter*

It appears from these quotes that even the Oracle of Omaha is of two minds when it comes to derivatives, and specifically credit default swaps (CDS's). Perhaps best known for their role in the downfalls of Bear Stearns, Lehman Brothers, and AIG, credit default swaps have been the subject of intense scrutiny and debate over the past year. In June, the U.S. Treasury Department weighed in, proposing that all OTC traded derivatives (including CDS's) be cleared through a central clearinghouse to increase market transparency and liquidity.

So what are credit default swaps? Are they a useful risk management tool or a financial weapon of mass destruction? And how should insurance companies think about using (or avoiding) them? This month's *View from the Bridge* addresses these questions.

What are Credit Default Swaps?

A CDS is a contract between two counterparties under which the seller ("writer") agrees to pay the buyer a pre-determined amount if a certain event transpires, most often default on a corporate bond or asset-backed security, in return for the premium on the CDS. Simply put, a CDS acts as a form of insurance for the owner of a bond-like instrument, providing protection in the event of default. Typically, the writer of a CDS (the insurer) agrees to pay the buyer (the insured) the difference between a bond's face value and its market value should the bond issuer default. A key difference between CDS's and more traditional forms of insurance is that the buyer of a CDS need not own the underlying asset in order to purchase the CDS. An investor can purchase a CDS that will pay in the event of default on a specific bond without actually owning the bond. Today's CDS market is largely unregulated. Terms and conditions of individual CDS contracts are negotiated between the two counterparties and need adhere to no standard template, as with exchange-traded derivatives. No specific capital requirements exist for writers of CDS's, although many writers assign capital to back the CDS's they write as part of a prudent risk management program.

Although difficult to measure precisely, the International Swaps and Derivatives Association pegs outstanding CDS volume at \$39 trillion in notional value, down from a peak of \$62 trillion in 2007. By comparison, the U.S. bond market has total outstanding debt of \$34 trillion, of which \$21 trillion is in instruments on which CDS's are written (corporate, municipal, mortgage-related and asset-backed securities). For some bonds, the notional value of outstanding CDS's is many times that of the total outstanding debt. While much of this difference is due to offsetting positions at institutions who make markets in CDS's, it is also indicative of the widespread use of CDS's as a "speculative" instrument to take positions on specific debt issues and the broader bond market.

Risks and Benefits

Credit default swaps can be a useful tool for bondholders who want to protect against specific credit events. The ability to write a CDS tailored to the exact needs of the buyer makes them a uniquely useful risk management tool for companies with complex hedging requirements. Events such as bankruptcy, failure to pay, and debt restructuring are commonly covered by CDS's. Some portfolio managers will pair ownership of a treasury bond with sale of a CDS against a corporate bond that is in short supply to create what is effectively a synthetic version of that corporate bond.

Among the reasons that some view credit default swaps as financial weapons of mass destruction are the following:



1. Absence of any authority imposing capital requirements on CDS writers

CDS writers can take on unlimited risk without needing to demonstrate the financial ability to absorb it. While states and rating agencies such as AM Best insist that insurance companies hold sufficient capital to absorb potential losses, and exchanges impose similar requirements on derivative traders, a company's ability to write credit default swaps is limited only by its own good judgment and the trust of its counterparties.

2. Scarcity of useful data on which to base loss projections

The risk profile of a writer of credit default swaps is not unlike that of a writer of facultative reinsurance. The difference is that where history can be a somewhat useful guide in predicting even catastrophic events like hurricanes and earthquakes, the frequency and severity of accounting scandals, supply and demand shocks, military coups, and financial crises affecting companies and whole markets obey no rules that even individuals as astute as Warren Buffet, Alan Greenspan, and Ben Bernanke have been able to divine.

3. Limited visibility into the trading positions of counterparties

AIG was rescued because the federal government believed its collapse would place our entire system of finance at risk. This came about not only because AIG's financial condition had become uncertain, but also because no one knew exactly where losses would fall among AIG's counterparties. This lack of visibility into the CDS positions of different companies and how they might or might not net out against one another inside a given company was at the root of the financial crisis in the Fall of last year and more than anything else earned CDS's their classification as financial weapons of mass destruction.

4. Moral hazard CDS's can create

Companies and individuals are not prevented from buying CDS's without owning the underlying asset being insured. A CDS buyer who does not own the underlying asset benefits if there is a default and therefore has an incentive to take actions that may encourage default. One who does own the underlying asset may be indifferent to whether there is a default. This can have highly undesirable economic consequences. Recently, some GM bondholders were, at least initially, unwilling to exchange debt for equity to keep the company alive and enable it to emerge from bankruptcy because they held credit default swaps and were financially better off in the event of a default.

In another example of moral hazard, Amherst Holdings, an Austin based brokerage firm, wrote CDS's insuring against default on a specific \$335 million subprime mortgage bond offering originally issued in 2005. While the remaining outstanding principal on this issuance had dropped to \$29 million through a wave of refinancing and defaults, Amherst wrote about \$100 million of CDS's against it. The bonds had a market value of only \$3 million, indicating a high probability of default, so the CDS's had a very steep price (80 - 90 cents per dollar of coverage, or \$80 - \$90 million total). Banks including JP Morgan, RBS and Bank of America bought the CDS's, taking a relatively "safe" position that the bonds would default and the CDS's would pay off. Amherst (through the loan servicer) then purchased and paid off the entire \$29 million in outstanding debt, ensuring it would not go into default, and pocketed the CDS premiums as profit. Because the outstanding principal was less than 10 percent of the original bond issuance, Amherst was allowed to pay off the debt in this manner and profit from the overall transaction.

Conclusions

Credit default swaps can indeed be a useful tool for hedging the risks associated with holding various assets, particularly corporate bonds and asset-backed securities, but the CDS marketplace lacks essential protections on which buyers of more traditional types of insurance have come to rely. These protections, or something approximating them, must be put in place before the systemic risks associated with credit default swaps will have been reduced to a manageable level. They include capital requirements for writers of CDS's, stringent reporting on the positions of market participants, and greater standardization of instruments so they can be understood by experts, rated, and traded in a liquid secondary market.

Insurance companies interested in writing CDS's should proceed cautiously. Correctly pricing (underwriting) a CDS requires a deep understanding of the underlying security and the creditworthiness of the issuer. The CDS writer also needs to understand its exposure to catastrophic credit events and the moral hazard potential of a given instrument before it can arrive at a price that accurately reflects both risk and profit potential. It is our belief that most insurance companies, particularly P&C companies, will find building this kind of expertise to be a distraction from their core businesses that they are better off doing without.