The Elusive CDS Payoff

What exactly is a Credit Default Swap (CDS) on Greece worth? It seems likely that the International Swaps Dealers Association (ISDA), the industry body that rules on such things, will soon confirm that the 50% write-down on Greek debt accepted by the banks does not constitute a credit event, because it was accepted voluntarily by the banks and not forced upon them. Although the EMEA Determinations Committee has not yet met, ISDA's website posts a press release that says, "…it does not appear to be likely that the restructuring will trigger payments under existing CDS contracts."

Analysts have been predicting as such for weeks. But if a 50% loss doesn't trigger an insurance pay-off, what does? And if Greek insurance doesn't pay off, will CDS contracts on Italy, Spain or even France ultimately ever have any value? A sovereign default is a political decision, and quite possibly the insurance contracts owned will ultimately not protect their holders. It reminds me somewhat of the market for perpetual floating rate notes. Many years ago these instruments used to be priced as if they would eventually mature and traded at spreads comparable to finite-lived instruments. Then in 1987 investors realized that these instruments shouldn't be priced as if one day the issuer would repay them and the market collapsed.

Such may be the fate of developed market sovereign CDS.

To list three credits of note:

COUNTRY	NET NOTIONAL (USD BN EQ)	GROSS NOTIONAL (USD BN EQ)	PRICE	NET MTM	GROSS MTM
FRENCH REPUBLIC	$24.0	$132.4	1.58%	$1.5	$8.4
KINGDOM OF SPAIN	$18.0	$167.8	3.16%	$2.3	$21.2

REPUBLIC OF ITALY	**$22.0**	**$309.5**	**4.05%**	**$3.6**	**$50.1**
TOTAL				**$7.3**	**$79.7**

Source: ISDA; CNBC.com

The table above takes most recent net and gross CDS outstanding from ISDA, combines them with current CDS prices and assumes four-year average maturity to estimate the approximate net and gross mark-to-market positions among participants from these three names. Although it should be a zero-sum game (i.e. gains for sellers of protections are losses for buyers) the table seeks to estimate the range of P&L swings among participants in the market. The true figures for these three are probably closer to the low end of the two totals above (i.e. $7.3BN) and even that assumes the swaps are worthless which is an extreme outcome. But the same analysis could be applied to other developed sovereigns, perhaps emerging market countries and even corporations deemed too big to fail. Indeed, it appears as if an important element of the negotiation between the banks and the EU was to ensure CDS contracts did not pay off. Avoiding contagion, but perhaps avoiding further losses (if the banks were themselves net sellers of CDS protection) were important consideration. A further step in the socialization of credit risk has been taken.

So buyers of CDS protection are confronting a brave new world. Perhaps selling protection on an EU sovereign credit is suddenly the easiest money out there.