

Special Report - The Next Black Hole (s)



Credit Default Swaps (or CDS), an insurance policy in the form of a derivative contract, may be the global capital markets next “Black Hole”. Or maybe it will be “Monoline” insurers. Or both.

There are an estimated \$46 trillion—not billion—trillion in “notional amount” of Credit Default Swaps outstanding. Notional amount is the term used to describe the principal amount of the contract in the same way that an insurance policy has a face amount. Premium is the amount paid for the insurance. As in an insurance policy, no money changes hands in a CDS, except the premium, unless there is a credit default.

The easiest way to “visualize” a CDS is to think of it as a life insurance policy, assuming for this example a death benefit of \$100,000. The \$100,000 is the notional amount—a placeholder to remind us of what we will receive in the future when and if we make a claim (and our effective benefit for paying our annual premium all those years). In a CDS, instead of a benefit paid upon death, the notional amount is paid to the owner of the CDS if the “insured”—normally a corporation, government, or Sovereign credit—defaults on its obligations to a specific financial instrument, such as a bond, or files for protection in bankruptcy. A Credit Default Swap is normally utilized to hedge an existing risk—in the case of a CDS, the existing risk is ownership of the credit of the borrower (or debtor) underlying a financial instrument such as a bond. In the commodity markets, a farmer hedges himself against future price fluctuation by selling a contract which obligates him to deliver a certain amount of the commodity at a previously agreed upon price. If the value of the commodity increases, the farmer does not benefit as he has pre-sold his crop at a price negotiated today. If the price of the commodity decreases, the farmer profits as he receives the higher, negotiated contract price rather than the lower, market price. In a

Credit Default Swap, an investor hedges himself by purchasing a CDS which protects him from a negative event such as a bankruptcy. However, his return is reduced by the amount of the annual premium charged by the counter-party in the CDS for the credit insurance provided. Alternatively, the investor suffers no loss in principal in the event of a bankruptcy as the CDS counter-party is responsible for paying him the notional amount.

As if the current capital market crises were not severe enough, along comes the next potential crisis in the form of CDS (we'll get to the monocline insurers a little later). In a recent article in *The Economist* (January 12, 2008), Bill Gross, Founder of PIMCO, was noted as thinking CDS may be the banking industries "most egregious" concoctions to date.

Why the problem? It's just insurance, isn't it? Well, it is and it isn't as in many instances, the writers of the insurance are financial institutions such a money center commercial banks and investment banks and not insurance companies which are both regulated as well as required to maintain reserves. Commercial banks and investment banks are neither regulated as to the writing of Credit Default Swaps nor required to maintain reserves. Nor have they laid off any portion of their exposure through "re-insurance" or "risk-sharing" agreements. To date, CDS premiums have been easy money for the writers of the CDS contracts as corporate credit defaults have been low by historic standards and the premiums collected have represented "found money". But as Bill Gross pointed out in the same article in *The Economist*, if defaults of corporate bonds returned to their historical average, CDS contracts in the amount of \$500 billion would become payable. For commercial banks and investment banks, this payout would be on top of the losses still projected on sub-prime, option-ARMs, Alt-A, etc. single family mortgages and leveraged buyout and other debt instruments held in inventory. So, if defaults increase which certainly seems possible in a weakening economy, commercial banks and investment banks will come under increasing financial pressure which may cause them to "husband" or ration capital among and between customers, borrowers, industries, regions, and business segments, such as commercial real estate. Now you know why we should be concerned about CDS and their impact on the global capital markets

You can tell when the financial markets sense trouble in the making as evidenced by the rapid upward change in the cost of CDS for financial services companies such as Citigroup, Merrill, Lynch, and Bear Stearns, among many others. The following table shows the change in pricing for a hypothetical \$10 million Credit Default Swap having a term of 5 years for the above firms during the period October 15, 2007 to December 31, 2007:

	\$10 MM CDS Cost at October 15, 2007	\$10 MM CDS Cost at December 31, 2007
Citigroup	\$27,000	\$94,000
Merrill Lynch	\$60,000	\$164,000
Bear Stearns	\$76,000	\$234,000

Now to the monoline insurers who, if they had stuck to their knitting, would not be the subject of such much negative press. Monoline insurers' primary business model was based upon their "renting" their triple-A credit ratings to municipalities so that the municipalities could issue bonds at a lower interest cost, including the fee to the insurer. Dull, but profitable.

Then they decided to use their credit ratings to enhance more exotic and perceived low risk, debt instruments including residential mortgage-backed securities and offerings comprised of sub-prime mortgage loans as well as collateralized debt obligations (CDOs) which we now know were actually a veritable "Witches Brew" of debt instruments. Now the monolines' credit ratings, which drive their business model, are being questioned by the various rating agencies as more and more residential mortgage securities and CDOs experience increased delinquencies and defaults in their underlying assets. Unfortunately, the contagion does not stop here because if you downgrade the credit of a monoline insurer, you downgrade the credit of everything it has insured. (Bloomberg Financial Markets recently reported that the value of the securities rated by Ambac, MBIA, and the other bond insurers was \$2.4 trillion). The deterioration in the insurer's credit in turn causes the holders of the now downgraded bonds to mark the bonds to market value (usually a downward adjustment) which in turn may cause certain institutional investors whose mandate is to hold only triple-A securities to become an immediate seller. The decline in the insurers' credit rating also means that the issuers of municipal and other debt securities will have to offer investors higher yields on their next offerings. Bloomberg has estimated that the additional cost to the issuers could be as high as \$200 billion.

The problem expands and becomes more complex when we learn commercial banks and investment banks have used the monoline's to "wrap" or insure various products and investments through the use of, you guessed it, credit default swaps. In fact, one firm recently wrote down the value of the guarantee of one of the insurers by \$1.9 billion, probably the unfortunate harbinger of bad things to come.

And for some of the insurers, their exposure to sub-prime mortgage-backed securities and CDOs is significant:

In \$ Billions	Direct Exposure thru Mortgage-Backed Securities	Indirect Exposure thru Collateralized Debt Obligations
Ambac	\$8.8	\$29.2
MBIA	\$5.1	\$25.3
Assured Guaranty	\$6.7	\$0.42
FSA	\$4.8	\$0.36
Sources: Thompson Datastream; CBM Group		

Where do we go from here besides wait and watch? Unfortunately, no where as few if any commercial real estate owners, developers, and investors are parties to Credit Default Swaps or monoline insurer guarantees.

All we can do is continue to connect the dots so that we are better informed and better understand events in the global capital markets that will impact on availability of capital.

**For readers who want additional information about Credit Default Swaps and Monoline Insurers, we include the following material from Wikipedia, the free encyclopedia:**

### **Credit Default Swaps**

A credit default swap (CDS) is a bilateral contract under which two counterparties agree to isolate and separately trade the credit risk of at least one third-party reference entity. Under a credit default swap agreement, a protection buyer pays a periodic fee to a protection seller in exchange for a contingent payment by the seller upon a credit event (such as a default or failure to pay) happening in the reference entity. When a credit event is triggered, the protection seller either takes delivery of the defaulted bond for the par value (physical settlement) or pays the protection buyer the difference between the par value and recovery value of the bond (cash settlement).

Credit default swaps resemble an insurance policy, as they can be used by debt owners to hedge against credit events. However, because there is no requirement to actually hold any asset or suffer a loss, credit default swaps can be used to speculate on changes in credit spread.

Credit default swaps are the most widely traded credit derivative product. The typical term of a credit default swap contract is five years, although being an over-the-counter derivative, credit default swaps of almost any maturity can be traded.

Credit default swaps can be used to manage credit risk without necessitating the sale of the underlying cash bond. Owners of a corporate bond can protect themselves from default risk by purchasing a credit default swap on that reference entity.

For example, a pension fund owns \$10 million worth of a five-year bond issued by Risky Corporation. In order to manage their risk of losing money if Risky Corporation defaults on its debt, the pension fund buys a CDS from Derivative Bank in a notional amount of \$10 million which trades at 200 basis points. In return for this credit protection, the pension fund pays 2% of 10 million (\$200,000) in quarterly installments of \$50,000 to Derivative Bank. If Risky Corporation does not default on its bond payments, the pension fund makes quarterly payments to Derivative Bank for 5 years and receives its \$10 million loan back after 5 years from the Risky Corporation. Though the protection payments reduce investment returns for the pension fund, its risk of loss in a default scenario is eliminated. If Risky Corporation defaults on its debt 3 years into the CDS contract, the pension fund would stop paying the quarterly premium, and Derivative Bank would ensure that the pension fund is refunded for its loss of \$10 million (either by taking physical delivery of the defaulted bond for \$10 million or by cash settling the difference between par and recovery value of the bond). Another scenario would be if Risky Corporation's credit profile improved dramatically or it is acquired by a stronger company after 3 years, the pension fund could effectively cancel or reduce its original CDS position by selling the remaining two years of credit protection in the market.

Credit default swaps give a speculator a way to make a large profit from changes in a company's credit quality. A protection seller in a credit default swap effectively has an unfunded exposure to the underlying cash bond or reference entity, with a value equal to the notional amount of the CDS contract.

For example, if a company has been having problems, it may be possible to buy the company's outstanding debt (usually bonds) at a discounted price. If the company has \$1 million worth of bonds outstanding, it might be possible to buy the debt for \$900,000 from another party if that party is concerned that the company will not repay its debt. If the company does in fact repay the debt, you would receive the entire \$1 million and make a profit of \$100,000. Alternatively, one could enter into a credit default swap with the other investor, by selling credit protection and receiving a premium of \$100,000. If the company does not default, one would make a profit of \$100,000 without having invested anything.

### **Monoline Insurers**

Monoline insurers (also referred to as "monoline insurance companies" or simply "monolines") guarantee the timely repayment of bond principal and interest when an issuer defaults. The monoline bond insurance industry provides services to one industry.

The economic value of bond insurance to the governmental unit, agency, or company offering bonds is a saving in interest costs reflecting the difference in yield on an insured bond from that on the same bond if uninsured. Insured securities range from municipal bonds and structured finance bonds to collateralized debt obligations (CDOs) domestically and abroad.

Insurance regulations prevent property/casualty insurance companies, life insurance companies, and multiline insurance companies from offering financial guaranty insurance. The monoline industry claims that it has the advantage over multilines of sole focus on capital markets.