Industry report casts doubt on CDS link to bankruptcy process

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The use of credit default swaps is not systematically altering the bankruptcy process, according to a study commissioned by an industry group.

The report examined concerns about the so-called "empty creditor theory" which posits that creditors who have hedged their economic exposure to a company collapse are changing the nature of bankruptcies.

Credit default swaps allow bondholders to insure their investments against the danger of a particular company collapsing - but they only pay out in the event of a full collapse. A CDS pay-out is likely to see the bondholder recouping a higher proportion of their funds than is likely for an unhedged creditor.

Under the empty creditor hypothesis, bondholders who have bought CDS protection still have the same contractual rights as their unhedged peers, but have different economic incentives - and could even be inclined to let a company reach bankruptcy rather than help agree a work-out while it was still solvent. In the case of a bankruptcy, an empty creditor could undermine the reorganisation, especially if their hedged position and different incentives were not fully disclosed.

Yesterday the International Swaps and Derivatives Association said its study could not find evidence to back the assertions.

"The hypothesis is not consistent with the way CDS work or with observed behaviour in debt markets," said David Mengle, head of research at ISDA. "Because it could influence future regulatory policy, it is important to analyse both the logic and the evidence in support of and against it.

The dangers of empty creditors have been highlighted by Henry Hu, a finance professor at Texas University who in September joined the US Securities and Exchange Commission as director of its new division of risk, strategy, and financial innovation.

Yesterday Mr Mengle said his study did not show that hedging led to systematic opportunities that could distort behaviour, and that this evidence would be needed before the issue should be treated by officials as a cause for concern.

Empty creditor supporters have also warned that overhedged bondholders - those who have bought CDS worth more than their underlying bonds - could profit from a company collapse. However Mr Mengle said data could not be found to verify whether overhedging was a significant activity. He also questioned, given the expense and low returns of the strategy, whether it was plausible.