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Credit Derivatives That Distort Markets

By RICHARD BEALES and NEIL UNMACK

Credit Derivatives

That Distort Markets

Critics of [credit-default swaps](#) like the “empty creditor” hypothesis. The theory is that buyers of credit insurance can profit by allowing — or even encouraging — companies to file for bankruptcy. It’s used as an argument for banning or severely restricting the \$31 trillion market for credit-default swaps. In reality, the empty creditor hypothesis is probably half full.

Credit-default swaps allow traders to insure themselves against a company’s default. Empty creditors are investors who have hedged with credit-default swaps and who stand to benefit if companies go bust, because the payout on the swap would make them whole on the value of their debt.

The International Swaps and Derivatives Association set out to debunk the hypothesis in a [research paper published on Dec. 17](#). The association is right to dismiss one element of the theory: the notion that traders of credit-default swaps can make quick profits from a company’s final spiral into bankruptcy.

The big flaw in this part of the theory is that traders can’t actually make much if any money doing that, because buying bankruptcy protection in the credit derivative markets gets very expensive as companies near failure. At the end of 2008, the cost of insuring against default on \$10 million of [General Motors](#) bonds in the credit-default swap market was \$8 million — payable upfront — plus \$500,000 a year for up to five years. That was almost six months before G.M. finally filed for bankruptcy on June 1.

Upon bankruptcy, buyers of credit-default swaps receive the insured amount less the recovery rate on the bonds. In G.M.’s case, the recovery rate was set by auction at 12.5 cents on the dollar. That means someone who bought swaps half a year before the company filed would scarcely have broken even. In the immediate timeframe before G.M.’s bankruptcy, the trade would have been loss-making. Fingering credit-default swap traders for companies’ short-term problems or final death throes is much like blaming short-sellers of stock: both are almost invariably the messengers, not the message.

But the International Swaps and Derivatives Association is mistaken in trying to knock down a central thrust of the empty creditor hypothesis. This argues that investors owning a company’s debt as well as the related credit-default swaps can prevent or distort a restructuring outside bankruptcy if the company gets into trouble. After all, blocking alternatives so that a company eventually has to file for bankruptcy would lead to a fat payout on the swaps.

As far as the association is concerned, there is no evidence that the ratio of bankruptcies to out-of-court restructurings has picked up since the credit derivatives market boomed. Still, the fear is that this dynamic could force companies into an otherwise avoidable collapse — or at least interfere with a restructuring. It's fodder for those who want to ban credit-default swaps, or at least want creditors who hedge with them to have restricted voting rights.

And despite the group's conclusion, credit derivatives clearly do in practice sometimes gum things up when companies are trying to negotiate out-of-court restructurings. Some of these debt revampings, as well as outright bankruptcies, can lead to payouts on credit-default swap contracts.

Whether that happens can depend on the terms of the restructuring, an interaction that has caused uncertainties in several recent cases, including a debt exchange carried out by [Cemex](#), the Mexican cement giant. Wind Hellas, the Greek telecommunications company that recently entered a pre-packaged bankruptcy, said attempts to restructure its debt would have been complicated by the presence of credit default swap holders.

Companies need to bear this issue in mind when they draft credit agreements. But instead of playing down the issue, the International Swaps and Derivatives Association could help, too. The industry group has already missed a trick or two in the face of widespread criticism of derivatives trading practices that go well beyond credit-default swap instruments. Rather than trying to defend everything about the industry, it should emphasize the useful features of derivatives markets while recognizing, and trying to address, their flaws.

This means making a concerted effort to find better ways to manage the difficulties posed by creditors who own credit-default swaps in restructurings. The extreme solution — draconian curbs on the voting rights of hedged investors — would not be workable. But a good first step could be full disclosure of which creditors are hedged with credit-default swaps before restructuring discussions begin. RICHARD BEALES and NEIL UNMACK

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