Role of credit default swaps debated in GM's bankruptcy risk

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As if Wall Street didn't already have an unsavory reputation for its role in the global economic meltdown, now we have the financial markets' version of a protection racket -- the credit default swap -- rearing its head in the General Motors drama.

Doomsayers who predict that debt-ridden GM will collapse into bankruptcy June 1 frequently cite as a key reason for their pessimism the improbability that 90% of GM bondholders will exchange their bonds for stock in the revamped auto company, as demanded by the U.S. government.

That's where the protection racket, or credit default swaps, comes into play.

About $2.7 billion of the $28 billion in existing GM bonds are backed by such swaps, a form of insurance that investors buy to protect against defaults or other adverse "credit events." In GM's case, these swaps would presumably entitle large institutional bondholders to be paid in full in the event of a GM default. Therefore, those big bondholders would likely keep their bonds and watch GM go bankrupt rather than trade the bonds for stock in a new GM that's 89% owned by Uncle Sam and the UAW.

Or so the logic goes.

But Tim Backshall, chief strategist for Credit Derivatives Research, doesn't see credit default swaps triggering a GM bankruptcy. Yes, Backshall told me, there are $2.7 billion of GM swaps outstanding, "but that's not quite as hairy as it sounds."

If speculators were trying to make money by trading swaps to bet on the odds of a GM bankruptcy, Backshall said, they would have cashed out long ago. And depending on the premiums paid for the remaining swaps, investors might not have much to gain from a default. Maybe a stock-for-bonds swap might be attractive, especially if GM and the U.S. Treasury sweeten the current offer, which GM said is equivalent to about 11 cents on the dollar.

Credit default swaps have been criticized as a largely unregulated form of trading, compared with the stock or bond markets. Such swaps have been blamed in part for the collapse of insurance giant AIG. But despite high anxiety after the bankruptcy of Lehman Brothers Holdings last fall, there was little impact on financial markets from the settlement of Lehman-related swaps.

Rounding up investors

A much greater obstacle to completing a bond exchange by the June 1 deadline for GM to prove its viability and preserve its lifeline of federal loans, Backshall said, is the sheer logistical challenge of rounding up hundreds of small investors to trade GM bonds for future equity.

"I think it's crazy," he said. "To expect the bondholders to find every mom and pop that has a GM bond and get 90% of them to agree is, I think, incredibly aggressive."
Still, there remains a possibility that bankruptcy can be averted. "There's going to be a better deal for bondholders somehow," Backshall said.

In other words, there might yet be an offer they can't refuse.

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