Debt revamps hindered by credit default swaps

Credit default swaps are complicating efforts to work out bank, auto and other restructurings outside of bankruptcy.

As the holders of billions in credit default swaps against a bankruptcy of General Motors Corp. and Chrysler LLC, the automakers' lenders have so far rejected the government negotiators' demands to greatly reduce their claims on the car companies.

Emboldened by credit default swaps, bondholders in other restructurings have resisted efforts to reduce the amount of money they are owed or refused to accept offers to swap debt for equity in hopes of at least sweetening the deal after a bankruptcy filing. They also are fighting to reserve their right to CDS payoffs, bankruptcy experts and analysts said.

The prevalence of credit default swaps has been blamed for at least worsening the financial crisis. Now they are complicating efforts to clean up balance sheets, ease debt burdens and unwind the tangle of financial obligations between financial firms and their counterparties -- critical steps in reviving the economy.

For instance, even as the federal government is conducting stress tests to gauge the financial health of the country's largest financial institutions, many of those same institutions are refusing to budge in separate government talks to bail out the car companies.

"Bondholders are very reluctant to agree to concessions due to the CDS situation," said Jason Gold, partner in the bankruptcy practice at Wiley Rein LLP. "I doubt the companies can cut a deal outside bankruptcy."

The International Swaps and Derivatives Association Inc. and the Bank for International Settlements estimate that the notional value of credit default swaps in the marketplace is $62 trillion.

The White House automotive task force late Wednesday offered a somewhat sweetened deal to Chrysler's lenders, including J.P. Morgan Chase & Co., Citigroup Inc. and Goldman Sachs Group Inc. The government is offering holders of $6.8 billion in secured debt a 5% stake in Chrysler if they write off all but $1.4 billion of what they are owed, according to a person familiar with the matter. The new deal is an improvement over the task force's initial demand that nearly the entire debt be erased for little in return. But the offer still falls well short of terms the lenders proposed earlier in the week. The lenders believe they are entitled to upward of 35% of Chrysler's equity in return for erasing $2.4 billion in debt.

Similar recalcitrance is likely at General Motors. Citing a report by Tim Backshall, chief analyst at Credit Derivatives Research, Barron’s reported that there are $2.68 billion net outstanding of GM credit default swaps.

Swapping debt for equity outside of bankruptcy would eliminate automaker creditors' CDS claims on any affected bonds. But if the creditors wait until a bankruptcy, holders of GM default swaps would enter the International Swap Dealers Association Settlement process, which would determine the value of the debt-for-equity switch through auctions and declare how much a CDS issuer owes.

It isn’t clear which firms would be obligated to make the CDS payoffs should the car companies file for bankruptcy, though government-controlled American International Group Inc., taken over by federal regulators in September, generated $447 billion worth and was the largest underwriter. If the government faces a huge exposure to the car companies’ lenders because of AIG, it is understandable why U.S. officials are striving to reach a deal outside of bankruptcy.

Helpful as it would be for taxpayers, with their own wobbly balance sheets, the financial institutions are in no position to walk away from a large financial asset either.

Money Morning newsletter author Martin Hutchinson argued that swaps were catalysts for the bankruptcies of AbitibiBowater Inc. and General Growth Properties Inc.

AbitibiBowater could not persuade enough of its bondholders to exchange a portion of its $6.2 billion in debt and went into bankruptcy. General Growth, with $27.3 billion of debt, also filed for bankruptcy after bondholders refused to approve a restructuring. Subsequently, the value of a major tranche of General Growth bonds was determined by auction to be worth 71% of par, allowing investors to receive $710,000 for each $1 million in CDSs. "A nice reward for voting 'no' to a restructuring," Hutchinson wrote. - Bill McConnell in Washington
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Comments

From: swappy mcgee,
first, your total # of CDS in the market is both stale and misleading. ISDA just last week published their survey and the notional amount was $38.6 trillion at year-end - not 62.
second - thats a gross number - it tells you nothing about the actual risk in the market for any given reference entity. CDS is netted down across positions and so net notional is the only number anybody really looks at.
third - the $2.68 billion in GM CDS outstanding is less than 10% of the bond float - hardly enough to scuttle an exchange - the exchange will have no problem failing on its own because its a bad deal, not because 10% have more to win with a credit event.
that said - there have been recent credit events where CDS holders have played a large role in restructurings - but not the ones you cite. The Rouse auction(the GGP subsidiary that tripped a credit event) only had 8.5 million in net open interest of bonds to settle. In auctions with a large basis trade presence(people held bonds and CDS) you would see a much larger amount of bonds that need to be physically settled.

POSTED ON: APRIL 28, 2009 2:46 PM

From: DickDern,
How can we find out the value of CDSs that the $6.9-Billion-bondholders had who forced Chrysler into bankruptcy? Don't you imagine that it was a lot more than the $2.25 billion offered by the government? That data must be searchable on the internet somewhere.

POSTED ON: APRIL 30, 2009 8:48 PM

From: Hank,
who is john galt?

POSTED ON: MAY 2, 2009 7:33 PM

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