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Naked Swaps Ban Portends Higher Borrowing Costs: Credit Markets
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By Abigail Moses

Oct. 29 (Bloomberg) -- European Union rules to curb speculation on government debt are prompting an exodus from credit-default swaps, making it harder for investors to insure bonds and threatening to boost sovereign borrowing costs.

Trading has dried up on the Markit iTraxx SovX Western Europe Index that was created in 2009 to help investors mitigate government credit risk following the worst financial crisis since the Great Depression. The volume of deals on the 14 nations now included in the measure fell 20 percent from last year's peak to $108 billion, the lowest since April 2010, according to the Depository Trust & Clearing Corp.

The derivatives Warren Buffett called "financial weapons of mass destruction" have worsened Europe's debt woes, according to leaders including German Chancellor Angela Merkel, who invoked a "battle of the politicians against the markets" with her own ban in 2010. From Nov. 1, the EU will outlaw so-called naked default-swap trades on the debt of its 27 nations, or positions where investors don't own the underlying notes.

"The impact on legitimate hedges, or people who have exposures, is that the product they could've used in the past will be less liquid," said Saul Doctor, a London-based credit strategist at JPMorgan Chase & Co., adding that investors may use swaps tied to banks and companies as proxies. "We've started to see evidence of investors taking off CDS positions."

Cutting Exposure

Investors have reduced holdings of European sovereign credit-default swaps, used to hedge against losses or speculate on creditworthiness, in anticipation of the EU ban. They cut their exposure to the 14 nations in Markit Group Ltd.'s SovX Western Europe gauge from a net $135 billion in August 2011, according to the DTCC in New York, which runs a market registry.

While volumes are down for CDS on individual countries, they're worse for the index itself.

Fewer than 10 trades were outstanding on the series of the

SovX WE that started last month, and trading fell almost as soon as the index began as the prospect of regulation made investors reluctant to put on new trades. The surging cost of insuring the bonds of Europe's most indebted nations also distorted the measure and sapped its effectiveness.

Hurricane Sandy

Elsewhere in credit markets, Hurricane Sandy stymied bond-trading and pushed a gauge of U.S. corporate credit risk to the highest in a month. Abbott Laboratories is preparing to raise about $16 billion of debt after the drug and medical-device company that plans to split in two said last week it will tender for as much as $7.7 billion of bonds.

The Markit CDX North America Investment Grade Index, a credit-default swaps benchmark that investors use to hedge against losses or to speculate on creditworthiness, climbed 2.7 basis points to a mid-price of 100.8 basis points at 11:32 a.m. in New York, according to prices compiled by Bloomberg. The index earlier touched 101.1 basis points, the highest intraday level since Sept. 27.

In London, the Markit iTraxx Europe Index of 125 companies with investment-grade ratings rose 2.4 to 131.5.

Credit swaps typically rise as investor confidence deteriorates and fall as it improves. The contracts pay the buyer face value if a borrower fails to meet its obligations, less the value of the defaulted debt. A basis point equals $1,000 annually on a swap protecting $10 million of debt.

Bond Trading

Volume of 278 trades of $1 million or more as of 11:34 a.m. in New York compares with a daily average of 4,319 during the past three months on days when the bond market was open, according to Trace, the bond-price reporting system of the Financial Industry Regulatory Authority.

The Securities Industry and Financial Markets Association recommended a close of noon today in New York and no opening tomorrow of U.S. fixed-income markets as Hurricane Sandy, the Atlantic's largest-ever tropical storm, approached the East Coast.

The U.S. two-year interest-rate swap spread, a measure of debt-market stress, fell 0.31 basis point to 10.13 basis points. The gauge narrows when investors favor assets such as company debentures and widens when they seek the perceived safety of government securities.

Abbott, which makes the world's top-selling medicine Humira, made a tender offer for four bonds with $4.75 billion

outstanding and as much as 47.2 percent on five other issues with $6.25 billion, the company said Oct. 26 in a statement.

Abbott Issuance

AbbVie Inc., a spinoff of Abbott's pharmaceutical operations, will raise just under $16 billion of debt in coming weeks, Thomas Freyman, senior vice president, finance and chief financial officer at Abbott said on an Oct. 17 earnings call.
AbbVie will make a cash distribution of about $8.5 billion to Abbott which the company will use to help fund the tender and pay down a portion of its commercial paper debt.
A deal that size would be the biggest since 2009, when a new issue last topped $10 billion, according to data compiled by Bloomberg. The largest offerings this year include a $9.8 billion issue from United Technologies Corp. in May and a $7.5 billion sale from Anheuser-Busch InBev NV in July, Bloomberg data show.
The EU's rules on speculation will require all market participants, including those from outside the trading bloc, to notify regulators of net short positions in regional shares and sovereign debt, according to the European Securities and Markets Authority regulator. A short position is a bet prices will fall.

'More Cumbersome'

Investors won't be allowed to enter into uncovered short positions on bonds unless they have a reasonable expectation that settlement can be effected when due. Naked sovereign swaps will be banned completely and investors will be required to prove that protection bought is proportional to their holdings of government bonds or other "correlated" securities.
"We see this as making sovereign CDS trading more cumbersome going forward, which will most likely be felt by lower liquidity in the product for at least the next few months," said Barnaby Martin, a credit strategist at Bank of America Corp. in London.
The regulations are an attempt to unify the efforts of individual EU members which are concerned that, in times of instability, short selling might accelerate a downward trend in share and bond prices and create systemic risks.

Merkel's 'Adversaries'

Germany was among governments to have already implemented piecemeal bans on short selling, with Merkel two years ago labeling speculators as "our adversaries." These moves failed to achieve their aim of keeping asset prices from falling and

succeeded only in impeding markets, the International Monetary Fund said in August 2010.
Borrowing costs of some of the world's biggest economies soared to unsustainable levels earlier this year amid the euro-region crisis, before European Central Bank measures to calm markets brought rates down again.
Spain's 10-year bond yield climbed to a record 7.75 percent before falling to 5.6 percent at the end of last week, while Italy's note yield jumped to as high as 6.71 percent and Portuguese rates climbed to 18.29 percent.
"We see the EU's new sovereign CDS regulation as being effective in discouraging demand for hedging with sovereign CDS," Phanikiran Naraparaju, an analyst at Morgan Stanley in London, wrote in an Oct. 26 note. "The regulation should naturally reduce the value of sovereign CDS compared to bonds."

Positive Basis

The so-called positive basis, which exists when default swaps exceed bond rates, has narrowed, though the EU ban is not yet fully priced in, Naraparaju wrote.
The first traded series of Markit's SovX Western Europe credit-default swaps index now insures $3.4 billion of government bonds, down from $12 billion in February 2010, DTCC data show. That's still more than any of the six subsequent versions of the gauge. The indexes are rebalanced every six months in an attempt to make them easier to trade.
The absence of activity on the latest version of the SovX WE index contrasts with the 510 trades covering $1.5 billion of debt on an equivalent measure of central and eastern European governments and the 463 contracts insuring $4.1 billion on a gauge of global emerging-market sovereign bonds. There are also 971 trades protecting a net $3.7 billion of U.S. Treasuries, down from a peak of $6 billion in August 2011, DTCC data show.
On the day the EU's naked-swap ban comes into force, Markit will start offering a version of its central and eastern European government index that strips out the trading bloc's members. It will be called the iTraxx SovX CEEMEA Ex-EU index.

Solvency Risk

The market for credit-default swaps tied to developed sovereigns grew out of the debt crisis as investors sought to hedge the solvency risk from governments shouldering the burden of saving their banking systems.
Trade volumes on the 14 nations in the SoxX Western Europe index climbed to a record $135 billion in August 2011 from about $80 billion in 2009, while contracts on U.S. Treasuries soared

to a peak of $5.9 billion from $1.2 billion in 2008, when
Bloomberg began recording the data.
"Because there was liquidity in CDS, people were willing
to take exposure to sovereigns and continue to lend and trade
and do business," said JPMorgan's Doctor.
The creation of the Western Europe index was "expected to
bring more investor demand for sovereign credit," Markit said
in 2009. Limiting credit-default swaps may have the opposite
effect, according to Michael Hampden-Turner of Citigroup Inc.

'Illiquid' Hedge

"If you can't use CDS as hedges because they've become
illiquid, the temptation is to get rid of sovereign positions
altogether," said Hampden-Turner, a London-based strategist at
the U.S. bank. "It will make it more expensive for governments
and companies to borrow in the market because people aren't able
to have a liquid hedge."
The impact on government bond prices may be limited by the
relative size of the markets, with credit-default swaps covering
just 1 percent of French, Italian and German debt, according to
data compiled by Bloomberg.
The swaps ban coincides with the Frankfurt-based ECB's
pledge to buy bonds issued by euro-region governments, which has
also helped reduce demand for sovereign debt swaps and lower
insurance costs. The Markit iTraxx SovX Western Europe Index
fell to a 2 1/2-year low of 100 on Oct. 25, from about 360 at
the start of the year, according to Bloomberg prices.
Less CDS trading and lower prices, combined with ECB-
supported bond rates, may remove important early indicators of
market stress, said Peter Tchir, the founder of New York-based
TF Market Advisors.
"No liquidity and no canaries," Tchir said. "It's a bad
combination."

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