"Standard" Credit Default Swaps on Greece Are a Sham and It's Not a Surprise

Credit Default Protection: Caveat Emptor

By Janet M. Tavakoli, President, Tavakoli Structured Finance, Inc.

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At least it's not a surprise to any financial professional that has paid attention to the false reassurances that the International Swaps and Derivatives Association, Inc. (ISDA) has given over the years to naïve participants in the credit derivatives market.

"Customers" that accepted ISDA documentation when buying credit default protection on Greece are now discovering that ISDA defends the position that a 50% discount on Greek debt is "voluntary" and therefore not a credit event for credit default swap payment purposes according to its documents. This makes the ISDA "standard" credit default swap (CDS) ineffective as a hedge for the widened spreads (reduced price) of Greek debt, and it makes it ineffective as a protection against default using reasonable standards of impairment to define default. ISDA can defend ambiguous definitions so that payment on the credit default swap is virtually impossible.

First Step in a CDS: Protect Yourself from the ISDA Cartel

As previous sovereign problems have illustrated, the only way to buy protection is to rewrite the flawed ISDA "standard" document and agree to new more sensible terms, before concluding the initial trade. One has to first protect oneself from the ISDA cartel "standard" documentation before one can buy sovereign default protection, or any other protection for that matter.

I explained the need to rewrite ISDA documentation in some detail to the IMF in April 2005. (A short excerpt is on my web site accessible via this link.) In the intervening years ISDA documentation changed, but the need to rewrite it remained the same. I cannot stress enough that the International Swaps and Derivatives Association, Inc. (ISDA) "standard" documentation touted by that organization does a grave disservice to unwary credit default protection buyers. The first thing a credit derivatives trader needs to do when presented with such a document is to rewrite it and agree upon new terms before the trade. There is no such thing as "standard" documentation in the credit derivatives market, particularly the sovereign credit derivatives market.

Credit default swap documentation has a long history of problems. This isn't the first time investors have been burned in the sovereign credit default swap market. Hedge funds Eternity Global Master Fund Ltd. and HBK Master Fund LP thought they purchased protection against an Argentina default and sued when J.P. Morgan refused to pay off on Argentina credit protection contracts they had purchased.

At issue was the definition of restructuring. Did Argentina's "voluntary debt exchange" in November of 2001 meet the definition of a restructuring? The Republic of Argentina gave bondholders the option to turn in their bonds in exchange for secured loans backed by certain Argentine federal tax revenues. J.P. Morgan claimed this didn't meet the definition of restructuring, at least for the protection it sold to Eternity.

J.P. Morgan's story was different when it wanted to collect on the protection it bought from Daehon, a South Korean Bank. J.P. Morgan claimed its slightly different contract language met the definition of restructuring under the credit default protection contract it had with the South Korean Bank.

In other words, J.P. Morgan made sure its contract language would allow it to get paid when it bought protection and would make it harder for its counterparty to get paid when it sold protection.

Language Arbitrage: You're Not a Sucker, You're a Customer

Banks that play this game call it "language arbitrage." Anyone that bought sovereign credit protection on Greece after accepting ISDA "standard" documentation without modifying the language now finds that they are on the wrong side of an "arbitrage." An arbitrage is a riskless money pump. In this case, it means that money has been pumped out of credit default protection buyers with no risk to their counterparties, the financial institutions that ostensibly sold them credit default protection on Greece.

Janet Tavakoli is the president of Tavakoli Structured Finance, a Chicago-based firm that provides consulting to financial institutions and institutional investors. Ms. Tavakoli has more than 20 years of experience in senior investment banking positions, trading, structuring and marketing structured financial products. She is a former adjunct associate professor of derivatives at the University of Chicago's Graduate School of Business. Author of: *Credit Derivatives & Synthetic Structures* (1998, 2001), *Collateralized Debt Obligations & Structured Finance* (2003), *Structured Finance* & *Collateralized Debt Obligations* (John Wiley & Sons, September 2008), and *Dear Mr. Buffett: What an Investor Learns 1,269 Miles from Wall Street* (Wiley, 2009), a book about early warnings and the causes of the global financial meltdown.

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