FT.com
FINANCIAL TIMES

Counterparty risk makes an anxious return
October 31, 2011

Every week the fixed income team of one large European bank takes two minutes out of its busy schedule to look at the credit default swap spreads of its competitors. They have been blowing out in recent months, a sign of rising stress at these institutions, becoming a prime marketing tool for the bank.

It is all about emphasising a better financial standing, or “preferred counterparty” status, says one senior fixed income banker.

As markets fret over the health of European and US banks by selling bank stock or bidding up the cost of credit default swap protection on banks’ bonds, the idea of “counterparty risk” has resurfaced. Last seen in the depths of the financial crisis, when the collapse of Lehman Brothers left many of the failed bank’s business partners in the lurch, counterparty risk is back with a vengeance, posing new challenges and skewing new business towards banks perceived to be stronger than their peers.

“Counterparty risk has been a key theme this year, especially with the Greek situation getting worse and worse, plus isolated incidents like the UBS rogue trader,” says Luke Spajic, head of European credit portfolio management at Pimco. “But it’s even more of a concern now than in 2008 and 2009, because of the scars from Lehman.”

Concerns are even spreading to the dealer banks themselves – evidenced by their own rising CDS spreads – simply because they are the sellers of CDS. That raises questions over whether these banks will be healthy enough to make good on their sold CDS contracts, in the event that a weaker European country restructures or defaults on its debt.

Banks and investors typically buy CDS protection from these ‘dealer’ banks, to hedge their assets or simply express an investment view. In the event that the bonds sour, sellers of the CDS are expected to make a pay-out to buyers of this insurance.

Concerns are so stark that some analysts are now lauding big banks for reducing their use of CDS as a hedge. “Compared to global peers, Deutsche Bank is less reliant on credit protection bought against its gross sovereign exposures,” Barclays Capital analysts wrote in a note to clients, after the German bank posted quarterly results this week. Concern over banks’ use of CDS, they wrote, stems from counterparty issues as well as questions over whether CDS written on Greek bonds will actually trigger.

“In a world of uncertainty, you have to ask who is really safe,” says Jeremy Sigee, BarCap bank analyst.

Nowhere is counterparty risk more prominent than in the interbank funding markets responsible for lubricating the financial system.

Key measures of interbank stress remain elevated, though still far from their Lehman highs. Three-month dollar Libor, or the rate at which banks can borrow the US currency for three months, climbed again on Wednesday, creating the longest run of gains since late 2005. Meanwhile, the spread between dollar Libor-OIS overnight indexed swap rates, a gauge of banks’ reluctance to lend to each other, widened to 34.52 basis points – close to the highs of summer 2009.

There's further evidence of counterparty concerns outside of bank-to-bank relationships. As credit spreads have widened out for some banks, clients who have prime broker business relationships with those institutions have also been getting cold feet.

Bankers at relatively healthy financial institutions describe how clients have been seeking to turn over their prime broker relations to stronger lenders. If they've been unable to do so – because they may have a myriad of assets and services linking them to their prime broker – these funds have found other ways to limit their counterparty risk.

For instance, they may choose to continue their prime broking relationships while taking out their cash in what are known as 'overnight sweeps' – depositing their money in a custodian bank, considered less risky by market participants.

This has been a growing trend, particularly as some funds go shorts financials. If you are shorting financials, a source within the industry says, as it is "nonsensical" to help the banks finance themselves by leaving cash with them overnight.

The pool of counterparties for billions of dollars worth of structured finance deals has also shrunk dramatically, Fitch Ratings has warned, as more banks have been downgraded.

Since October 2007 the number of eligible counterparties, dictated by an institution's credit rating, has fallen by about 60 to fewer than 250 globally, Fitch says.

"It is now at a point that is putting pressure on how easily counterparties can be replaced and on the liquidity of derivative counterparties," Fitch said in a report . "It is also increasing concentration risk in an already vulnerable financial system."

Regulators are already looking to reduce counterparty risk in the financial system by shifting derivatives towards central clearing. Users of derivatives such as CDS will have to run their trades through central clearing counterparties, who will stand between them and those on the other side of the trades.

But that, together with a smaller group of elite banks taking more and more of the derivatives business, could also concentrate risk in the financial system. And with funding costs climbing for Europe's banks, many will have to shrink their balance sheets, radically alter their business models or merge with competitors to survive, further concentrating risk.

This poses challenges not just for regulators but for banks too, with sidelined instutions having to question their business models.

"The big get bigger and the smaller get more original," quips one senior banker.

•Jonathan Epstein, superderivatives **|** October 31 2:09pm **|**

The consensus is that a 50% haircut on Greek debt, short of triggering a credit event, will do more harm than good. Regulators are yet again undermining CDSs, the very instruments put in place to hedge against corporate and sovereign risk, leaving market participants questioning whether the focus was really on stabilizing the Euro Zone economy or it was a way to avoid a Lehman-style collapse of the Hellenic Republic of Greece.

From my perspective a Greek default would actually benefit the Euro Zone. This would provide a shot across the bow to Portugal, Spain or Italy to get their economies in order expeditiously, bringing more stability to the EU. The lynchpin to market stability is accurate, real-time pricing data. For example this afternoon, Greek CDSs were trading erratically with most showing a sharp tightening of their five-year spreads to around 54% upfront or 3,600 bps. This is a time when pricing data is vital. Without this information, customers have no visibility into the CDS market, inhibiting their ability to utilize this instrument to effectively hedge.

Ultimately we won't know until sometime in 2012 how this will all play out. However, we do know we're on the precipice of some market changing decisions within the CDS community as to whether these instruments can be used as an effective hedging tool moving forward.

•Report Heinz Geyer | October 27 4:38pm
As in tighter regulation of maturity mismatches, future regulation of banks should also reduce the need for the interbank merry-go-round. Banks should be incentivised to fund the predominant part of their balance sheet with customer deposits. Only very marginal amounts should be financed in the interbank market, more like smoothing out the natural flow of deposits.
Heinz Geyer, Temple Associates, London

•SMS5459491 | October 27 3:06pm
You mention central clearing but it's no longer hypothetical...check out LCH, CME and ICE volumes....defintely a reflection of increased counterparty risk concerns. In current state, CCPs have regulatory approval and commercial viability. No mandate needed.