Have Swaps Overdone the Gloom?; Values Imply Losses, Default Risk Across Wide Swath


Abstract (Summary)
The ABX has been criticized as an inaccurate indicator of subprime mortgage losses -- even the Bank for International Settlements said in a recent report that loss estimates implied by the triple-A slice of the index may be overstated.

Full Text (527 words)

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Stocks keep falling but the prices of derivatives that track how investors feel about potential defaults are signaling even deeper concern.

The values of these credit-default swaps have hit levels that imply high losses or default risk over the next few years on everything from subprime-mortgage debt to bond insurers and auto makers.

Analysts say the markets for swaps have likely gone too far and the doom they are predicting overstates the problems in the mortgage market and broader economy. But the moves reflect significant concerns in the marketplace over how individuals and companies will be affected by the mix of slumping housing prices, spiking oil and commodity costs, and a slowing economy.

Swaps tied to the bonds of General Motors Corp. and Ford Motor Co. are indicating that investors see more than a 70% chance that the auto makers will default in the next five years. For bond insurers MBIA Inc. and Ambac Financial Group Inc. the swaps are implying an even-higher default probability of over 90%.

In the subprime market, an index of swaps suggests that a majority of the home loans made to less-creditworthy borrowers in recent years will end up in default.

Chip Stevens, U.S. head of active fixed-income trading at Barclays Global Investors, says investors bracing for a worst-case scenario are willing to pay more for insurance against bonds they feel are increasingly likely to default. He adds that while prices are probably overestimating default risk in some sectors, "as compared to the onset of the credit crunch, there's now a real chance that the recessionary outlook could become longer and potentially deeper."

Banks and investors buy credit-default swaps to protect against losses on bonds or loans they hold; many traders and hedge funds also use the swaps to bet on the fortunes of companies or sectors. The swaps moves don't always correlate to the actual securities.

In the past week, the ABX index of swaps, which tracks the performance of subprime-mortgage bonds, dropped to new lows as the cost of default insurance on these assets soared. The index that tracks triple-A subprime-mortgage-backed securities fell to 45.9 cents on the dollar, down 17% from a month ago and 38% in the year to date, according to data from Markit.

The ABX has been criticized as an inaccurate indicator of subprime mortgage losses -- even the Bank for International Settlements said in a recent report that loss estimates implied by the triple-A slice of the index may be overstated. Financial institutions continue to use the index to hedge their holdings of mortgage assets, and their buying of protection has the effect of pushing the index lower still.

Credit-default swaps tied to GM imply it has a 31% chance of defaulting in the next year, even though GM has billions in cash to tide it over the near term.
Meanwhile, the cost of protecting against a default by Ambac and MBIA is especially high. However, "a fair amount of what's going on involves firms hedging their counterparty risk, rather than outright fear that the [insurers] will default in the next few months," says John Tierney, head of credit derivatives research at Deutsche Bank.