When banks cannot trust each other

There is a lot to worry about when you deal in the financial markets—whether you have made the right judgment about profits, interest rates or the economy. But life gets even harder if you worry that the bank you trade with is about to go bust.

That problem—counterparty risk—has been roiling the markets lately. Traders often insist on some protection in the form of collateral (usually cash or short-term government debt) when dealing in derivatives. But in recent weeks counterparties have been pushing to ensure that collateral gets bigger “haircuts”—that is, they accept assets only at a greater discount. The idea is to make sure they do not end up as the ones being scalped.

Even with collateral, sorting out a counterparty default would be a nightmare. Hence the Federal Reserve’s extraordinary measures to keep Bear Stearns from falling into bankruptcy. “If Bear Stearns had failed, banks would not have known where they were for days or weeks,” says a hedge-fund manager. The markets might well have frozen and other banks might have collapsed.

What makes life particularly difficult is that banks have a multitude of offsetting positions with each other. When assessing their market risk, they normally look at their net positions. But if a counterparty is in trouble, that may not be appropriate.

Investors may have taken one position with Bear Stearns as a counterparty, and then hedged its risk through another trade with, say, Morgan Stanley. In the event of a Bear Stearns default, that hedge would have broken down; they would suddenly have found themselves with an unanticipated (and unwanted) market risk. The effect could have been chaotic.

Bear Stearns was particularly active in the credit-default swaps (CDS) market, which has grown exponentially to around $45 trillion. A CDS enables its buyer to separate the risk of default from a bond’s other features, such as its interest rate. Like insurance against fire or theft, it protects investors against the risk of default.

But, as often in finance, an instrument designed for insurance became a tool for speculators. In some cases, the amount of outstanding insurance via CDSs is far greater than the underlying value of the bonds. That can be overcome through cash settlements in the event of default. But the auction price of the cash settlement may not represent the eventual recovery rate after the company has been wound up. So the CDS is far from a perfect hedge.

Even more difficult is the question of what constitutes default. Say a brilliant investor had forecast Bear Stearns’s troubles last month and bought protection accordingly. Even though Bear Stearns’s shareholders have been all but wiped out, the company has not defaulted on its debt. Indeed, once the investment bank becomes part of JPMorgan Chase, the risk of default will fall sharply. The cost of protection on Bear Stearns
duly fell by two-fifths on March 17th. And the CDS premiums on the debts of other American banks also
dropped, even as their shares were taking a pasting. That suggested investors had decided that the Fed, while
penalising shareholders, would not allow another member of Wall Street's finest to fail outright.

Even trickier cases than Bear Stearns may be in store. What if troubled firms are split into good banks and
bad banks, with the shaky assets being shoed into the “bad” entity? The effect on CDS buyers would
depend on whether the good or bad bank was deemed to be the counterparty. Before this crisis is over, the
CDS market looks almost certain to become a lucrative trade for lawyers.