

Behind counterparty risk and credit default swaps

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Given the crisis on Wall Street and the focus on American International Group Inc., one of the world's largest insurers, everybody is suddenly talking about counterparty risk.

What is counterparty risk, and why is it suddenly an issue?

In the simplest terms, counterparty risk is the chance that the person on the other side of a deal - the counterparty - won't be there when it's time to pay up. Take an example most people can relate to: Selling a home. There's always the chance that when it comes time to close the deal a month or so down the road, the buyer won't show up or won't have the money.

In financial markets, traders and banks are constantly thinking about counterparty risk. When they make a deal to buy or sell, they often look at the credit rating of the party on the other side of the transaction. If the credit rating is high, they will go ahead with the deal. If the credit rating isn't so hot, they might ask for additional guarantees or collateral. Or maybe they won't do business with the counterparty at all, which is what happened to Lehman Brothers and Bear Stearns in their last days.

How does that relate to what's happening at AIG.?

As an insurer, AIG expanded into the business of selling insurance against bond defaults, probably figuring it wasn't that much different than writing life or home insurance. AIG provided the insurance through derivative contracts known as credit default swaps. The problem for AIG is that it looks like there could be a lot of claims at once because of a wave of defaults on mortgages and by companies such as Lehman Brothers, Fannie Mae and Freddie Mac. By some estimates, the firm could face losses of \$25-billion (U.S.) on the swaps.

How does a credit default swap work?

It's almost like an insurance policy against a credit default – the possibility that some entity won't make good on its debts. Take the example of a Canadian government bond: The seller of the swap, or policy, gets a regular stream of premium income. In return, the seller of the swap agrees to pay the buyer if the government of Canada goes broke or stops paying its debts for some other reason. There are \$62-trillion (U.S.) of credit-default swaps outstanding, according to the most recent estimates by the Bank for International Settlements. However, that number may be low because the contracts are private in nature and not traded on any central exchange where they can be tracked.

Why is there so much panic because AIG's credit-rating has been slashed?

With a lower credit rating, counterparties are demanding that AIG put up some extra collateral to ensure that it can pay claims on bond defaults. AIG, according to regulatory filings, may face calls for as much as \$13-billion of money to be set aside. That's adding pressure on the company to raise money, but in today's markets, it's next to impossible.

How did AIG end up in this situation?

The company worked through the weekend to raise capital by selling subsidiaries, but at the end of Sunday it rejected bids from private equity firms and instead appealed to the U.S. government for a loan. The government, which is trying to avoid further bailouts, said no and told AIG and the rest of Wall Street to seek a private-sector solution. Banks such as Goldman Sachs Group Inc. have been asked by the U.S. Treasury to try to come up with as much as \$75-billion to lend to AIG, but there are questions about the viability of that plan.

Why would a failure at AIG potentially be more trouble than Lehman Brothers?

For the world financial system, AIG is a powderkeg because of its CDS contracts. Lehman too was a big player in the market, but it was both a buyer and a seller, so its net exposure is relatively small as many contracts cancel one another out. AIG is primarily a seller of credit default swaps, meaning there are many players out there who are depending on AIG's ability to pay up on insurance policies. If AIG can't do so, the ripple effects on the holders of that insurance could be trouble.

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