

Lehman exposes faults in credit default swaps

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The failure of Lehman Brothers has exposed new fault lines in the credit default swap market, with the bank's absence putting pressure on its counterparties to buy more credit insurance just as confidence in the market is waning.

"It is a cannibalistic frenzy," says one lawyer representing some of the Lehman counterparties in disputes with the failed investment bank. "The credit default swap market has taken on a life of its own. There are huge exposures out there."

Lehman's mid-September bankruptcy is the largest in the US and recoveries for unsecured creditors might be as low as 11 cents on the dollar.

"Many investors had long and short CDS positions with Lehman which are terminated post Lehman's default," said a recent report from JPMorgan Securities. "This leaves investors suddenly long or short on credit risk. Investors need to reset these positions with other counterparties, sometimes at a loss."

In other words, at the moment, participants can't just extinguish credit derivatives contracts with Lehman, they can only offset them. That, in turn, puts pressure on some participants to buy more credit insurance and the cost of such contracts is rising.

Moreover, many counterparties to Lehman who believe it owes them money have joined the ranks of unsecured creditors. This increases the number of claimants and reduces the money available to bondholders and other creditors.

"The impact of a default far outweighs the economic impact of just the debt and equity a company has issued," said Gregg Berman, co-head of the risk business at RiskMetrics. "When you write derivatives to take exposure and have more people betting, you magnify the impact of a default".

The exact amount of any claim is determined by the difference between the value of the collateral and the cost of replacing the contract. The cost has risen in line with fears about the health of financial institutions and the creditworthiness of counterparties.

Theoretically, claims against Lehman should be offset by claims on Lehman's part. But those who believe Lehman owes them money are pressing their claims, and those who owe money to Lehman "basically say come and get me", the lawyer added. * Nomura continued its rescue of Lehman yesterday after the Japanese bank said it would hire 150 fixed-income staff from the US banks' European operations.

Nomura also said that the conditions to closing the acquisition of Lehman's European and investment banking and equities division had been met and that a significant number of the 2,500 staff employed in that unit had been retained.