Wall Street Shrinks From Default Swaps as Dodd-Frank Rules Hit Speculators

Bloomberg
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November 29, 2010

Trading in credit-default swaps, Wall Street's fastest-growing business before the credit crisis, has tumbled 40 to 60 percent from three years ago as banks prepare for new regulation of derivatives.

The declines estimated by executives at four of the biggest dealers of swaps means lower profits at firms that used to get as much as two-thirds of credit-market trading revenue from the derivatives. Moody's Investors Service says pending rules may translate into job cuts of as much as 50 percent in groups that trade the contracts.

Investors are avoiding strategies that contributed to $1.82 trillion in writedowns and losses amid the worst financial crisis since the Great Depression. The net amount of credit swaps outstanding globally has fallen 20 percent from October 2008, the earliest figures disclosed by the Depository Trust & Clearing Corp. in New York.

"This was a major profit center for a lot of banks," said Hal Scott, a Harvard Law School professor who also is director of the Committee on Capital Market Regulation, a nonpartisan group of academics and business executives that in May 2009 called for measures to reduce the risks derivatives pose. "It's part of a bigger picture of reduced financial activity due to uncertainty and regulatory reform."

$62 Trillion

While JPMorgan Chase & Co. created credit swaps in the 1990s as a way for investors to protect themselves against loans going bad, trading soared after the industry began developing standard terms by 2003.

The contracts, in which a seller of protection is paid an annual premium for agreeing to cover the buyer's losses should the underlying borrower default, ballooned to more than $62 trillion at the peak in 2007 on a gross notional amount from $632 billion in 2001.

In October 2008, Richard Fuld, then chief executive officer of Lehman Brothers Holdings Inc., blamed his firm's collapse partly on "destabilizing" forces including the escalating cost of swaps on the investment bank's debt. Hedge fund manager George Soros called the market "unsafe," and billionaire investor Warren Buffett once likened derivatives to "financial weapons of mass destruction."

Unlike with Treasuries and corporate bonds, dealers don't disclose historical trading volumes in swaps. The four banks provided estimates on the condition they not be named. Derivatives are contracts whose value is tied to assets including stocks, bonds, commodities and currencies, or events such as changes in interest rates or the weather.

Fed Data

The five biggest dealers -- JPMorgan, Goldman Sachs Group Inc., Morgan Stanley, Citigroup Inc. and Bank of America Corp. - - bought a net $430 billion of credit protection as of Sept. 30, down 38 percent from $689.9 billion in March 2009, filings with the Federal Reserve Bank of New York show.

Barclays Plc analyst Roger Freeman in New York estimates that before and during the credit crisis, Goldman Sachs generated two-thirds of its credit-trading revenue from derivatives. The contracts now likely contribute about a third, with the rest coming from bonds, he said. Michael DuVally, a spokesman at Goldman Sachs in New York, declined to comment.

Average daily trading in U.S. corporate bonds fell 12 percent the past six months compared with a year earlier, according to the Securities Industry & Financial Markets Association, a trade group.

While Freeman expects a rebound once regulators meet their July deadline to write market rules, the changes will likely squeeze profit margins and prompt bank executives to cut more trading jobs.

'Growing Comfort'

"There seems to be growing comfort over the structure of this market and how it's going to evolve," Freeman said in a telephone interview. "So I'd say we and people in this business are cautiously optimistic it grows from here."

Credit-derivatives departments were some of the hardest hit when the U.S. securities industry slashed more than 80,000 jobs after the financial crisis, according to Michael Karp, the chief executive officer of Options Group, a recruitment firm in New York. Banks that employed 20 to 30 people in credit derivatives sales and trading in 2006 and 2007 now have between 5 and 10.

The Dodd-Frank financial overhaul, signed by President Barack Obama in July, is intended partly to curb risks to the economy from swaps. It will require most trades to go through clearinghouses that are capitalized by the banks and demand uniform amounts of collateral backing the trades.

To reduce opacity that Commodity Futures Trading Commission Chairman Gary Gensler says gives banks an information advantage, trades will have to be done on systems that make dealers compete over pricing and may automate some transactions now done by phone. The deals also will be reported publicly.

Declining Margins

The changes may drive down pre-tax profit margins for credit swaps to 22 to 23 percent from about 35 percent, said Sanford C. Bernstein & Co. analyst Brad Hintz, ranked by Institutional Investor as the top analyst covering brokerage firms.

“That’s a big drop,” he said. “But it doesn’t mean the business goes away. It just becomes a cash business like the equities cash business or a corporate bond business.”

Goldman Sachs Chief Executive Officer Lloyd Blankfein described such a scenario at a Nov. 16 conference sponsored by Bank of America. After changes in equities markets drove commission rates down and volume up for the bank, the firm invested in new computerized stock-trading platforms and was able to slash half the department’s 5,000 trading jobs, he said.

Regulation of the over-the-counter “derivatives market will drive greater transparency and automation,” Blankfein said at the conference. “While transparency can reduce margins, it also introduces new opportunities in the form of greater client participation and product innovation.”

Fed Clamps Down

While the creation of swaps in the 1990s freed up capital to allow banks to make more loans, they also made it easier to bet on or against a borrower’s creditworthiness.

Trading in the contracts grew so fast that banks struggled to keep up with the paperwork. Former Federal Reserve Chairman Alan Greenspan complained at an industry forum in May 2006 that dealers often recorded trades on “scraps” of paper, calling the practice “appalling.” Concerned that a backlog of unconfirmed contracts could trigger a loss of confidence, the Federal Reserve Bank of New York forced dealers to clean up their recordkeeping.

Hedge funds and banks started using the contracts to speculate on the ability of companies, governments and even homeowners to repay debt they didn’t hold. American International Group Inc., once the world’s largest insurer, needed a $182.5 billion government bailout because of credit swaps it sold that guaranteed payment of subprime mortgages.

Rules in Flux

Congress considered banning investors from buying swaps if they didn’t own the underlying debt they were insuring. Though that proposal died, the threat contributed to the slowdown in trading. Would-be users of the derivatives are staying out of the market until they determine how stringent the final rules will be once regulators impose them next year, Hintz said.

“No one’s going to enter into a credit-default swap when you don’t know what the rules are going to be going forward,” Hintz said.

Before 2008, as much as half of the trades in the market were done to create and protect against losses from so-called synthetic collateralized debt obligations that investors bought to bet on the creditworthiness of companies and countries.

The market for CDOs, which are securities made up of bonds sliced into different levels with varying degrees of risk and returns, is in decline, with $72 billion of the securities created this year, down from the record $503 billion in 2006, according to Morgan Stanley.

Less Hedging

Money managers who bought swaps protecting against plunging asset prices in 2008 unwound those hedges in 2009 as markets rebounded, said Andy Hubbard, head of U.S. structured credit trading at Credit Suisse Group AG in New York.

“Now that we’ve recovered, people aren’t as worried about credit risk and there’s not the same degree of hedging happening,” Hubbard said.

Banks have more than made up for the loss of revenue from dealing in credit swaps by trading the underlying bonds. Institutions that once derived about 70 percent of debt-market trading revenue from swaps and the rest from bonds have largely reversed the ratio, said Alexander Yavorsky, a securities firm credit analyst at Moody’s in New York.

A surge in bond trading helped drive Goldman Sachs’s revenue from buying and selling securities and derivatives in the fixed-income, commodities and currencies markets to a record $23.3 billion last year, according to company statements.

New Products

With volume in that business declining, fixed-income revenue at Goldman Sachs, JPMorgan, Citigroup, Morgan Stanley, Credit Suisse, Bank of America, Deutsche Bank AG and Zurich-based UBS AG slipped an average 12 percent during the first nine months of 2010 from the same period in 2009, regulatory filings, investor presentations and Bloomberg data show. Only Morgan Stanley and UBS reported a gain.

To make up for lost revenue, banks are considering products they rebuffed three years ago: futures contracts that would be tied to benchmark credit indexes and traded on exchanges such as CME Group Inc.

Goldman Sachs, Deutsche Bank, Morgan Stanley and Barclays are among dealers coordinating with credit swaps index owner Markit Group Ltd. to potentially offer exchange-traded futures linked to the Markit CDX indexes, people familiar with the discussions said last month.

The contracts would open the market to small hedge funds, equity investors and money managers that don’t trade the contracts enough to justify the cost of negotiating two-party agreements with banks, said the people, who declined to be identified because the talks are private.

“The world’s changing and the regulatory pressures are changing the rules of the game,” Andy Nybo, head of derivatives at research firm Tabb Group LLC in New York, said in a telephone interview. “The dealers are adapting and looking to remain relevant and create the products that their clients want and need.”