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Debunking Some Myths About The "Greek CDS Contagion" Threat

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Created 06/18/2011 - 18:42

Now that the Greek bailout is topic front and center for the second year in a row, it means that it is time for the mainstream media to once again prove to the world that in the past year it has learned precisely *didley squat* about how the more complicated securities used in capital markets operate. Such as CDS. Just like in May 2010, the prevalent trope among the clickbaiters is that CDS written against Greece will destroy the world, in superficial attempts to bring about panic induced by the faulty conventional wisdom that CDS was the cause for the implosion of AIG. Well, wrong.

First, for those who actually care, CDS is nothing more than a low margin synthetic method to express a bearish position on an underlying credit (such as US government bonds), in the process facilitating market clearance and price discovery. Period. And as long as there is an idiot who is willing to take the other side of a trade which expresses nothing more than appreciation of risk, CDS can be written into existence (which is how Paulson made his Abacus money) or traded on the secondary market (the fact that said idiot is *still* trading CDS is thanks to the US government policy of making financial risk and failure a thing of the past, but that is the topic for another post). Another key CDS feature that is constantly ignored by nearly everyone is variation margin, or the daily posting of cash collateral based on intraday moves of CDS. This was [extensively discussed](#) [1] in our post on the threats posed by the \$600 trillion OTC market. A third key fact is that all the data on Greek CDS is [publicly available](#) [2] yet nobody bothers to actually check it: after all why let facts stand in the way of a good story. So here are the facts: there is \$5 billion in **net notional daily margined** risk exposure on the Hellenic Republic (also known as Greece). This is a **28% reduction** in net notional risk over the past year, the largest drop in risk exposure of any of the top 30 credits tracked by DTCC. The total notional of Greek CDS outstanding is the 21st biggest in the world, behind such names as Italy (at the top), France, Spain, Goldman, JPMorgan, Berkshire and Wells Fargo. Lastly, 5 Year Greek CDS (at last check about 45 points upfront) is currently trading wide of cash bonds, which upon an event of default will likely rise on short covering and higher recovery expectations, which means that sellers of protection will actually *receive* a cash payment from this point until an actual EOD occurs when the basis between cash and CDS collapses.

The truth is that there is certainly risk from a Greek contagion effect, and far more than a risk - it is a certainty, and the catalyst will be none other than the world's largest and most undercapitalized hedge fund - the ECB, which holds tens of billions of Greek debt as cash collateral which would have to remarked 50% lower in the process making the key European liquidity backstopper insolvent (in practice if not in theory: after all the ECB will just print more €), forcing a self-fulfilling liquidity run prophecy. But the contagion risk is **not** in Greek CDS, where risk sellers have not only contracted their exposure by the largest amount of the most active contracts,

but where daily steady cash outflows to satisfy variation margin mean that banks have "overreserved" for an event of default, and may in fact be cash inflow beneficiaries.

As the DTCC-sourced chart below shows Greek CDS has seen the largest drop in net notional outstanding among the 30 largest positions. Furthermore, as can be seen it is well down on the table. The names in the top 5 positions should be a far greater source of risk, as that is where the perception of risk, and the market "reality" have not yet converged.

Rank	Reference Entity	Week of June 16, 2011			Week of June 15, 2010			Net Notional Change	
		Gross Notional	Net Notional	Contracts	Gross Notional	Net Notional	Contracts	\$ Value	%
1	Republic Of Italy	278,048,059,154	25,898,100,449	7,630	224,326,297,485	22,888,232,127	6,094	1,149,878,322	4.8%
2	French Republic	104,331,250,952	20,136,853,641	5,110	37,322,751,813	11,351,126,873	2,299	8,783,728,668	77.4%
3	Kingdom Of Spain	153,636,896,021	18,392,483,646	7,200	102,786,886,895	13,728,580,302	4,369	4,662,908,944	34.0%
4	Federative Republic Of Brazil	186,693,777,331	17,115,178,868	12,472	134,093,473,815	14,588,629,820	11,821	2,526,548,948	17.2%
5	Federal Republic Of Germany	99,362,638,170	16,324,283,933	3,248	72,472,396,372	14,217,776,382	2,827	2,306,528,528	16.2%
6	United Kingdom Of Great Britain And Northern Ireland	63,820,375,884	11,837,285,039	4,688	48,663,978,873	10,446,349,817	3,262	1,493,933,122	13.9%
7	General Electric Capital Corporation	101,293,985,473	11,382,986,204	7,812	88,998,692,609	15,117,349,204	7,291	-34,443,000	-0.3%
8	United Mexican States	126,796,678,854	9,989,921,793	10,660	107,896,544,321	8,177,593,833	9,879	2,911,327,990	47.3%
9	Japan	46,631,867,449	8,299,580,694	3,146	38,187,568,450	4,520,274,790	2,794	3,777,865,984	83.6%
10	Kingdom Of Belgium	33,807,215,423	7,398,528,025	2,834	27,947,440,535	3,439,367,998	1,289	1,889,160,099	34.4%
11	People's Republic Of China	41,847,196,929	6,884,486,433	4,370	34,212,506,099	3,375,770,940	3,739	3,188,736,396	86.9%
12	Portuguese Republic	64,692,483,511	6,248,973,668	3,408	46,402,788,724	8,127,295,941	2,723	-1,778,522,073	-21.9%
13	Republic Of Turkey	145,283,380,581	6,125,960,829	8,987	138,671,867,252	3,799,681,745	7,897	526,279,084	9.3%
14	Republic Of Austria	53,938,453,311	6,252,589,246	2,193	42,411,217,756	7,795,542,247	1,731	-1,543,033,000	-19.9%
15	Bank Of America Corporation	81,419,321,311	5,797,283,961	8,844	82,178,886,280	3,808,806,697	8,028	-172,522,096	-2.9%
16	The Goldman Sachs Group, Inc.	70,377,079,440	5,324,425,443	6,683	65,419,809,306	3,866,174,982	6,852	-441,748,462	-7.4%
17	Jpmorgan Chase & Co.	84,865,436,094	5,454,925,071	6,617	82,834,513,890	3,817,213,423	6,819	127,611,648	2.6%
18	Bofillias Natixis Inc.	29,867,484,086	5,432,894,681	3,336	24,164,200,171	3,433,186,471	3,817	-2,381,780	0.0%
19	Morgan Stanley	72,832,376,734	5,284,343,277	6,935	67,941,710,748	3,212,796,518	6,213	51,548,739	1.8%
20	Wali Fargo & Coosway	61,788,720,956	5,073,254,226	6,775	58,154,587,830	4,966,425,625	6,540	166,728,620	2.3%
21	Hellenic Republic	76,737,847,323	5,036,409,125	4,889	77,302,368,832	6,090,168,287	3,877	-3,889,399,268	-51.2%
22	Deutsche Bank Aktiengesellschaft	60,220,468,274	4,994,232,182	5,747	61,650,319,223	5,718,139,296	6,273	-728,087,104	-12.7%
23	Unicredit Societa Per Azioni	42,340,781,921	4,837,223,133	4,633	45,466,275,306	2,720,876,406	3,269	2,136,848,727	77.8%
24	MetLife, Inc	32,199,043,353	4,722,685,862	4,429	24,405,400,245	3,548,401,824	3,533	1,174,204,178	33.3%
25	Russian Federation	103,082,964,821	4,666,163,336	7,287	97,218,365,305	2,780,131,018	6,612	886,034,338	23.4%
26	United States Of America	27,273,785,565	4,375,780,387	1,042	18,697,863,003	3,924,833,144	438	2,623,947,163	30.7%
27	Republic Of Korea	35,310,440,733	4,418,824,043	6,226	46,084,507,391	3,784,870,363	7,237	623,833,680	16.7%
28	Telefonos, S.A.	62,836,653,381	4,412,884,063	6,595	48,301,297,472	2,721,736,487	6,854	1,681,138,598	62.3%
29	Mitsui Insumos Corporation	73,838,333,041	4,319,024,686	6,980	66,917,126,277	3,254,737,433	5,644	-927,712,957	-17.9%
30	Ireland	40,131,311,432	4,277,354,834	2,363	35,263,139,156	4,541,776,381	1,846	-264,421,527	-3.9%

Source: Zero Hedge [3]

Most important, at least in our opinion, in the table above is not the 21st ranked name, but the 26th one, which has seen the change in its net notional CDS outstanding **increase by 136%, or the most of the top 30, over the past year.**

It should be rather obvious which "entity" is ranked #26... soon to be #1.

And for those who missed it, such as the entire mainstream media, here is your guide to the uber secret intricacies (yet completely public to those who search) that actually happen in CDS daily margin flows.

CCPs typically rely on four different controls to manage their counterparty risk: participation constraints, initial margins, variation margins and non-margin collateral.

A first set of measures are **participation constraints**, which aim to prevent CCPs from dealing with counterparties that have unacceptably high probabilities of default.

The second line of defense is **initial margins** in the form of cash or highly liquid securities collected from counterparties. These are designed to cover most possible losses in case of default of a counterparty. More specifically, initial margins are meant to cover possible losses between the time of default of a counterparty, at which point the CCP would inherit its positions, and the closeout of these positions through selling or hedging. On this basis, our hypothetical CCP sets initial margins to cover 99.5% of expected possible losses

that could arise over a five-day period. CCPs usually accept cash or high-quality liquid securities, such as government bonds, as initial margin collateral.

As the market values of counterparties' portfolios fluctuate, CCPs collect variation margins, the third set of controls. Counterparties whose portfolios have lost market value must pay variation margins equal to the size of the loss since the previous valuation. The CCP typically passes on the variation margins it collects to the participants whose portfolios gained in value. Thus, the exchange of variation margins compensates participants for realised profits/losses associated with past price movements while initial margins protect the CCP against potential future exposures. Variation margins, typically paid in cash, are usually collected on a daily basis, although more than one intraday payment may be requested if prices are unusually volatile.

[Full link for the above \[1\]](#).

[AIG](#) [American International Group](#) [Capital Markets](#) [Contagion Effect](#) [Counterparties](#)
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