DEALBOOK; Debt Insurance in Greece Must Pay Out, Ruling Says

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Greece's debt restructuring will prompt payouts on credit-default swaps tied to the country's government bonds.

The decision by the International Swaps and Derivatives Association ends months of speculation that a Greek default might not set off the swaps, a result that could have undermined their role as insurance against debt defaults.

"We saw today that the credit-default swap market worked," said the association's chief executive, Robert Pickel. "Market participants expected it to work."

Still, doubts about the instruments' effectiveness may linger. European officials initially shaped the Greek debt restructuring to avoid activating them. The concern is that future restructurings could be arranged to stop swaps from paying out.

"This is the right result, through a very circuitous path," said John Sprow, chief risk officer at Smith Breeden Associates, a fund management firm.

While Greece's debt exchange has been in the works for weeks, the restructuring activated the swaps only after the country made a legal move on Friday.

The Greek government chose to apply so-called collective action clauses, which it had earlier inserted into its bonds registered under Greek law. The deal maximized total debt relief for the country, but it also forced losses on bondholders - a credit event, and therefore a trigger, for the swaps.

The decision to invoke the clauses showed that European policy makers no longer feared that setting off the swaps could put stress on the financial system. Certain parts of the credit-default swap market helped destabilize the financial system during the 2008 financial crisis. Since then, banks and regulators have taken steps to strengthen the market, mostly by making sure that investors can pay out the money they owe on swaps.

Nearly $70 billion of swaps are currently outstanding on Greek debt. But after both sides settle their accounts, the amount that will need to be paid out should be no more than $3.2 billion.

The Greek default swap story has not quite ended, though. Next, an auction has to be held of the defaulted bonds to set a price at which the swaps will pay out. One question is what bonds will be used because most of the old Greek bonds will be replaced on Monday with new Greek bonds.

The swaps and derivatives association said Friday that there might still be old bonds available for the auction, and it added that the new bonds "might satisfy the requirements." The organization has set the auction for March 19.

It is not the first time the organization has ruled that swaps tied to sovereign debt should pay out. In 2001, Argentina defaulted on its bonds, activating the swaps. Ecuador followed in 2008.

Some investors entered swaps on Greece as a way of effectively insuring themselves against losses on their Greek bonds, while others used them as a way to bet on a default happening.

Before investors doubted Greece's solvency, the swaps offered insurance at what turned out to be an extremely cheap price. At the start of 2008, an investor buying protection on Greek debt had to pay only $22,000 annually to insure against default on $10 million of Greek bonds over five years, according to Markit, a data provider. Now, the protection would cost about $7.6 million.

Investors will most likely continue to want default swaps to protect against losses on Greece's new bonds. These bonds, to be issued Monday, are expected to have yields of well over 15 percent, according to advance pricing. This suggests investors have strong doubts about Greece's creditworthiness even after its restructuring. Fitch Ratings said on Friday that it would probably give Greece's new bonds a low, junk-bond rating.

But some analysts say they believe the uncertainty related to Greek swaps could have a lasting effect on the market.

Last year, European policy makers proposed a voluntary debt exchange for Greece, an approach that would not have set off the swaps and would have left bondholders with big losses. The swaps and derivatives association defended the instruments, saying the swaps' contracts always made it clear that a voluntary restructuring would not prompt payouts.

"It comes back to the contract," Mr. Pickel, of the association, said Friday. "Market participants understand that."

This is a more complete version of the story than the one that appeared in print.

PHOTO: The Hellenic Stock Exchange in Athens. With a legal move on Friday, Greece's debt exchange activated credit-default swaps. (PHOTOGRAPH BY KOSTAS TSIRONIS/BLOOMBERG NEWS) (B2)

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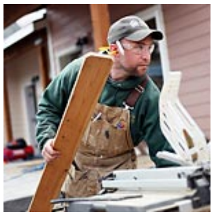

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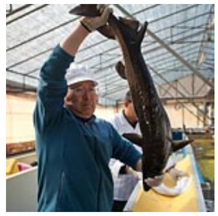

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