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CDS markets signal rising fear of euro breakup

3/6/2017

By: Marcello Minenna

Financial markets are well aware that the next few months could be decisive for the future of the Eurozone.

In April, the French will vote in the first round of presidential elections. Marine Le Pen, who is currently expected to make it to the second round in May, has said that if she wins she will dedicate the first six months of her term to lead the country out of the single currency.

Italy is another potential risk, even though there is no imminent election. The country is saddled with high levels of public and private debt, meagre growth prospects, and persistent political instability. The single currency is deeply unpopular in Italy, with only 41 per cent of Italians considering the euro “a good thing” for their country, compared to 47 per cent who think it’s “a bad thing”, according to the latest Eurobarometer survey.

Euro area institutions haven’t been helping.

Germany continues its crusade for fiscal virtue. If countries aren’t willing to cut spending and raise taxes, the German solution is to restructure public debt — starting with Italy — according to the scheme already applied to Greece. Angela Merkel recently declared herself in favor of a “multi-speed Europe”.

At the same time, the European Central Bank’s commitment to defend the irreversibility of the euro is based as much on threats as on positive pledges. Mario Draghi recently said that if a country wants to quit, it must first fully settle its Target2 balance with the rest of the eurosystem. Italy, for example, would have to pay more than €360 billion — the equivalent of a (big) war debt, like the one imposed on Germany a century ago. But those were different times, and a different Europe!

Financial markets understand the risks of “Italexit” and “Frexit” even if the likelihood of either event is still judged to be low.

This can be seen in the data on credit default swaps (CDS), which offer protection in the case of an “insured event” or, in the jargon, a *credit event*. The widening gap in prices between different types of CDS contracts reflects the rising risk that some euro area sovereign debts may be redenominated into new, depreciating, currencies, which would probably lead to real losses for investors.

To correctly interpret the data on CDS prices, we need a quick flashback to 2012, another year of great tension for the single currency. While the center of the crisis was in Greek sovereign debt and the Spanish banking sector, institutional investors had already begun to think of how to protect themselves from the danger of the euro's total dissolution, which might be prompted by the exit of a big country such as Italy or France.

Back then, there were no good options available. Buying CDS wouldn't have helped because the standard contract explicitly excluded debt redenomination from the list of credit events if the issuer were a member of the G7 or an OECD investment-grade sovereign.

Two years later, new ISDA standards entered into force: contracts made since 2014 protect against euro area countries redenominating their debt into new national currencies.

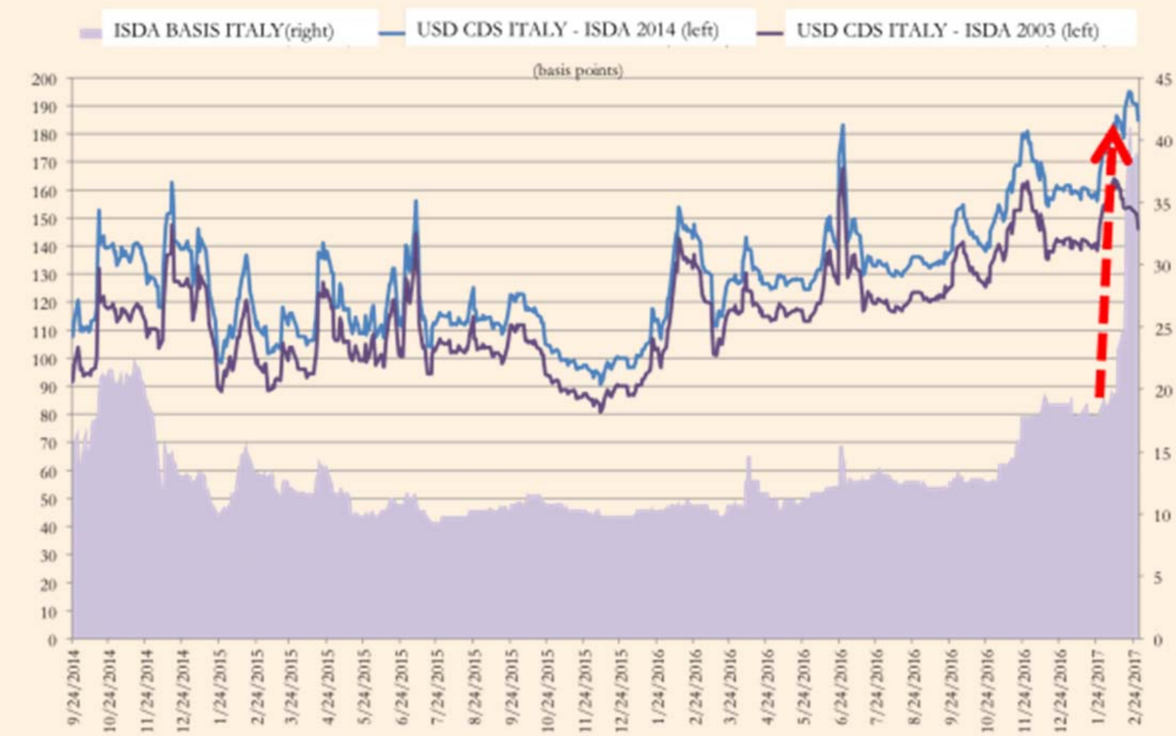
Strictly speaking, it's still possible to redenominate debt into a *different* currency without triggering a credit event, but this only works if the debt is switched into a reserve currency: the US dollar, the Canadian dollar, the British pound, the Japanese yen, or the Swiss franc. In all other cases, the only way to avoid the triggering of a credit event is if the switch to the new currency does not result in a loss for the investor: "no reduction in the rate or amount of interest, principal or premium payable".

Since 2014 two types of sovereign CDS therefore coexist: the old (ISDA 2003) and the new (ISDA 2014). The latter has always traded at spreads wider than the CDS-2003, but the difference (the ISDA basis) has generally been small: 15-20 bps for Italy, 8-12 bps for Spain, 2-4 bps for France, and 1-2 bps for Germany.

The width of the spread between the two types of CDS — the Isda basis — reflects both the perceived risk of redenomination risk and, in addition, the potential scope for depreciation in the event of a return to a national currency.

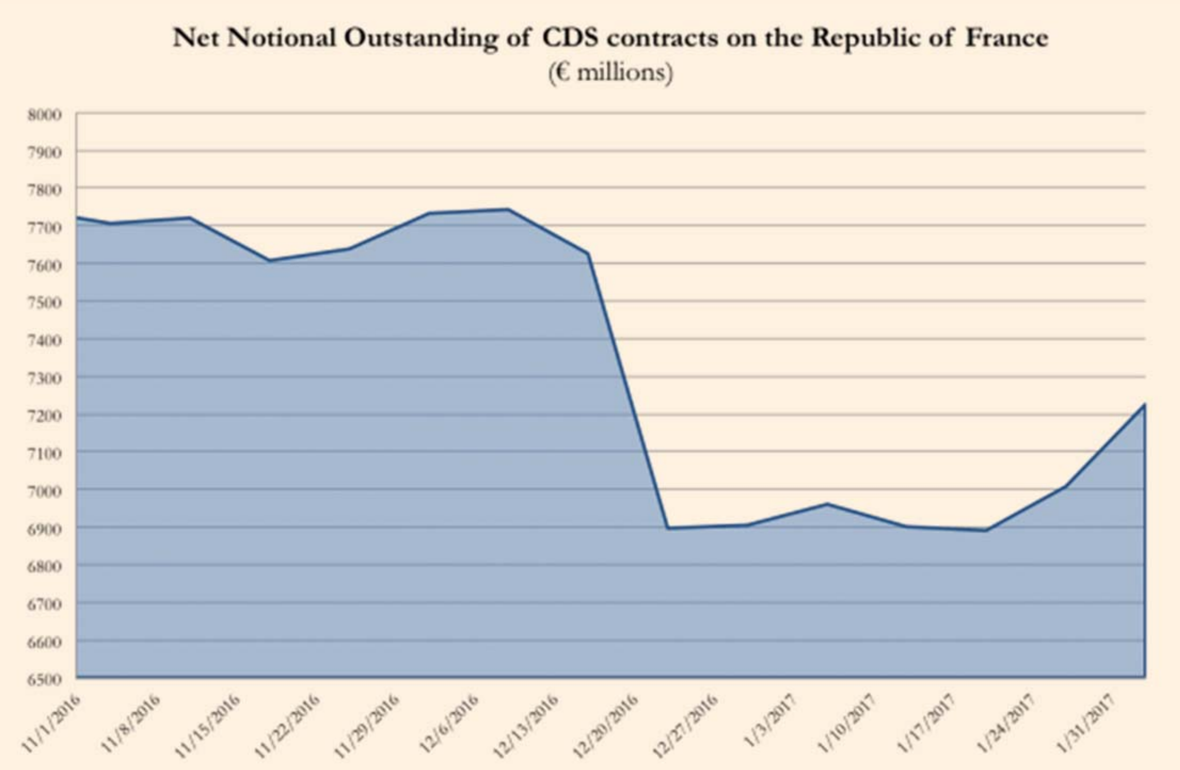
This year, something has changed. Since late January, the ISDA basis has rocketed upwards in the major Eurozone economies, indicating that investors perceive greater redenomination risk than before. The rest is pure physiology of the financial markets: a greater risk raises the demand for protection which, in turn, leads to an appreciation of the 2014-vintage CDS, which are the most appropriate instrument to smooth out any losses arising from the change of the payment currency of the contract.

The following chart shows the phenomenon in the case of Italy. In February, the difference between CDS-2014 and CDS-2003 has doubled from 20 to 40 basis points:



For France, the phenomenon is even more overwhelming. In February the Isda basis soared from 3 to 24 bps. While the level of this basis is still relatively small in absolute terms, traders think the risk has increased by roughly eight times as they assess the upcoming elections:

Further confirmation comes from the increase in the net notional outstanding amount of CDS contracts linked to the French Republic. Since mid-January, the amount of protection purchased on a credit event by the French government has grown by about €320 billion, or roughly 5 per cent:



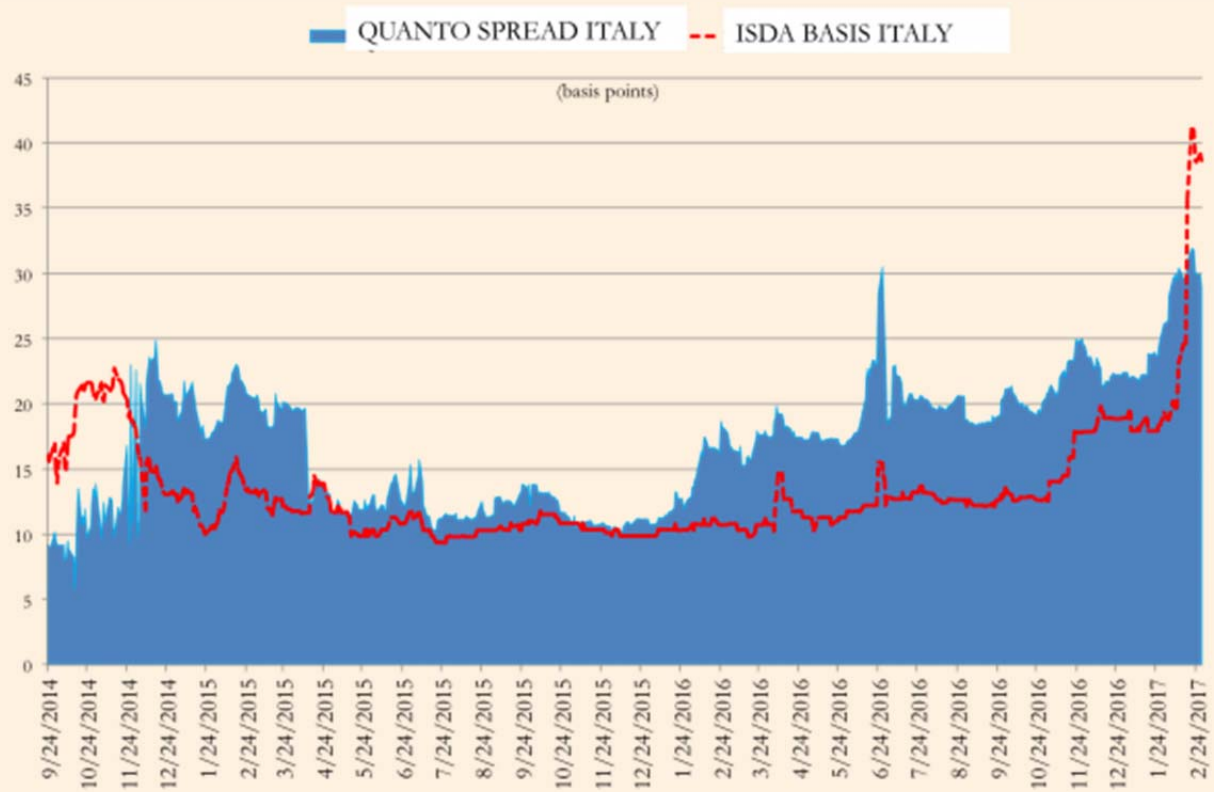
“Frexit” would have far more devastating effects than “Brexit” on the resilience of Europe, and especially for the integrity of the euro area. The contagion effect is one of the main components of the widening ISDA basis in Italy.

But no one is completely immune from the possible consequences of a French secession. Even in Germany, the basis shows similar trends to those displayed in France and Italy, especially when viewed as a percentage increase. (In absolute terms it is still laughable, at around 5 basis points.) The differential between CDS-2014 and CDS-2003 has also widened in Spain, although by less than in other countries.

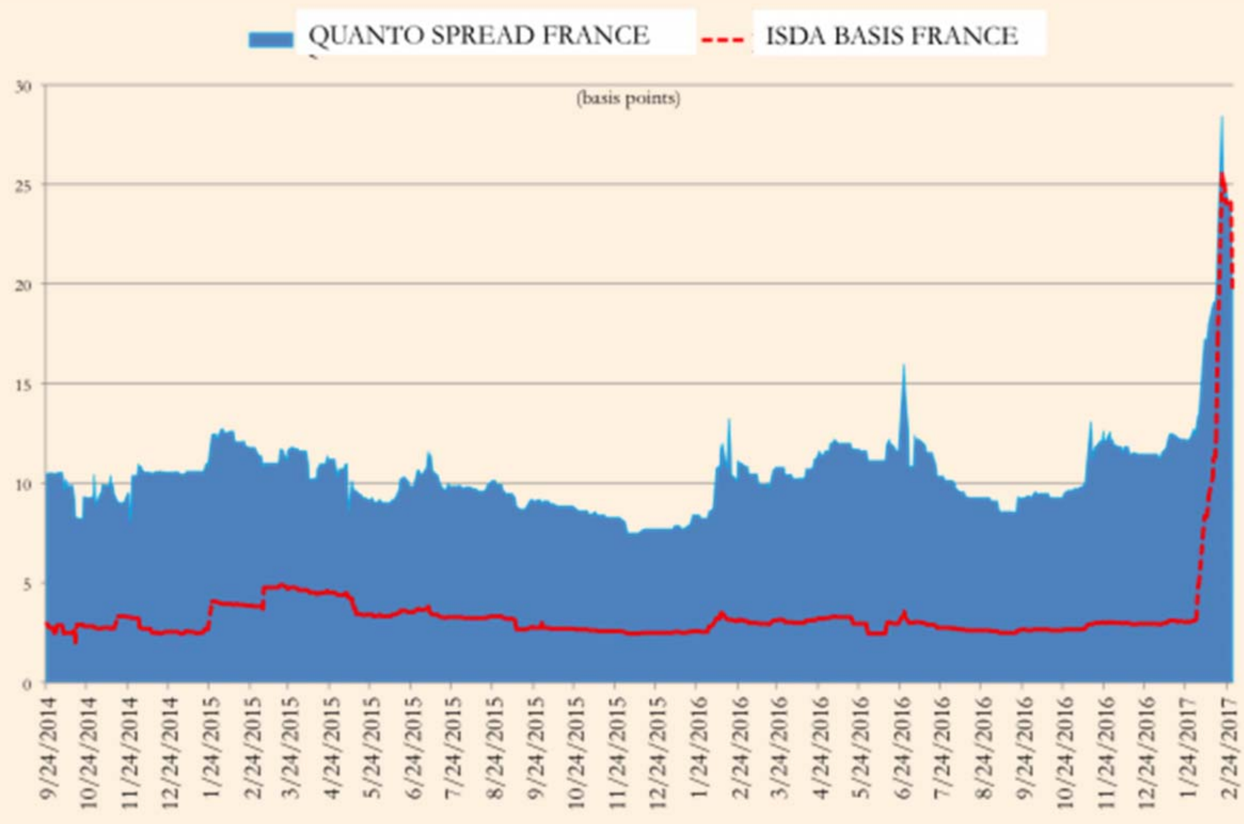
So far we’ve been looking at the gap between CDS-2014 and CDS-2003, both of which are US dollar-denominated contracts. There are similar dynamics at work in the “quanto spread”: the difference between the prices of dollar-denominated and euro-denominated ISDA-2014 CDS contracts insuring against credit events by the same reference entities.

If redenomination affects a liability issued by a sovereign of the euro area, it’s reasonable to expect that euro-denominated CDS would offer only limited protection to investors. It would certainly offer less protection than the corresponding USD-denominated contract could give, presumably because the of the nontrivial possibility the euro would cease to exist.

The next two charts compare the trends of the quanto spread and the ISDA basis for Italy:



And for France:



Markets do not lie. Institutional investors may hope to get special deals from Le Pen. Germans, unnerved by reflation, may not want to increase the size of their Target2 liabilities and demand the interruption of QE. Italy must avoid remaining with short end of the stick. I wonder if our leadership will rise to the challenge.

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The Opinion are strictly personal