



## “Credit Default Swaps: Part II”

June 26, 2008

I received a number of comments regarding my recent Chairman’s Corner titled “The Perverse Effect of Credit Default Swaps: A catastrophe in the making.” I am pleased to provide some necessary clarification, as well as to expand on my initial findings.

First, the article’s intent was to focus on the largest capitalized companies that had (have) substantial exposure to the CDS market. This focus was entirely independent of the company’s AGR® rating. However, it is interesting to note that the majority of the big-cap companies that have CDS exposure are rated **Very Aggressive** by our rating model.

I doubt this is merely a coincidence; rather, it is an indication that many of these companies are taking substantial -- and often, undisclosed -- risk. Of course, not all the companies listed are using CDS in a speculative manner; unfortunately, the lack of detailed disclosure of their positions does not allow me to make that judgment.

Secondly, it should be noted that the Audit Integrity rating is based on forensic analysis of data that is gleaned from multiple governance and accounting metrics. Exposure to derivatives, including CDS, is not one of the specific metrics utilized, but their exposure is captured in part in the Interest Expense and Interest Income metrics used in the AGR analysis.

In the recent class action litigation involving American International Group (AIG) and Swiss Reinsurance Company (SWCEY PK), the plaintiffs argue that both companies failed to disclose the CDS holdings that exposed them to substantial risk. In an article dated March 4, Bloomberg reported that **over \$181 billion in writedowns and credit losses** had been disclosed by financial institutions. I believe it is realistic to assume that more legal action will follow as losses continue to mount – a real time bomb.

When you include Hedge funds, you can double the time-bomb factor. Hedge funds are unregulated and are not required to report financial positions. According to Greenwich Associates,

**Hedge funds account for over 50% of the trading in CDS.** Large Hedge funds, including D.E. Shaw and Citadel, are major players. Stakeholders in these particular funds, as well as many other funds, are most likely unaware they are bearing unusual levels of risk.

A meltdown, which I fully expect, will not only implicate the sellers of CDS but also the buyers.

In recent litigation against UBS (UBS AG) and Wachovia (WB), VCG Special Opportunities Fund has sued both companies claiming breach of contract and unjust enrichment. The interesting part of both suits is not the claim itself, but the fact that both UBS and Wachovia, two very sophisticated financial companies, purchased insurance from a pocket portfolio very thinly capitalized in the Channel Islands. I can reach only two possible conclusions: (1) these big, sophisticated financial companies don’t know what they are doing, or (2) they were unable to purchase insurance for the low-quality debt they wanted to insure, and were forced to turn to a third-tier provider.

If the latter is true, UBS and Wachovia purchased the insurance not to protect their debt, but to eliminate the need to mark the debt to market – thereby masking a serious problem.

In either case, the stakeholders are the last to know, unless they demand transparency.

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