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Swaps Soar on Germany's 'Act of Desperation': Credit Markets

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By Shannon D. Harrington and Pierre Paulden

May 19 (Bloomberg) -- Credit-default swaps soared as German Chancellor **Angela Merkel**'s curb on using the contracts to speculate on European sovereign debt sparked concern among investors about increasing government regulation.

The Markit iTraxx Europe Index of contracts linked to the debt of 125 investment-grade companies jumped 9.5 basis points to a mid-price of 120.6 basis points as of 12:52 p.m. in New York, after earlier climbing to as high as 124.7, according to Markit Group Ltd. A U.S. benchmark, the Markit CDX North America Investment Grade Index, pared yesterday's 12.2 basis point increase, the second-biggest since March 2009. The index fell 3.5 basis points to 117.2, Markit prices show. The jump in the indexes signals deterioration in investor confidence.

Merkel's coalition seeks to prevent traders from buying credit insurance on government bonds they don't own, so-called naked swaps, as German lawmakers debate a bill authorizing their contribution to a $1 trillion bailout to support the euro. The unexpected ban, done independently of the European Union, came after the aid package failed to stop the 16-nation common currency from weakening to a four-year low and as banks became increasingly reluctant to lend to one another.

"The market sees an inadequate policy such as this as an act of desperation and a refusal to address the fundamental problems at hand," said **Brian Yelvington**, head of fixed-income strategy at Knight Libertas LLC in Greenwich, Connecticut.

Limited Impact

Germany largely failed to persuade other nations to follow its prohibition and the **U.K. Financial Services Authority** said the ban doesn't cover branches of German institutions outside of Germany, indicating it will have little impact on trading in London, the biggest hub for swaps bets on European government debt.

Yesterday's announcement caused confusion at Wall Street firms seeking clarification on how much of the market would be covered and prompted concerns that it would have a chilling effect on trading, said **Tim Backshall,** the chief strategist at Credit Derivatives Research LLC in Walnut Creek, California. That could limit the ability for other investors to hedge risks, increasing borrowing costs or limiting the flow of capital, he said.

Credit-default swaps on Europe's most indebted governments fell initially on concern the restrictions on short-selling will devalue existing agreements. They erased those declines as it became clear Germany failed to persuade other nations to join in the ban. A Europe-wide prohibition on the practices is "doubtful," according to **Eddy Wymeersch**, chairman of the Committee of European Securities Regulators in Paris.

Bond Spreads

Elsewhere in credit markets, the extra yield investors demand to own corporate bonds instead of government debt rose 1 basis point to 172 basis points, or 1.72 percentage point, the Bank of America Merrill Lynch Global Broad Market Corporate Index shows. The spread peaked at 511 on March 30, 2009, and dropped to as low as 142 on April 21. Average yields fell 4.1 basis points to 3.905 percent.

Fannie Mae, the government-supported mortgage company, sold $3.5 billion of three-year benchmark notes.

The debt yields 1.506 percent, or 0.27 percentage point more than similar-maturity Treasuries, the Washington-based company said today in an e-mailed statement.

Medical Properties Trust Inc., a real estate investment trust that develops health-care facilities, got a $450 million loan package to finance acquisitions. The credit facility includes a $150 million six-year term loan, the Birmingham, Alabama-based company said today in a news release distributed by Business Wire. The interest rate on the term loan is 3.5 percentage points more than the London interbank offered rate, with a 1.5 percent Libor floor.

Euro's Slide

A $300 million 3.5-year revolving credit line has an interest rate that will vary from 3 percentage points to 3.75 percentage points over Libor, the rate banks charge each other on loans, depending on the company's level of debt, according to the release.

Emerging-market bonds weakened, with the spread to Treasuries climbing 15 basis points to 309 basis points, the highest since this year's peak of 328 on May 7, according to JPMorgan Chase & Co.'s Emerging Market Bond index.

Germany's ban, which took effect at midnight Frankfurt time and lasts until March 31, 2011, also applies to the shares of 10 banks and insurers, German financial regulator BaFin said in an e-mailed statement.

The move failed to buoy the euro, which fell 0.5 percent to its lowest level in four years, before recovering to $1.2335 as of 12:58 p.m. in New York, from $1.2202 yesterday.

'Exceptional Volatility'

German Chancellor Merkel said today the prohibition on short-selling ban was part of an attempt to gain control over "destructive" financial markets. Stocks slid, with the **Stoxx 600** Europe index falling 3 percent.

The ban was needed because of "exceptional volatility" in euro-area bonds, BaFin said.

The announcement came the same day that a report showed German investor confidence plunged in May as Europe's deepening debt crisis stoked concern about the euro's future. The **ZEW Center for European Economic Research** in Mannheim said its index of investor and analyst **expectations** dropped to 45.8 from 53 in April, the biggest decline since the collapse of Lehman Brothers Holdings Inc. in September 2008.

The Markit iTraxx Japan index jumped 14 basis points to 138 in Tokyo, according to Morgan Stanley.

Default Swap Bets

Credit swaps tied to Greece's government debt climbed 55.5 basis points to 669.5, while Portugal rose 3 basis points to 274.5, according to CMA DataVision prices. Contracts on Italy rose 2 basis points to 139, Ireland dropped 6 to 198 and Spain was 1 basis point lower at 179, CMA prices show.

Credit swaps pay the buyer face value if a borrower fails to meet its obligations, less the value of the defaulted debt. A basis point equals $1,000 annually on a contract protecting $10 million of debt. The contracts are used to hedge against losses on corporate debt and bet on creditworthiness.

Bets made with swaps on the bonds of 10 European nations including Greece, Spain, Italy and Portugal total less than $108 billion, according to the **Depository Trust & Clearing Corp.,** which runs a central registry that captures most trading. That's 0.97 percent of the $11 trillion in outstanding debt of those countries, International Monetary Fund data show.

BaFin itself said two months ago it found "no evidence" that credit-default swaps were being used excessively to speculate against Greek bonds. Depository Trust data "do not support the conclusion that speculation is taking place on a massive scale," the regulator said in a March 8 statement on its Web site.

Libor Rises

The **London interbank offered rate**, or Libor, which banks charge to lend to each other, rose for a seventh day to the highest since July 31, according to data from the British Bankers' Association. The rate climbed to 0.477 percent today from 0.465 percent, while the Libor-OIS spread, a gauge of banks' reluctance to lend, rose about 1 basis point to 25 basis points. The gap was as low as 6 basis points in March.

"We have seen tensions rise in interbank markets as renewed concerns regarding counterparty risk among banks have intensified," **Loredana Federico**, an economist at UniCredit SpA in Milan, wrote in an e-mailed report. "Given that some sovereign debt tensions will accompany us for a while, new waves of increasing risk aversion within the banking system cannot be ruled out."

Speculation Curbs

German Finance Minister **Wolfgang Schaeuble** said the government decided it was best to introduce the ban on naked short-selling as soon as possible. "If you do something like this, you don't let it drag out but you implement it right away," he said in an interview on ZDF television.

Merkel and French President **Nicolas Sarkozy** have called for curbs on speculating with sovereign credit-default swaps. EU Financial Services Commissioner **Michel Barnier** called this week for stricter disclosure requirements on the transactions. Last month, the EU proposed that the Financial Stability Board, set up by the Group of 20 nations to monitor financial trends, "closely examine the role" of swaps on sovereign bonds.

"In some ways, it's a battle of the politicians against the markets" and "I'm determined to win," Merkel said May 6. "The speculators are our adversaries."

The move also added to concern the EU nations aren't working in coordination.

"Since it's not synchronized, it smacks of knee-jerk panic," said **Scott MacDonald**, head of credit and economics research at Aladdin Capital Holdings LLC in Stamford, Connecticut, which oversees $12.5 billion. "This has a huge potential impact on credit-default swaps. You're saying CDS is evil."

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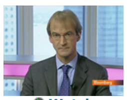

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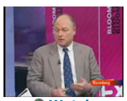
Barclays's Gardiner on German Ban
May 19 (Bloomberg) -- Kevin Gardiner, head of Europe, Middle East and Africa investment strategy at Barclays Wealth, talks about the German ban on naked short-selling and speculation on European government bonds with credit-default swaps. Gardiner, speaking with Bloomberg's Linzie Janis from Hong Kong, also discusses financial regulation and the outlook for the global economy.



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JPMorgan's Kasman Says Short Selling Ban Not Constructive
May 19 (Bloomberg) -- Bruce Kasman, the chief economist at JPMorgan Chase & Co., talks with Bloomberg's Susan Li in Hong Kong about Europe's sovereign debt crisis and the outlook for the euro. The euro slid to its least since April 2006 after Germany prohibited naked short-selling and speculating on European government bonds with credit-default swaps, and the Bank of Italy allowed lenders to exclude losses on government debt.

Watch

McAlinden, Lieberman Interview About Short-Selling Ban
May 18 (Bloomberg) -- Joseph McAlinden, fund manager at Catalpa Capital LLC, and Charles Lieberman, chief investment officer at Advisors Capital Management, talk with Bloomberg's Pimm Fox about Germany's temporary ban on naked short selling and naked credit-default swaps of euro-area government bonds. McAlinden and Lieberman also discuss the U.S. economy and stocks, legislation to overhaul financial regulation and their investment strategy.