

17:51 07Oct2009 Thomson puts credit derivatives in spotlight

- * Thomson test case for simplifying CDS
- * Fears of price distortions

By Jane Merriman

LONDON, Oct 7 (Reuters) - The opaque world of credit derivatives is in the spotlight ahead of an auction to settle contracts on a debt restructuring at French electronics company Thomson <TMS.PA> that could expose flaws in the process.

The auction is taking place as politicians and regulators push for more clarity and less complexity in credit derivatives markets, which were at the heart of the credit crisis that crippled the world's banking system.

"Regulators will be watching this very carefully," said Betsy Mettler, a partner at consultancy B&B Structured Finance.

"Given this is the first restructuring under a new system, and given the industry is trying to get away from the negative view of credit default swaps, there is a lot of pressure around this auction," she said.

The finance industry has tried to simplyfy and standardise the process for CDS restructuring auctions in Europe, in theory to help a move to central clearing of these derivatives.

But Thomson's has taken weeks longer than expected to organise and there is a risk that some investors could lose out.

"The Thomson auction is probably too obscure to attract a lot of mainstream attention, but if you are an investor and receive no pay-out, it will dent confidence in the CDS market and increase pressure for more reform," said Michael Hampden-Turner, credit analyst at Citi.

"An awkward auction for Thomson at a time when other restructurings are likely will bring the CDS market into the limelight - just at the time when it needs to be able to demonstrate reformed efficiency and fairness," he said.

"The situation has the potential to be quite messy."

Credit default swaps are contracts that pay out if an issuer defaults on its bonds -- effectively an insurance policy. They can also be triggered if a company restructures its debt.

The Thomson auction was triggered by the company's restructuring in July. [ID:NL0331877]

The auction aims to determine how much buyers and sellers of Thomson credit default swaps get paid.

But because of a shortage of eligible Thomson bonds to deliver against CDS contracts, prices could get distorted and CDS holders might not get the value they expected contracts to deliver.

PRICE SQUEEZE

After a company restructures its debt, bonds with shorter maturities are usually worth more than longer-dated bonds as there is less risk of the company going bust in the near term.

In Thomson's case, there are relatively few shorter-maturity bonds to deliver against the relevant Thomson CDS, which could mean their prices get squeezed even higher.

So sellers of protection on Thomson are likely to want to trigger the auction because the bond prices will rise. Under these circumstances buyers of protection on Thomson, on the other hand,

might not want to participate in the auction in case Thomson restructures again at a later date, where they could get more money.

"With credit default swaps on Thomson trading at 20 to 25 percent upfront, the market's implied default rate for a further credit event is very high," said Tim Brunne, credit analyst at Unicredit.

When a company's CDS trades "upfront" it means there is a high risk of default and investors have to make a big downpayment to buy protection against its default.

For those investors which bought Thomson CDS as a hedge against holdings of Thomson debt, they can deliver the underlying paper, which should result in close to full recovery, said Brunne.

If they bought CDS as a bet, they have taken a risk that settlement might be complicated by technical factors, he said.

There are nearly \$2 billion worth of net notional CDS on Thomson, according to finance industry data provider Depository Trust & Clearing Corp.

Bonds eligible for delivery in the CDS auction total about \$1.2 billion, according to a list agreed by the credit derivatives committee of the International Swaps and Derivatives Association (ISDA).

There is also a 1.750 billion euro loan facility.

Investors that have sold CDS protection on Thomson have to decide to trigger the auction by Thursday.

Buyers of CDS protection on Thomson wishing to take part have until October 13. There is no date yet for the auction.

(Additional reporting by Jane Baird)

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