Stocks, Bonds And Auto Parts

Insurance creates perverse incentives. Imagine how you would approach your stock trading if you were given a free put option with every purchase or a free call option with every short sale? Chances are you would become much more aggressive in your actions as your downside risk from the trade is limited.

One of the sadder and more predictable outgrowths of the expansion of the Federal Savings & Loan Insurance Corporation (FSLIC) insurance in 1980 to $100,000 per account was the emergence of the "Texas Run" toward troubled S&L's. That's right, towards. As word spread an S&L was in trouble it was forced to pay a higher rate on its certificates of deposit. CD brokers, not to be confused with homonymous seedy brokers, bundled all sorts of small deposits into $100,000 packages and sent them to the troubled S&L. Who cared if the S&L then failed, the CD's were insured?

Credit Default Insurance

The topic of credit default swaps (CDS) and how they are used was introduced here last April and then again in May. These instruments act as put options; they allow the bondholder to deliver the bonds at par to the CDS writer in the event of a credit event. As the risk of bankruptcy or another credit event rises, the price of a CDS expressed in basis points rises as well. CDS writers, like those who write put options, are on the hook to buy the bonds at par from the CDS buyers

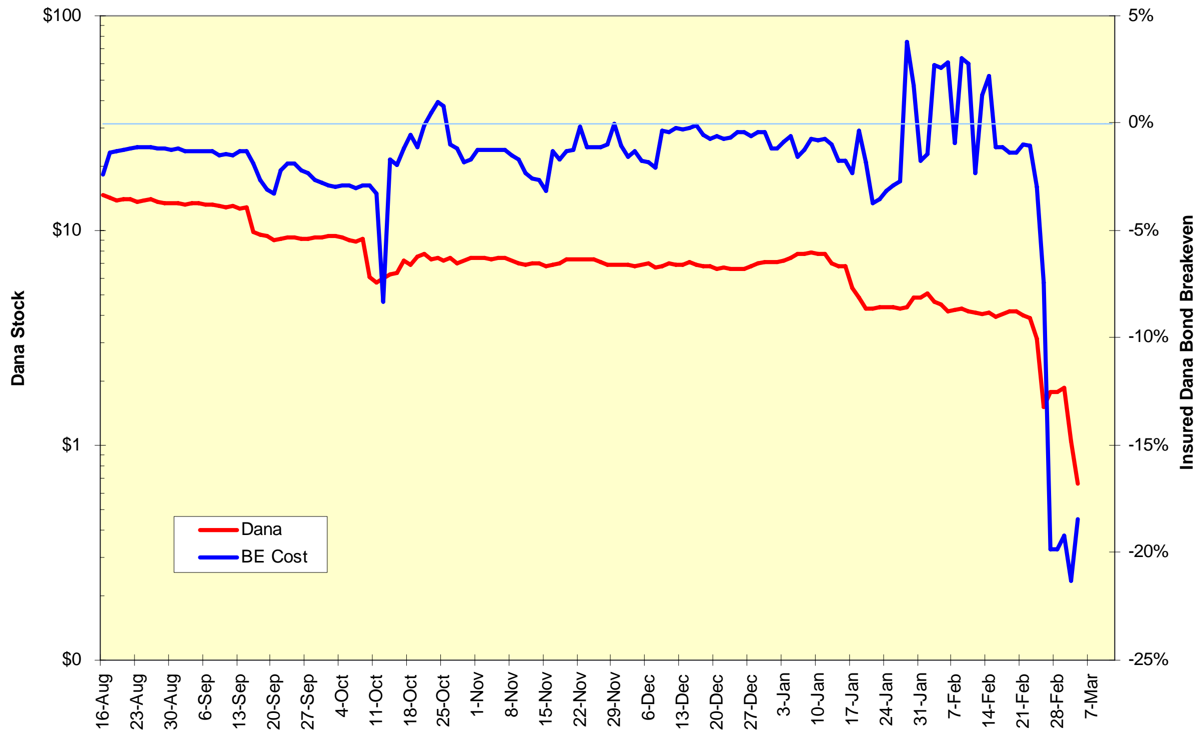
Just as the open interest of a futures or options contract can swell to a quantity greater than available for delivery, the volume of CDS contracts created in this over-the-counter market can swell way beyond the physical quantity of the actual corporate bonds being covered. And I do mean way beyond; while actual data are hard to come by, some estimate that the volume of outstanding CDS contracts on auto parts manufacturer Delphi's bonds was 140-175 times the actual quantity of bonds available.

As early 20th Century stock operator Daniel Drew chirped about short-selling, "He who sells what isn't his'n / Buys it back or goes to prison." Recall the scene in Mel Brooks' *The Producers* when Max is informed he has sold well more than 100% of the profits. Most of us do not fancy ourselves wearing a bright-orange jumpsuit.

The Dana Case

Last week's entry in Chapter 11 bankruptcy protection by auto parts manufacturer Dana Corporation illustrated how the mechanics of CDS delivery have produced a variation on the Texas Run. Let's look at both Dana's stock and a measure of its corporate credit quality since last August 16th, a date chosen for a low point in the yield of Dana's 9% bond due August 15, 2011. The stock, represented below on a logarithmic scale to enhance its final plunge, was under pressure, but the insured credit breakeven of this particular bond was stable.

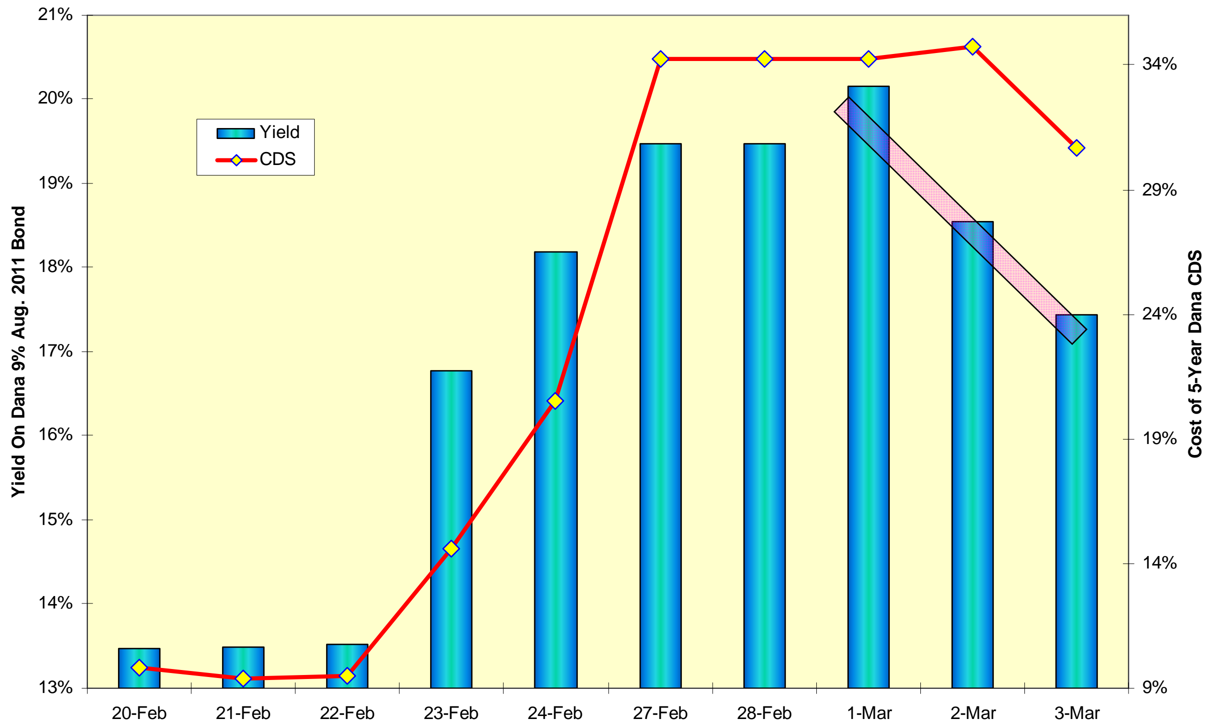
The insured credit breakeven is calculated by subtracting the cost of a five-year CDS from the bond and then comparing it to the base case of simply earning the return on a five-year swap. If the resulting number is less than 0%, as it was for Dana between August and October, the bond will remain under pressure until its yield rises. And if the bond remains under pressure, why own the stock? That, too, should fall, and indeed the stock kept falling throughout this period.



Corporate bonds can remain intact even while the stock deteriorates. Bonds stand before stocks in the event of bankruptcy, as Dana's shareholders will discover, and while stocks are a claim on future earnings, bonds simply are a claim on some measure of future cash available, a much lower hurdle. Even as the stock started to deteriorate markedly in January and early February, the breakeven on the insured bond remained in a range.

The End Game

This changed markedly for the worst on February 21st as Dana delayed a decision on paying a dividend for the first quarter. By the time the decision was made on the 23rd, both the bond's yield and CDS costs jumped. But then an interesting thing happened: The bond's yield peaked on March 1st, two days before last Friday's bankruptcy announcement, and then declined during the shaded period shown. This is prima facie evidence of increased demand for the securities. The likely suspects for the bond buying are the CDS buyers scrambling to find bonds for delivery.



One Big Happy Family?

Stockholders and bondholders often have opposing interests. A shareholder, especially one in corporate management with a boatload of options, has an incentive to leverage the firm and take on more risk. This has been the history of leveraged buyouts. Bondholders just want their money back.

But bondholders may be more than stodgy institutional investors and aging coupon-clippers. The world of distressed security hedge funds and the emergence of credit traders have created a situation wherein the bondholder gets rewarded when the company gets in trouble. Every corporate bond with an excess of CDS written on it now embeds a call option on the firm's bankruptcy. Once a firm gets into trouble and blood is in the water, the bondholders' may have a positive incentive to see the firm fail.

Yes, insurance changes behavior. Free stock options created problems in the 1990s boom. Will these "free" call options on bankruptcy create incentives amongst the bondholders, especially those who hold CDS protection, to see the firm fail? Absolutely, and the sooner we address this issue the fewer next-generation Enrons and WorldComs we will see.