Company – Country Credit Default Swaps Not Upside Down

Here is something we are going to have to get used to as sovereign credit risks rise: A company's credit default swap (CDS) costs can be lower than those of its headquarter nation. For example, at the time of this writing, a five-year CDS on Spain's bonds is priced at €160.1 basis points while a CDS on Telefonica is priced at €108.7 basis points. Jokes about Telefonica having a better year, per Babe Ruth's remark on his salary relative to Herbert Hoover's notwithstanding, this is completely rational.

Here's a Top-Ten list of why this can be so:

1. A corporation is not formed from the nation and its government, but rather from the contracts between investors and the legal entity of the firm itself. While the corporation is incorporated under its nation's laws, it was not formed from the sovereign entity;
2. Corporations have equity shareholders who are exposed to the company's successes and failures; a nation's citizens are stakeholders in the government and may be creditors thereto, but they have no equity interest they can claim in bankruptcy;
3. While a corporation may be incorporated in a single country, it may have legal entities spread across numerous countries, each of which may have assets subordinate to the interests of the bondholders. If the headquarters country tries to seize its assets or tax them at a confiscatory rate, they can do so only on what is under their jurisdiction;
4. A corporation's capital structure can and often does change over time. Debt at risk of default can be restructured, forgiven or converted into equity as the need arises and as bondholders consent. New equity can be issued to pay off creditors at the pain of dilution for existing shareholders;
5. While a government can print money to pay its bondholders at face value, they cannot, **as noted in the previous entry in this series**, do so without raising the risk of future inflation. Sovereign CDS costs represent, in part, a call option on future inflation. Bondholders are willing to accept a little inflation but fear catastrophic inflation;
6. While a government can claim its citizens' assets under taxation at any rate with due process of law or with confiscation via force, it does so at the pain of extinguishing future revenue streams. This abuse of power is far different than that of a private monopoly that can raise prices but not seize customers asset by force;
7. Sovereign bondholders must insure against currency debasement, a growing risk as several key countries are engaged in policies of competitive devaluation and monetary creation. Corporate creditors face no such risk;
8. A corporation domiciled in a country whose currency is about to become worthless can shift assets into another currency or it can hedge that currency risk. Although various governments have issued debt in other currencies – Yankee bonds and Samurai bonds come to mind – and even have "dollarized" their economies (see Ecuador and Argentina), the wholesale shifting assets into another currency would be difficult for a government to do;
9. Some bond portfolio managers write corporate CDS to synthesize otherwise illiquid issues. This has been a great boon to the corporate bond market as it has allowed investors to gain exposure to a wider variety of credit risks than heretofore. Few sovereign issues suffer from liquidity constraints as governments seem to be quite good at issuing new debt; and
10. Many private corporations are quite simply better credit risks than many governments. They cannot run open-ended deficits or engage indefinitely in money-losing operations. Whenever you hear a politician talk about running the country "like a business," beware: A government is a political entity and not a business facing the eventual risk of bankruptcy if it fails.

It will be sad if a large number of countries' credit quality falls below that of individual companies. The time to prevent it is now. If you have seen one of those national debt clocks ticking away, you know each day we wait adds more risk to the pile.