MONEY & INVESTING

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Swap Skirmish: Risks Hidden, Says Hedge Fund

Citigroup, Wachovia Face Lawsuits Involving Credit Derivatives

HEARD ON THE STREET

By Susan Pulliam, Serena Ng and Tom McGinty

As financial markets boomed in recent years, some Wall Street players began selling insurance against things going wrong, in what looked like prudence.

It wasn't.

In separate lawsuits filed in a New York federal court, a $58-million-asset hedge fund alleges that **Citigroup** Inc. and **Wachovia** Corp., respectively, improperly required the fund to pay out more money from insurance derivatives contracts known as "credit default swaps" amid a steep decline in the value of mortgage-backed bonds.

The hedge-fund manager says he didn't view the insurance-related trades as particularly risky and now says he feels "suckered." Citigroup and Wachovia each say the fund's claims are "without merit."

Meantime, other financial players say they have been stiff-armed by trading partners when they've tried to cash out on profits from such insurance-related transactions. In one instance, a hedge-fund manager says he was blocked from selling out of a swap position, unless he made another credit-default swap trade.

The skirmishes signal cracks in the vast and unregulated market for such credit default swaps, where banks, hedge funds and others trade insurance against debt defaults. In these swaps, one party pays another to assume the risk that a bond or loan will go bad. The market for such swaps has soared to nearly $45 trillion, a number comparable to all the bank deposits world-wide, according to the International Swaps and Derivatives Association, or ISDA, a trade group.

Hedge funds have played both sides of this market—in some cases buying this insurance and cashing in when mortgage bonds faltered, and in other cases, selling insurance to other players.

Not everyone who buys these contracts has bonds to insure; because the value of an insurance contract rises or falls with perceptions of risk, they are also bought as a speculation. If the value of the debt changes, parties in a swap may be required to make large payments to each other. Now it looks like reckoning day for some of the speculators.

Deep problems already have emerged in the role of traditional bond-insurance companies such as **MBIA** Inc. and **Ambac Financial Group** Inc. involving these contracts. They wrote guarantees on billions of dollars in complex mortgage securities. Such bond insurers in recent years represented a small but psychologically important part of the credit-derivative market, comprising 8% of the sellers of credit protection, according to estimates from the British Bankers Association.

But hedge funds are an even bigger player in this arena. Hedge funds provided roughly one-third of trading volume in all credit derivatives in 2006—up tenfold from 2000, the BBA says. And hedge funds accounted for 60% in credit-default-swap trading in high-grade debt and 80% in low-grade debt in the 12 months ending April 2007, Greenwich Associates estimates.

During the credit bubble, even small hedge funds made speculative bets by selling big banks insurance protection on mortgage-backed bonds. Banks bought the protection, reckoning it wouldn't be needed.

"The problem with banks and brokers buying credit protection from hedge funds is that you just don't know when they are going to go dark, turn out the lights and say this is now the brokers' problem," says David Lippman, a managing director of Metropolitan West Asset Management, a bond manager in Los Angeles.

Unlike most other big players in the swaps market, hedge funds aren't subject to heavy oversight by regulators or capital requirements. Financial firms usually guard against the risk of their hedge-fund trading partners being unable to pay by requiring they put up cash or collateral for their swap trades.

The industry defends the role of hedge funds. Robert G. Pickel, ISDA's executive director, says hedge funds add "price competitiveness and liquidity" and help spread risk.

The legal cases underline the gridlock that can emerge when such insurance agreements break down. One suit, filed Feb. 14, outlines a credit-default-swap agreement in which Citigroup bought $10 million of protection against a security backed by subprime-mortgage assets from a small Florida hedge fund with just $58 million in capital. The security was a "collateralized debt obligation," known as a CDO, or a thinly traded investment that packages pools of loans.

The fund—VCG Special Opportunities Master Fund Ltd., which is owned by an investment firm that also owns a Puerto Rican investment bank—alleges that Citigroup breached its contract after the bank demanded the fund post additional collateral. By this January, the hedge fund says, the collateral Citi sought from it nearly equaled the $10 million "notional," or underlying, amount of the swap.

In the other suit, the hedge fund, which at that time was named CDO Plus Master Fund Ltd., says it sold credit protection on a mortgage-related security to a unit of Wachovia last May, only to be asked to pony up millions of dollars of collateral in the ensuing weeks.

The hedge fund entered into a credit default swap with Wachovia under which the bank bought protection on a $10 million security issued by a CDO, which had a credit rating of double-A and was issued in April 2007.

Over the next several months as the mortgage market swooned, Wachovia repeatedly demanded the hedge fund—which had put up an initial $750,000—deposit additional collateral for the swap. The hedge fund said in the suit it made more than a dozen additional payments, totaling roughly $8.2 million. In late November, Wachovia requested still more margin, which the fund said brought the total it was asked to fork out to $10.4 million.

The hedge fund refused to pay the final request for collateral of $1.49 million, and Wachovia foreclosed on the fund's nearly $9 million in collateral, meaning the hedge fund got stuck with the losses. "We are concerned that Citi and Wachovia are attempting to take advantage of smaller hedge funds to seek return of capital...to minimize their own exposure in the marketplace," says Steven Mintz, a lawyer for the fund.

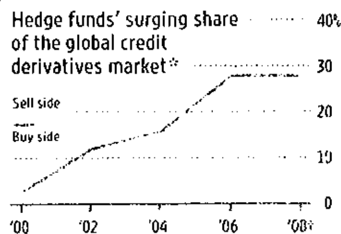
Donald Uderitz, the hedge fund's manager, says he believed there was little likelihood of having to pay out insurance to cover losses from the CDO. In an interview, he says he bought the investment to earn the fees the banks would pay the hedge fund, equal to 5.5% of the $10 million notional amount of the swap from Citigroup and 2.75% from Wachovia. Mr. Uderitz says he feels "suckered."

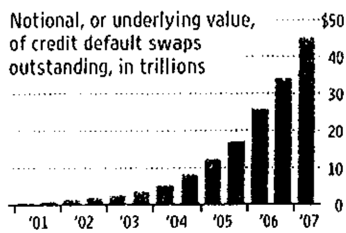
Citigroup and Wachovia say they did nothing wrong and are fighting the suits.

Some other hedge-fund managers say they've been bullied by securities firms when they've tried to cash out on profits from such positions. When one hedge-fund manager considered selling out of a credit-default swap—in which his fund bought protection on $10 million of bonds of Countrywide Financial Corp.—he says there was a condition attached by two securities firms. He says the firms—**Bear Stearns** Cos., which sold him the swap, and **Morgan Stanley**—told him they would cash him out of his profitable position, only if he would simultaneously enter into another swap-selling insurance protection on the bonds equal to his fund's $3 million profit. Eventually, he says, his fund sold the position through **Goldman Sachs Group** Inc. and **Lehman Brothers Holdings** Inc., allowing him to book the $3 million profit.

Representatives for Bear Stearns, Morgan Stanley, Goldman and Lehman declined to comment.

A Higher Profile





*Total credit derivatives market, including credit default swaps †Projection

Sources: British Bankers Association;