Thursday is D-Day

Thursday's auction for Lehman's credit default swaps (CDS)

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Forget the stock market gyrations. Forget Bernanke and Paulson's ineffective, unconstitutional schemes.

Thursday's auction for Lehman's credit default swaps (CDS) is much more important.

Why?

Well, if banks are reassured by the CDS auction, it could do more to free up frozen capital than all of the Fed and Treasury's ill-conceived plans put together.

As Bill Gross, head of $721 billion dollar fund Pimco, says:

> 'Credit markets are based on trust and when there is no trust, markets can freeze up . . . . Imagine yourself at the drive-thru ordering a Big Mac. At one window you order and pay, at the other – 20 feet ahead – you pick up your lunch. What if you thought that after paying at the first window, your 1000 calorie sandwich might not be waiting for you a few seconds later. You might not pay; business as usual might not take place. That is what is happening in the credit markets. They are frozen in "McFear." After the failure of Lehman Brothers – an investment bank which took orders at one window, and promised to pay at another for trillions of dollars of those CDS, swaps, and other derivative "sandwiches" – institutional investors said that they'd prefer to stay at home and have peanut butter instead of risking their money ordering a Big Mac. And so their money goes into that figurative mattress instead of the register at McDonald's, people are laid off, profits go down, bank loans become less available, our economic center cannot hold."

An auction occurred today to determine the value of Freddie and Fannie's CDS. While there were approximately $500 billion in CDS written against Freddie and Fannie, those who issued CDS will be repaid between 91.5 percent and 99.9 percent of protection they sold. In other words, the issuers of such CDS will only have to pay out between .1 and 8.5 cents on the dollar.

For a rough, back-of-the-envelope calculation, let's split it down the middle and call it 95% of $500 billion, which means that the issuers of Freddie and Fannie CDS will only have to pay out about 5 cents on the dollars, or about $25 billion total. That's a lot of money, but not catastrophic.

On the other hand, "investors who wrote protection on a Lehman default will have to pay out between 81 and 85 cents on the dollar."

No one has disclosed how many billions of dollars in Lehman CDSs are out there. And no one knows the exact payout amount which will be determined at Thursday's auction.

But it is known that "Lehman was one of the 10 largest parties participating in credit default swaps, the New York Times reports. The company's most recent quarterly filing said it bought and sold $729 billion in derivatives with a fair net value of $16.6 billion." And a lot of people bought CDS betting on Lehman's failure in September.

D-Day

So Thursday is D-Day, where "D" is for "derivatives".

If there are a lot of Lehman CDS out there, and if the auction price comes in high, it could greatly exacerbate the global economic crisis no matter what Bernanke and Paulson do. On the other hand, if there aren't that many CDS out there, or if the price comes in lower than people expect, it would be a huge sign of stability in the CDS market that could reassure financial institutions and investors worldwide, which could "free up liquidity" and help avert a depression (no matter what Bernanke and Paulson do).

Washington Mutual's CDS auction is October 23rd, and we might not have a final answer on how big the CDS crisis is until then

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