Swap Skirmish: Risks Hidden, Says Hedge Fund
Citigroup, Wachovia Face Lawsuits Involving Credit Derivatives

As financial markets boomed in recent years, some Wall Street players began selling insurance and related trading products, going against their own prudence.

In separate lawsuits filed in a New York federal court, a $58 million asset-backed bond lawsuit alleged 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 "sucked." Citigroup and Wachovia each say the fund's claims are "without merit."

Meantime, other financial players say they have been stung 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 banks and their derivatives.

Hedge funds have bought 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 of 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. "This is an opportunity to be able to pay off insurance on their CDS, as well as their own exposure in the market," 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 "sucked.""

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