SENDING THE RIGHT SIGNALS

IN THE RIGHT HANDS THE CREDIT DERIVATIVE MARKET IS AN EXCELLENT INDICATOR OF SHIFTS IN CREDIT SENTIMENT, SAYS **HAYLEY JOHNSON** OF CREDITTRADE.

Reminiscent of other maturing financial markets in the past, such as the interest rate swap market in the mid-1980s, the credit derivatives (CD) market is rapidly approaching the next phase of its lifecycle. However, while poised to take the leap to becoming a transparent and open market, it remains relatively opaque and closed.

Early CD trades took place in the mid-1990s and the single name credit default swap (CDS) has emerged as the most commonly traded instrument, whereby the buyer pays the credit protection seller an annual premium measured in basis points, in much the same way as an insurance policy enables investors to hedge the risk of a borrower defaulting on a bond or loan.

Whether or not a company is active in the CD markets, some are using CDS prices as one of the purest signs of shifts in credit sentiment, viewing them as a clearer indicator of credit quality than the cash market. Without interest rate or currency elements, the CDS purely reflects the credit quality of an issuer. Enron provides a clear example of this, with the CDS price moving more significantly than the cash bond price as events unfolded.

Figure 1 tracks the events in the lead up to Enron's bankruptcy. It shows the CDS price widening out in response to changes in credit sentiment, while the cash bond price remains relatively unchanged for longer.

REACHING MATURITY. As the CD market matures, more organisations outside the banking and finance sectors, such as corporates and hedge funds, are entering the fray. Within these organisations there is a need for risk managers and product controllers to have access to accurate, independent market pricing to act both for pre-trade fair pricing analysis, as well as for mark-to-market, model calibration and related activities – all of which helps them to track their organisation's credit risks.

Independent inter-dealer brokers (IDBs), such as CreditTrade, GFI and CreditEx have a global view of bids, offers and trades, with access to prices from all the major market makers, equating to about 15,000 prices a month – they can offer a true reflection of market activity. While it is the cardinal sin of broking to come between a bank and their client, the key market-making banks recognise the need for packaging market prices both historically and on a continuing basis.

FIGURE 1
ENRON ASW VS CDS.

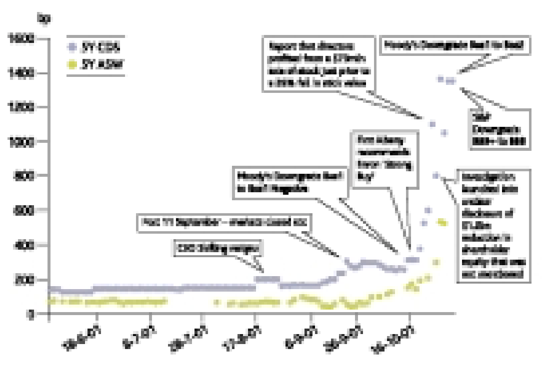
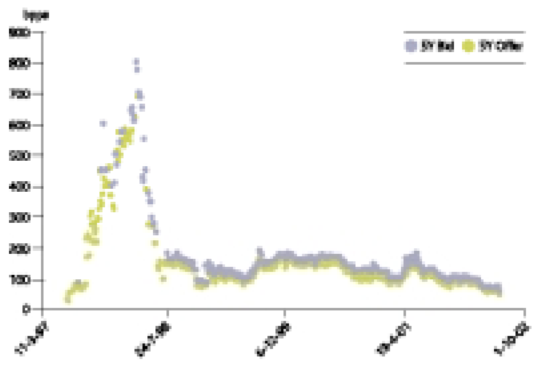


FIGURE 2
KDB 5Y.



KEY USER REQUIREMENTS.

- **Comprehensive data.** Users will need a comprehensive view of shifts in the market and need to access historical market data on a particular issuer, stored from the market's inception. For example, *Figure 2* plots CDS prices for Korea Development Bank. While it is a

FIGURE 3
ROLLS ROYCE 5Y CDS ASW BASIS.

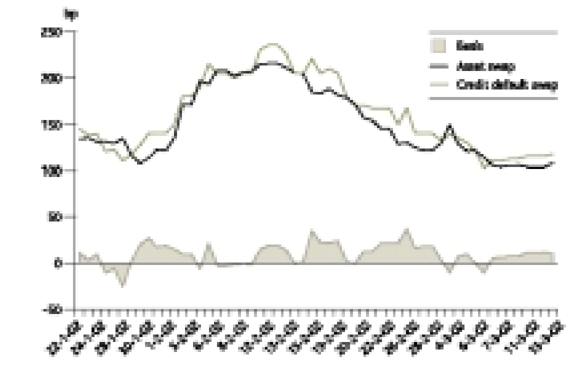
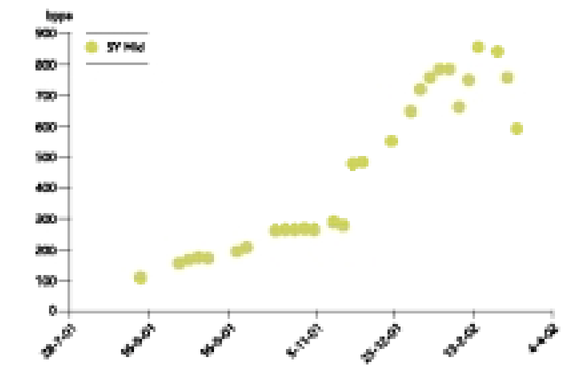


FIGURE 4
GAP INC 5Y MID.



relatively stable credit, it has experienced periods of volatility. Having an historical long-term view of the credit allows investors to analyse periods of volatility within a broader context.

- **Objectivity.** A user will want to be sure that the data is objective. John Lowe, former Director of Information Sales at Tullett & Tokyo, says "While the vast majority of dealers will post prices on the various quote vendors' services, they are often an indication of where that particular bank is willing to deal, and the prices are generally shaded towards whether the bank is a net buyer or seller of the instrument. IDB prices, on the other hand, offer an unbiased indication of the true market. The IDB collects expressions of interest from many wholesale participants and depicts the tightest market available by posting the best bid/best offer for a particular instrument."
- **Accuracy and integrity.** The user needs to ensure that the data professionals are taking the utmost care to ensure they database their prices accurately and comprehensively, for example through close liaison with brokers across all sectors to check for missing prices, price spikes and other anomalies.
- **Clarity.** Clear and comprehensive tagging of all fields is needed to ensure that users understand exactly what the prices they are seeing represent: trades, market quotes or indications.
- **Ease of transference.** Users also need to take into consideration how they access their data. Huge amounts of time can be spent incorporating data from a large number of sources into proprietary models, and often the simplest method of data delivery – whether it be via Excel spreadsheet, CSV file or XML – is the least onerous in terms of manual intervention required when importing data from a number of sources.
- **Flexibility.** Users should consider the amount of information or data required: they can opt for a data subscription service or can access a service which offers data as and when they need it, eg by providing end-of-day prices on a range of issuers on a pay-per-view basis. For a subscription customers should expect to pay anything from £120-£3500 per month, depending on region and type of credit required. One-off downloads start at £100.

HOW THE WEB IS PAVING THE WAY. CDS prices may have some way to go before we see them flickering on a Reuters screen in the way FX and equity prices do today, but the timeliness of price delivery is improving – another signal that the market is maturing. Users are now able to see intra-day prices no more than one week delayed – a significant step forward from the one-month delay on market prices we saw less than a year ago. Benchmark and indicative prices are generally available to reflect the previous day's trading.

While traditional data platforms still dominate dealing rooms across the financial markets, the internet has opened up new data delivery channels, particularly to those not operating in a large dealing room environment. Whether it be through web browsers, email or ftp downloads, these new delivery channels enable data originators to deliver data directly to the customer in exactly the format they need.

WHAT'S NEXT? 2001 really tested the CDS market with some dramatic credit events resulting in the activation of protection contracts. Led by Enron, Argentina and Global Crossing have also put the market through its paces and, on the whole, the purpose of CDS has been successfully proven.

In addition to this, CDS are being used more commonly as part of structured products such as collateralised debt obligations (CDOs). Traders have always looked at trading the basis between CDS and asset swaps and good quality data is crucial in spotting trading opportunities. The Rolls-Royce example in *Figure 3* shows the CDS price going negative to the asset swap, enabling the investor to buy the asset swap for a better yield than the cost of protection on the credit.

Credit indices also look set to develop. A notable example is JPMorgan's newly launched JECI, a tradable index based on the returns of CDS. Its structure enables JPMorgan to offer liquidity that might not otherwise be found in similar cash indices, allowing short-term positions to be quickly opened and closed. (See article on page 43) This has benefits for all users of credit products. A typical example could be a corporate concerned about market spreads widening in its future issuance over which it has no control.

Everyone is keen to identify the next 'fallen angel' and market watchers using CDS prices as one of the purest indicators of credit quality will have observed widening CDS prices of Dow Chemical, Ford Motor Credit, Tyco and Gap over recent months. The financial fortunes of US clothing retailer Gap have been well-documented in the press, as can be seen from its widening CDS prices over the past six months in *Figure 4*.

Whether or not one of the ISDA-defined credit events will follow for any of the issuers mentioned remains to be seen, but it is clear that accurate CD pricing serves investors well as a weather vane on credit sentiment.

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