Ask the experts:

A rapidly growing market

Why should treasurers care about credit default swaps?

TO BUY ADEQUATE PROTECTION ON LARGE PENSION SCHEMES YOU ARE TALKING ABOUT SPENDING HUNDREDS OF MILLIONS OF POUNDS.

David Blackwood
Group Treasurer, ICI

The size of the credit default swap (CDS) market has really kicked off in the last few years, but I am not aware of any significant corporate usage.

One theory is that CDS can play a part in the financial management of pensions. There has been talk of pension trustees buying the CDS of the sponsoring company as a means of protecting themselves against an insolvency event of the sponsor. It sounds a good idea for a pension scheme trustee – but not the company sponsor that has to pay for it.

However, such a strategy is fraught with difficulties, not least of which is size. To buy an adequate amount of protection on large pension schemes you are talking about spending hundreds of millions of pounds since it's the buy-out deficit that needs to be covered. A scheme which is fully funded on an FRS 17 basis would need to purchase CDS roughly equivalent to 30% of the FRS 17 liabilities.

And then bear in mind that the insolvency protection only lasts for a fixed period of time and when that period has lapsed, you have to start again – at the prevailing price.

Overall, it is complicated and unlikely to be very practical. Obviously, a scheme may well invest in diversified CDS in a collateralised debt obligation (CDO) investment – but that's just an asset class choice.

In the corporate arena, the area that treasurers could look to use them is for credit insurance for major customers but I am not aware that companies are doing that, but it's an area that could make sense for large exposures.

In theory, you could use CDS to secure your own credit pricing at any time prior to issuing a bond. This is attractive. Most things can be locked up from the dealing desk, but credit spreads are normally only securable on the day that you issue. We had a theoretical look at this some years ago but the difficulty then was that the market was thin, although that has changed to some extent.

We also looked at yield enhancement – selling CDS on structural cash surpluses. It works, but corporates in most sectors rarely have large cash balances for long periods.

Lastly, the corporate governance issues of dealing in one's own credit are not trivial. It has been suggested the CDS is becoming a major tool for corporates. CDS has its possible uses, but I think it's an area where treasurers need to retain a healthy scepticism and some caution.

BREAKFAST SYMPOSIUM

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Matt King
Head of Quantitative Credit Strategy, Citigroup

There are many reasons why treasurers should care about CDS, mainly depending on the size and rating of the company.

For smaller companies, the demand for diversification (for example, in synthetic CDOs) frequently creates demand for names even if they don't have many bonds outstanding. Knowing that that demand exists – which is possible by monitoring CDS markets and levels – can help treasurers tap into cheaper borrowing than would have been the case otherwise. In addition, the fact that an entire curve – from two to 10 years – will normally trade means that issuers can better gain an idea of their own potential borrowing costs in different maturities.

For frequent borrowers, the argument is slightly different. In their case, the completeness and liquidity of the CDS curve are also useful as a pricing reference, but more important is the variation in implied demand (or lack of it) for their name as the market becomes more or less concerned about the credit.

This is reflected in the cash-CDS 'basis' – that is, the difference between CDS levels and bond spreads at the same maturity point. By issuing when there is demand – and staying away from the market when investors

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are nervous – they can again improve their funding levels.

The situation in high yield (and in particular around buyouts) is more technical, but potentially even more rewarding. CDS levels are determined by the probability of a company defaulting. As such (and to prevent lawsuits) a 'default' needs to be carefully defined. This is done with the aid of a 'reference obligation', normally a bond or publicly traded loan on the entity.

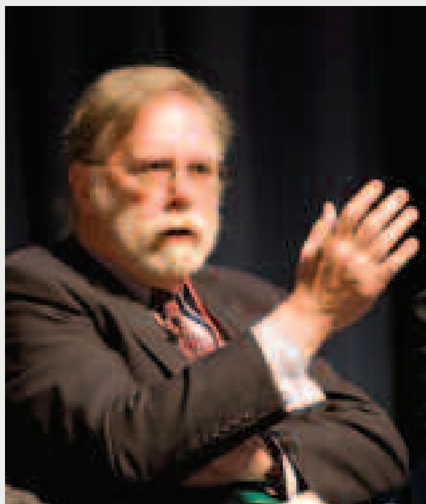
In a takeover situation, the reference obligations (and associated CDS) will usually pass over from the target company to the acquirer. If, though, certain triggers are not met – for example, if financing is raised beforehand, and not explicitly for the purpose of the acquisition – a 'successor event' may not be triggered. If at the same time existing debt is bought back, this can leave CDS 'orphaned' without a reference obligation.

Why should treasurers care about orphaned CDS? Basically because of a combination of the potential for associated publicity and the possible savings in funding rates to be gained. CDS investors who shorted a name in anticipation of a buyout can lose a great deal of money if successor events are deemed not to occur.

Those same investors will typically be buyers of new bonds issued after the buyout – and will potentially pay up for anything which reduces their previous losses. By putting in place cross-guarantees, or by issuing debt out of the orphaned entities, treasurers can potentially save themselves tens of basis points in funding.

While the last example may seem esoteric, such considerations have been very much at the heart of market movements over the past year or two at a great many names.

To sum up, the CDS market is by now much larger and much more liquid than underlying bond markets, especially in sterling. Entire curves trade for a great many more names than have actually borrowed in the market. What's more, the investors in CDS tend to be the same investors who buy bonds. By understanding where CDS on their name trade, and how CDS and cash markets interact, treasurers can not only better relate to their investor base, but they can save themselves money as well.



Bob Buhr
Head of Credit Research, Credaris

Credit default swaps are the most rapidly growing part of the derivatives market. The International Swaps and Derivatives Association indicated that there were over $35,000bn notional value of outstanding CDS contracts at year-end 2006, which is far greater than that of several bond markets, including the corporate bond market, and the notional outstanding of these contracts has continued to grow.

One reason for this is the increasing liquidity of CDS contracts. For an investor, there are only a limited number of bonds you can buy, which is not the case for CDS.

For example, many hedge funds have most of their assets in CDS. But even for more traditional money managers, the proportion of how much of their total credit assets is in the form of CDS contracts has grown over the last few years.

Most fixed-income investors now hold an array of assets, including cash bonds and loans, and CDS assets as well. In addition, CDS contracts can give investors more flexibility in developing and executing trading strategies, including index-based strategies, as the rapid growth of correlation trading during the past several years has shown.

The interesting point, however, is that the CDS contract does not entail any contract with the issuer of the underlying instrument that the contract is written over. This reflects the fact that a CDS contract is a contract between a buyer and a seller based on an underlying reference instrument, which is either a bond or a loan.

These are, after all, derivative instruments. For instance, if you buy a bond from an issuer or in the secondary market, you own the bond and now have a contractual relationship with the issuer, which is governed by whatever legal document sets out the terms and conditions of the offering. But when an investor enters into a CDS contract, that contract is with the counterparty to the trade, not with the issuer of whatever bond or loan acts as the reference instrument to the contract. Issuers have no legal obligation to holders of CDS contracts, then.

This creates an interesting dilemma for issuers – should the interests of CDS holders ever be given consideration? There is no firm answer to this. However, treasurers should recognise that holders of CDS contracts are often holders of bonds as well – we're the same people. And in most cases the interests of CDS holders are similar to holders of cash bonds and loans. Positive or negative credit trends or events have a comparable impact on both, since CDS spreads tend to move in line with spreads on cash bonds in most circumstances.

The main exception to this can be in the event of an unanticipated bond redemption, where redeeming the bond may make bondholders (and banks) happy, but may cause some distress to the CDS contract holder, depending on which side of the trade they are on. This is because if the reference obligation to the CDS the contract is redeemed, and there is no other outstanding bond or loan which is eligible to become a new underlying reference instrument, the CDS contract becomes worthless. This can make the seller of the contract happy, but the buyer quite unhappy, since the value of the contract can now approach zero. Most CDS investors are aware of these risks.

The main lesson for corporate treasurers, then, is not that CDS contracts are different – they are, but mostly as a new and useful tool for many investors. More importantly, it's the same investors that historically have purchased bonds and, in some cases, syndicated loans who are now using CDS contracts as an active part of their investment and trading strategies. There is no easy or arbitrary way to distinguish between bond investors and CDS investors – more often than not, it's the same group.

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