

# MAKE SWAPS FOR MORE SECURITY

THE RISE OF THE CREDIT DERIVATIVES MARKET HAS BEEN PHENOMENAL, AS MORE AND MORE CORPORATES STRIVE TO PROTECT CREDIT RISK, SAY **CHRIS DANIELS** AND **CLAUS MIKKELSEN** OF BARCLAYS CAPITAL.

**P**rudent businesses look to protect their key business interests, whether by insuring their main production plant against fire or their inventory against theft. So it is a logical extension for a business to understand – and possibly 'insure' against the default of a main debtor. Although individuals and companies have sought the Holy Grail of protecting credit risk for as long as business deals have existed, it is only in the past few years that the market has fully developed to protect against the default of a specific credit entity. The market is now worth some \$1trn and it is possible for businesses to manage their credit risks efficiently.

**CREDIT DERIVATIVES IN ACTION.** Many counterparts (banks and corporates) wisely took out credit protection to the many defaulted companies of the past 18 months, such as Federal Mogul, Polaroid, Railtrack and most recently Enron. This was often simply in line with their normal risk management policies and they have all now been compensated for the loss associated with any business deals they had with these companies. Unfortunately, many more did not take out protection against the default and have lost substantial amounts of money.

**TYPE OF PRODUCTS.** Some 95% of all credit derivatives are credit default swaps, which can be thought of as akin to insurance contracts (although legally they are not defined in this manner). A credit default swap is a contract defined by reference to a credit-risky asset, typically the bonds or loans of the entity, as they are generally liquid and price transparent. Many users of credit instruments refine the 'standard' credit default swap to fit their specific circumstances. The most common ones mirror the performance of credit

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## ■ A BRIEF HISTORY

The phenomenal growth rates of the credit protection markets have so far been driven by the appetite of banks and financial institutions to exchange credit risk amongst each other. The credit default swap is the ideal instrument to facilitate such trades and corporates have increasingly warmed to the idea of quantifying their exposures to large trade partners in business contracts and managing associated risks. In the past, companies sought to manage credit risk primarily through clauses in commercial contracts and essentially had three options open to them:

The above options did not allow businesses to efficiently hedge the risks associated with default among their main customers and so there was a clear need for the banks to create a third-party outlet to facilitate hedging of credit risk. In 1992, credit derivatives emerged and over the next few years the credit derivatives market grew from a small inter-bank market, designed to split up the risk and spread it around the players in the market, to a market used by individuals, corporates and institutions. The market accelerated rapidly from 1997, when a number of banks launched credit-risking systems into the public domain and was given a further boost in 1999 when the International Swaps and Derivatives Association, Inc (ISDA) introduced industry-wide benchmark documentation. Although still dominated by banks, the credit derivatives market is now accessed by a wide range of incumbents, from corporates to financial institutions (including insurance companies, fund managers and hedge funds).

default swaps but were created to cover the situations where default swaps are not suitable due to lack of liquidity in the underlying bonds and loans or where there are special clauses of default payments that need to be covered.

**CORPORATE USE OF CREDIT DERIVATIVES.** Companies are increasingly using credit derivatives to offset the credit risk of business deals. Taking the example of vendor financing, companies will bundle their product offerings together with medium-term financing packages (last one we have seen had a nine-year tenor). This activity is particularly popular in the cash-strapped TMT sector, where incumbents are looking for increasingly generous credit terms, while at the same time being increasingly likely to default. Providers of vendor financing solutions are obvious buyers of credit protection. The cost of hedging, to be taken into account by the vendor finance provider

FIGURE 1  
INSURING AGAINST DEFAULT OF PAYMENT.

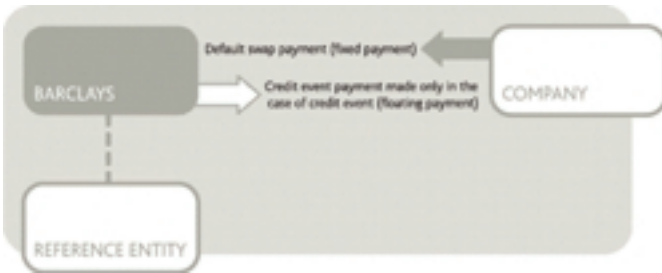
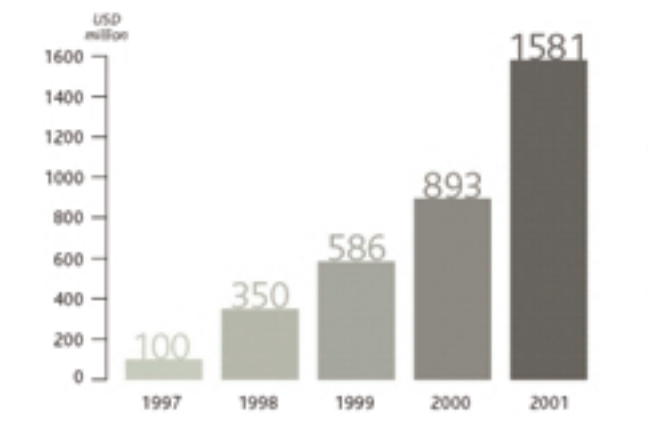


FIGURE 2  
GLOBAL OTC CREDIT DERIVATIVE SIZE.



depends on the credit rating of the customer and the required tenor of the protection. As an indicative figure a credit default swap on a strong investment grade corporate may cost 15-25bps of notional per year, whereas a sub-investment grade corporate – BB rated or below – may reach as high as 600bps of notional per annum. The rationale behind the premium is that it should be roughly equal to the spread over Libor paid on the corporate's bonds – albeit with adjustments for liquidity in the credit swap, bid-offer spreads and other market-related factors.

**HOW DOES THE CREDIT DEFAULT SWAP WORK?** In a credit default swap the buyer of protection makes a running payment (say every quarter) to a bank in exchange for a payment should a credit default occur. The payment to compensate the buyer of protection in case of default can take various forms. In the simplest form the payment is a predetermined fixed amount. However, most commonly the default payment is a means of compensating holders of the defaulted bonds, and the credit default seller (the bank) makes payment by delivering the par value of the bond in cash in exchange for the defaulted bond. This way the bondholder is being accurately compensated for loss of principal due to the default.

Corporates entering into credit default swaps will most often receive the par value of a reference bond in cash and be required in exchange to deliver the defaulted bond. As the corporate will not be holding the bonds it will have to purchase them in the market and

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deliver them to the protection seller. It may seem a cumbersome process but the market for defaulted securities is generally liquid and the company will be able to buy the securities – typically, at hugely discounted rates to par (20%-30% of par value).

For the corporate to be accurately compensated in case of default it should make sure that the business contract ranks senior (or at the very least pari passu) with the bonds or loans, so that on default the amount received from the creditors should match the cost of the defaulted bonds. Due to the bond related mechanics of credit default swaps, corporate names with no bonds or loans trading in the market tend not to be traded in the credit derivatives market, and are often structured on a bespoke basis.

**IS CREDIT PROTECTION TOO EXPENSIVE?** The most common reason for companies not to enter into credit default swaps is that they think it will be 'too expensive'. In case of default it does not matter at which price protection was bought, as the buyer of protection would still be better off with than without it. Corporates with no credit risk hedging policy in place also run substantial reputational risk, as stakeholders in the company might question why the management did not take out insurance against a crippling default. For example, since filing Chapter 11, bonds issued by Enron, the world's former largest energy trader, recently traded around 20% of face value, therefore a credit default swap would have monetised 80% of notional for the buyer of protection. Enron is just one example, but many other companies also default on payments and go bankrupt. Rather than taking a view on individual companies and trying to outguess the market, it may be that companies need to look at their portfolio of credit risk – how risky is it, and can they quantify and analyse it? It is likely that the '80:20' rule comes into play here – that is, that 80% of credit exposure is concentrated with 20% of a company's clients. Therefore, the most cost-efficient solution could be to take protection out on just these clients.

**WHAT 'S ON THE HORIZON?** In the short term, the complexity of products available seems unstoppable. The credit default swap market is becoming as developed, mature and significant as the interest rate swap market, and this trend will only continue in the future. Although the market will continue to be dominated by financial institutions, companies will become increasingly active participants. It is likely that credit risk will be an integral part of the risk management policy statements of the future, in the same way as foreign exchange and interest rates are now. With shareholders demanding more certainty in results from blue chip companies, the pressure to engage in credit default protection is as likely to come from external sources as from within the boardrooms. New accounting regulations in the UK, Europe and the US requiring corporates to disclose their derivatives exposures in detail is also driving the positive development, as it helps investors to assess whether appropriate credit risk management policies have been implemented.

Investment banks are already making markets in most individual credits, as well as in broader classes of credits, and this will continue to expand. Within a few years, it is expected that credit derivatives will be available through market data service providers and the internet.

A great benefit of a mature credit default market is the reduced need for costly bespoke solutions and one-off transactions. The broadening of user base will, given time, help drive transaction costs lower (tighter bid-offer spreads). Product offerings will become more sophisticated, and the popular credit default and total return swaps will be joined by more sophisticated products such as call

options on credit spreads. Markets have historically become more efficient – and one certainty is that they will continue to do so. The developments described would be another step towards truly efficient financial markets, as credit risk for the first time would be quantifiable as well as tradable.

**A HEALTHY VIEW ON RISK.** In today's defensive shareholder community, it is important for businesses to demonstrate that risks have been mitigated as much as possible. Credit exposures are a very real concern for managers and shareholders alike. The credit derivatives' market has grown rapidly away from the public eye, as almost all transactions are still over-the-counter, and users have been sensitive to information falling into the public domain. Recent high profile defaults have brought the market squarely into the public consciousness. More businesses (including banks) are reviewing and managing their credit exposures regularly. The more successful, in our opinion, are the ones that complete 'financial health checks' and quantify their credit exposures with a view to managing their risk. Given the challenging economic landscape ahead, we expect this trend and the credit market in general to continue to evolve.

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