Restructuring clause still a US default swap feature

Around half of the single name credit default protection swaps traded on US corporates still feature restructuring as a credit event. Expectations had been more in the range of 75/25 [trades without restructuring against those with the clause]. The most active New York credit derivatives market-makers took a hit on default swaps last year when Conseco restructured its liabilities without actually failing to make payments. Dealers felt that they were being unfairly penalised when default swaps were exercised despite the fact that there had been no economic default.

The biggest New York trading desks reacted by unilaterally deciding to start providing standard US corporate default swap quotes without the restructuring clause. This is a feature of the credit derivatives definitions produced by the International Swaps and Derivatives Association (ISDA) in 1999.

Dealers will still provide default swap quotes that feature the restructuring clause on request, however. A market convention has been established that default swaps featuring the restructuring clause on corporates in the mid to low end of the investment grade rating category trade at a 5-10% premium to swaps that do not incorporate the clause.

European users and traders of credit default swaps were unhappy that a self-appointed group of New York-based dealers made a shift in market convention without submitting to a formal consultation process under the aegis of ISDA. The trade group is currently holding meetings of market officials to try to patch together an amendment to its 1999 definitions.

Inter-dealer default swap liquidity in New York has not been harmed by the move to a fractured market convention, but globally standardised documentation is crucial to the continuing adoption of credit swaps by end users of derivatives.

The New York dealers may also have inadvertently hurt the ability of their parent banks to receive capital relief through the use of credit derivatives to hedge their loan and bond exposure.

The Bank for International Settlement's (BIS) new capital adequacy framework proposal, which was issued last month, is predicated on ISDA's 1999 credit derivatives documentation, which lists restructuring as a credit event. "[The BIS proposal] implies that unless you have restructuring as a credit event, you won't get relief," said Jonathan Davies, head of credit derivatives at PricewaterhouseCoopers in London.

A decision by regulators that banks using a credit derivative without a restructuring clause should not get capital relief would defeat the purpose of many of the trades done by banks that are users of credit default swaps, rather than market-makers. IFR

Future of pan-Euro retail offerings

Pan-European retail tranches on equity offerings have become increasingly popular in the last two years. Many bankers consider it to be a necessity for global players and large privatisations. But the regulatory obstacles and huge costs involved are limiting its success. A recent paper submitted to the EU for a harmonisation of regulations may be the answer.

Although the development of a pan-European retail market for equities is somewhat difficult in light of the current regulatory restrictions, Forum of European Securities Commissions (FESCO) has compiled a report for the EU Commission outlining its idea to create a European passport for offerings. That would allow issuers to extend their offers to other countries without the current extensive regulatory hurdles in their way.

FESCO's report suggests that the home country of the issuer should have full control over documentation. Any additional information required relating to local taxes should be made accessible on an issuer's website via links. Common disclosure standards would allow a single format for prospectuses, which FESCO advises, should only need to be available in English, together with a summary in the local language. IFR

Moody's rolls out five-year credit assessment product

Moody's Risk Management added RiskCalc to its flagship risk management tool. RiskCalc is a five-year default prediction product for US and Canadian companies. The new product is meant to act as an early warning system for banks that are monitoring actively managed credit portfolios and underwriting loans.

The product's debut coincided with the release by bank regulators of a proposal that would let banks use their own internal credit assessments as a basis for the capital they must hold against bad-debt risks.

Forecasts that US speculative-grade corporates' default rates will jump from 6% last year to 9% this year, and projections for growth in the collateralised debt obligations (CDO) market, also help feed the appetite for the default probability tool, said CDO and credit derivative officials in New York. The new product is intended to complement rather than replace five-year credit default swaps as a gauge for predicting the likelihood of defaults. IFR

Raising the floor

In the recent rush of convertibles issuance across Europe, a key feature on many of the new issues has been high bond floors. To attract more fixed-income buyers and to reduce their own downside potential, underwriters are structuring securities that cap downside risk.

With issues earlier this year sporting bond floors in the low 90s, mid-February saw an issue from Vivendi emerge with a floor of 95. This marks a big change from 2000, when an A3/A- credit like Standard Chartered could bring a £575m deal with a bond floor in the mid 80s.

The trend to higher bond floors in part reflects the changing nature of the target investor base. Many German and Italian fixed-income fund managers are on the lookout for a relatively safe performance booster. They face a much more competitive marketplace for their funds and – especially in the case of the Italians – a historically low interest rate environment.

One way of raising the bond floor is to have shorter maturities, perhaps with the inclusion of short-dated puts. But that approach can also create problems if the company (or its bankers) misjudge the economic cycle and the issuer has to refinance the bonds at an inopportune time. But high bond floors are not just a question of attracting fixed-income buyers. More concentration on investment-grade credits means lower credit spreads, which in turn determine the investment value. So far, European equity-linked issuance in 2001 has been overwhelmingly investment-grade.

High bond floors also appeal given bankers' own nervousness about the equity markets. "The higher the bond floor, the less downside there is for the leads if they get stuck with the bonds on their books," said one analyst.

On some recent new issues the fees (normally close to 2%) are more than one third of the difference between the issue price and the investment value. So with a bond floor of 95 and 2% fees, a bookrunner has only three points of risk before the investment value kicks in. IFR

The price of innovation

Freddie Mac has spawned the first true Dutch auction programme ever undertaken by a non-sovereign. By eschewing the traditional syndicate structure, Freddie stands to save millions of dollars in underwriting fees. Faced with the prospect of losing a large chunk of fee-based business, dealers are hinting that they may be less enthused about putting their capital on the line. Agencies are not, they argue, Treasuries after all.

Freddie has committed to auction its two and three-year reference notes this year. All bids are to be submitted to the issuer through a 35-member designated dealer group, with other dealers and investors participating by submitting bids through the group. The borrower aims to mimic Treasury auctions.

The chief question is whether Freddie's auctioned securities will benefit from the same dealer support and liquidity as its syndicated deals.

Freddie is betting big on the auctions' success. It has committed to increasing its two and three-year note sales this year to eight issues of at least US$3bn each. Last year, Freddie sold just four short-dated issues. Fannie Mae, meanwhile, plans to continue to stick with the syndicate structure.

Freddie Mac officials argue that, partly through when-issued trading, which should begin leading up to the first auction, secondary market and repo volume should increase. That will offer nimble dealers a different opportunity to make money. IFR

Reinsurer diversifies with CAT-bond coverage

Munich Re came to market recently with the largest multi-peril catastrophe bond that uses a parametric trigger structure, in a move to diversify its insurance risk. In a parametric trigger structure, pay-out is determined by a catastrophe of a certain magnitude occurring, rather than by the cat-bond sponsor's losses. Munich Re Capital Markets structured the three-year US$300m deal.

Munich Re is the world's biggest reinsurer, and because of its size and rating the number of entities it can buy reinsurance from is limited. Munich Re cannot buy coverage from entities that do not carry a Triple A or Double A rating. This safety measure imposes certain limits on how much protection the reinsurer can draw from the top reinsurance companies. Munich Re, with €20bn in capital, is one of only a handful of Triple A rated insurance organisations worldwide.

To expand investor appetite for the catastrophe risk-linked securities by diversifying investment options, Munich Re set up separate three-year Cayman Island-based special purpose companies: PRIME Capital CalQuake & Euro Wind and PRIME Capital Hurricane.

The deal's parametric trigger structure provides the issuer with liquidity relief in the event of a major catastrophic event. Using a parametric trigger structure removes some of the underlying risk because reinsurers and insurance companies do not disclose the totality of their portfolio when seeking reinsurance, say industry officials. IFR

These extracts are from IFR (International Financing Review). For further details, please contact Lara Bull on 020 7369 7984 (tel) or 020 7369 7397 (fax). Email: lara.bull@tfeurope.com