New restructuring definition to cut basis risk

The amended definition of restructuring as a default swap credit event, which was agreed at the annual general meeting of the International Swaps and Derivatives Association (ISDA), should lead to a sharp reduction in basis risk for banks.

US default protection sellers currently charge around 10bp more for a standard five-year swap on a well-rated corporate that has a base cost around 50bp when it features restructuring as a credit event, compared to a swap that does not. Dealer consultation indicates that this premium will fall to around 2bp when the restructuring clause uses the new language, according to Dennis Oakley, a managing director at JP Morgan and an ISDA board member.

ISDA's credit derivatives committee managed to reach a consensus on wording of a supplement to the 1999 credit derivatives definitions. The supplement limits the maturity of obligations that are physically deliverable when restructuring has been used by a default swap buyer to trigger exercise on a deal. The restructuring maturity limitation date was set at 30 months after the event of restructuring.

Loans that have triggered restructuring will only be deliverable if they are fully transferable. This section of the supplement will be unpopular with some European buyers of protection, as many European loans require the consent of the borrower for transfer.

Users as well as dealers of credit default swaps, both from Europe and the US, were involved in the debate over the terms of the supplement, however, and were willing to compromise on wording of the clause in order to achieve standardisation for the bulk of default swap contracts.

"The critical issue... is the question of what can be delivered, and the key to this is limitations on what can be delivered in restructuring," said Bob Pickel, Chief Executive Officer of ISDA.

Default protection dealers are still smarting from the exercise of swaps on Conseco last year. The company did not go into economic default, but restructured short-dated loans. Although the restructured loans eventually appreciated in value, protection buyers were able to exercise their swaps and deliver long-dated bonds that were trading at a steep discount, thus realising windfall gains at the expense of protection sellers. This will not be possible under the new definition of restructuring.

The new language also restricts loan restructuring from being a default swap trigger unless there are at least four unaffiliated holders of the obligation, two thirds of whom agree to the restructuring. This is designed to prevent loan holders from engineering a restructuring to collect on default swaps they have bought. There is also a limit placed on the extent to which notice must be given when restructuring is used as a credit event.

Swaps will still be written without the restructuring clause, but the introduction of the supplement to the 1999 ISDA definitions should restore liquidity to the core "with restructuring" section of the credit default swap market, according to Blythe Masters, a managing director at JPMorgan, and co-head of ISDA's credit derivatives committee. IFR

Portfolio managers warm to CAT bonds

The uncorrelated market risks and high rates of return of catastrophe bonds are winning over large bond portfolio managers.

Since the debut of CAT bonds in the early 1990s, fund managers overall have consistently represented about one-third of the investors in new deals, according to Goldman Sachs statistics. Hedge fund investment in CAT bonds has been waning as many macro-funds have left the market, said Mike Millette, a vice president at Goldman.

Super-CAT bond structures represent the best value, according to some fund managers. These offer the best value in deals where traditional insurers have reached capacity in the reinsurance market. An example of this type of super-CAT bond deal was Munich Re's Prime Capital transaction last quarter. Munich Re sought to get an extra layer of protection in the event of a massive calamity.

As the world's largest reinsurer, there were few other places for it to go to top-up its protection. Prime Capital was Munich Re's first risk-linked securities transaction and the largest high-yield transaction of any asset class in the fourth quarter.

Industry specialists expect an increase in liquidity in CAT bonds to follow the adoption of the rules that the Bond Market Association unveiled in March for book-entry settlement of secondary market trades in risk-linked securities. These rules should reduce trading risk and streamline settlement in the developing market, which currently stands at around US$7bn. IFR

Traditional valuation methods back in fashion

Internet and other high tech companies are avoiding flotations at a time when valuations for the sector are at their lowest and as traditional earnings and cashflow-based valuation methods are coming back into fashion.

Stocktrade, the online division of stockbroker Brewin Dolphin, is the latest to have postponed its flotation owing to a reduction in trading volumes. Online investment bank EO is planning a flotation, but only when market conditions improve. The flotation of Symbian, the company which controls the Epoc operating system introduced by Psion, was planned to take place by June this year but is now on hold pending product developments.

Semiconductor companies planning flotations include Brightcom and Powerex, but again the timing is dependent on market conditions.

The tightening of investors' standards is hitting high tech companies at the first funding level. They will only gain funding at any stage now if they have a market crying out for their products and services, according to James Purcell, CEO at FirstStage Capital, a corporate finance house.

In Purcell's view, the toughest part of assessing the value of a high tech or internet business is summing up its management. "If a management team cannot take a product to market, it is no good. There should also be genuine operational experience in the divisions, and domain experience. It is an advantage if the team has worked together before."

On the revenue model, Purcell said that the company should be able to generate cash as well as profits. "We will look at how revenues and costs evolve, and whether the company's assumptions are valid. Very often they are not. We also look for cost control – the days of large salaries are long gone."

Post-IPO market valuations of internet and other high tech companies are, in the worst cases, 99% below their peak. Valuation methods common in the bull market until March 2000, including multiples of users and of page impressions, are no longer relevant, according to Purcell. "In the good days, it was common to hear that tried and tested valuation methods such as cash generation and DCF did not work with Internet companies. Now investors are returning to these," he said. IFR

Clearing of swaps gets under way

Eight large derivatives dealers have started clearing over-the-counter interest-rate swaps through the London Clearing House's (LCH) SwapClear system – the first international central counterparty (CCP) for OTC swaps. Some leading swap houses, including JPMorgan and UBS, were notable by their absence from the LCH launch party, however.

The initial tranche of swaps entered into SwapClear totalled roughly 4,250 trades, with a notional principal in excess of US$250bn. These trades are now margined and settled through the LCH as the CCP on a daily basis. The initiative was undertaken by the eight members of OTCDerivNet, which was launched last October as a partner to the LCH on the SwapClear project and to provide funding. The members are Bank of America, Barclays, Citigroup, CSFB, Deutsche Bank, Goldman Sachs, Merrill Lynch and Société Générale.

The key benefits for swap houses from using a CCP are more effective straight-though processing; capital and credit savings; and the opportunity to pre-match trades, thus reducing operational risk.

Some officials sceptical of the new venture said they are not convinced the expense of setting up SwapClear will be rewarded with significant savings. Banks whose interest-rate swaps business is characterised by a wide variety and complexity of products will only achieve modest savings, one official said. IFR

Three benchmark era arrives

Interest-rate swaps are not quite ready to supplant Treasuries as the benchmark for the US fixed-income market, but will rank as one of three co-existing benchmarks, alongside treasuries and agency securities, according to Chip Carver, head of e-commerce for interest-rate products at Goldman Sachs. "Eventually one will emerge as the dominant benchmark," Carver said, without guessing which sector will prevail.

The limitations of treasuries as a benchmark in an era of debt buy-backs and curve distortions are well understood. Swaps still lack some of the desirable characteristics of a fixed-income benchmark, however. Bid/offer spreads are not as tight in swaps as treasuries, for example.

Swap prices are effectively observable, now that dealers are joining brokers in providing real-time spread and rate information, and swaps are increasingly becoming more liquid than treasuries. But swap trade sizes are still a matter of informed guesswork, and only the biggest dealers can make a realistic gauge of flow at any given time.

The swap market could also face new forms of stress if it has become the benchmark for fixed-income trading by the time of the next LTCM-style credit disaster. "I wonder what happens in those sorts of situations," said Carver. "Maybe one benchmark isn't really the answer." IFR

These extracts are from IFR (International Financing Review). For further details, please contact Ann Gordon on 020 7369 7521 (tel) or 020 7369 7330 (fax). Email: ann.gordon@tfeurope.com