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Credit derivatives

Risky business

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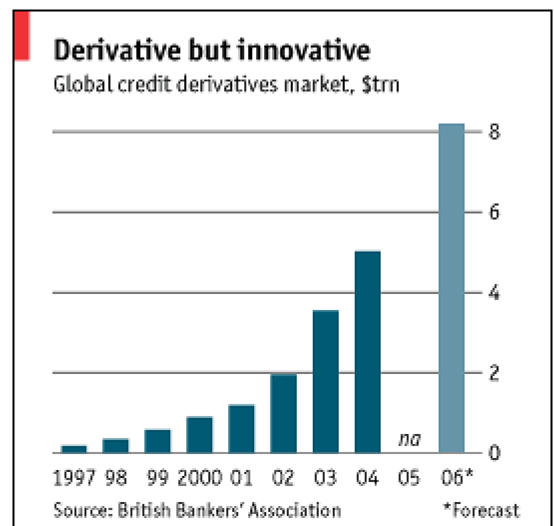
The market for insurance against credit default continues to boom

WHAT do Delphi, a huge auto-parts company, Northwest Airlines and Delta, another airline, have in common? All three American companies are fighting hard to avoid filing for bankruptcy. There was a time when those who had lent money to such firms would have watched events nervously. Today, it is unclear who exactly is sweating.



The reason is the proliferation of credit derivatives—contracts that let lenders shift the risk that a company will default on to another party for a fee. So a bank lending to Delphi, say, could pay a premium to another financial institution (perhaps a pension fund or an insurer, or another bank) to take on the risk that the parts maker will be unable to meet its obligations.

A decade ago, credit derivatives barely existed. Now the market for them is big, and still growing fast. The British Bankers' Association, which carries out a survey every couple of years, reckons that the global market hit $5 trillion last year and that it will pass $8 trillion in 2006 (see chart).

So far, credit derivatives seem to have been healthy for the banking system. By enabling the unbundling of financial risks (splitting, say, the interest-rate and credit risk in a corporate bond), they have allowed finer tuning of risk management. Alan Greenspan, chairman of America's Federal Reserve, has attributed the resilience of his country's banks in 2001 and 2002—when Enron, WorldCom and the Argentine government defaulted—to credit derivatives, which spread the burden of the defaults across a broad group of banks and other institutions.

The market's development has been helped by the increasing standardisation of credit-derivatives contracts. And new investors have been attracted by the creation of standard products based on credit derivatives, such as indices that offer exposure to, or hedges against, pools of risk (eg, European or Japanese corporate credit).

Sold by the slice

But perhaps most important has been the growth of complex products that appeal to yield-hungry investors. The first credit derivatives were fairly straightforward “credit default swaps” that transferred the credit-default risk of a single company. But the lion's share of recent growth has been in the “tranched” market. Here, in essence, pools of credits are sliced into riskier and less risky bits (or tranches) and sold. So, for instance, a risk-averse investor could choose to buy the tranche that exposes him to credit risk only after the first 10% of credit losses have been absorbed by other investors. An investor with a bigger appetite for risk and yield would buy this first slice. “In a lowish interest-rate environment, with tight credit spreads, investors are desperate for yield—and tranched instruments are a way for investors to get juicier returns,” says one bank regulator.

Of course, things can go wrong. It is possible that the pricing of ever more complicated instruments might sometimes be too much even for the ultra-brainy lot who do it, with expensive results. Tranched instruments have no clear market price, so they have to be valued with complex models. Working out whether a default in a portfolio is likely to be an isolated event, or is a harbinger of more to come, is especially tricky, not least because data on credit defaults are relatively sparse.

Some worry about the increased activity of hedge funds which, lured by the yield on illiquid, complicated instruments, make up as much as 70% of trading volume in credit derivatives, by some counts. Mainly, this concern revolves around newer funds that lack experience in managing complicated risks. Their inexperience might increase counterparty risk—the danger that a seller of credit protection cannot pay in the event of a default. The worry is exacerbated by the high leverage (ie, use of borrowed money) of many hedge funds: this boosts returns on good days but magnifies losses too.

So far, though, there have been no big problems. Some hedge funds lost a lot on credit derivatives after the debt of General Motors was downgraded earlier this year, but these troubles were isolated. They may even have been a good thing: a salutary reminder of the risks.

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