New Minerva Report

Credit Derivatives

Last month we touched on the subject of Collateralised Debt Obligations (CDOs), and how they had effectively removed the proper scrutiny by lenders necessary to ensure healthy lending. This month we want to explore further the risks to markets of credit derivatives. Basically there are two main credit derivative terms used. These are the ones you are most likely to see mentioned by investment commentators. They are CDO and CDS. There are a number of other acronyms, like CLO, CPDO, CDPC, synthetic CDO and so on. For simplicity purposes it is best to say that most of the others are a variation on a theme of either the CDO or CDS.

A Collateralised Debt Obligation (CDO) is really a type of collective investment. In their most basic form they parcel up a selection of bonds, loans and swaps. Then they slice up the portfolio into a number of tranches, just like the split cap investment trusts in the UK. These tranches then carry different credit ratings. So for example, they could have a AAA credit rating tranche that will get up to 80% of the cash flow They will be protected up to 30% of first defaults that could hit the overall portfolio. At the other end, you have lowest credit rating tranche, sometimes know as 'equity', who would suffer the most from defaults, and be the last to get the cash flow. In recent times with the default rate so low, these 'equity' holdings have been getting returns as high as 20%. Finally, there is normally an in-between tranche known as mezzanine, whose expectations and risks are between the other two.

A Credit Default Swap (CDS) is an arrangement whereby one investor agrees to pay another a series of payments, for which the other investor will pay a compensation if the bond on which the default is written goes into default. This enables investors to 'protect' themselves from the credit risk of the bond. It is really an insurance policy which is tradable.

There are two very different opinions about these innovations in markets. On the one hand you have Warren Buffet who calls them the financial markets equivalent of weapons of mass destruction. On the other hand there are those who say that they disperse risk and make the financial system safer.

Our view is that they could well turn out to be the weapons of mass destruction. They have not been tested in any credit downturn. The sheer speed at which they have developed, and the vast size they have now reached, should be a worry to all. The Bank of International Settlements said the CDS market reached $20 Trillion by June last year. Volume has almost doubled each year since 2000. Whilst they may not double this year, forecasts are that the market will reach over $30tn next year.

Pitfalls

The CDS market's unique problem is when a company restructures its debt. Basically it can mean that the fixed interest stock that is being insured against default, can cease to exist. A bit like having car insurance on a non-existant car. So the CDS becomes worthless. This has become an increasing problem as the amount of CDSs now far outstrip the number of actual bonds.

The CDO market is probably where the biggest future problems lie. Firstly, we don't think that the market is being realistic about the potential for future defaults. The potential for more defaults than expected is increasing, as the leverage being put on new deals, especially by private equity firms, is becoming more and more stretched. At the moment the market is expecting the default hits all to be taken by the 'equity' tranches, but we think it is quite likely that the defaults will get up to the mezzanine level of CDOs. Secondly, as we move into slower growth, which we will inevitably do sometime, the credit rating agencies will have to keep abreast of the CDO's credit ratings. Any adjustment to below investment grade will mean that certain funds will be forced to sell.

The final question that will only be answered by a downturn in these markets is how good are the counter-parties to these products, and what will prices do in a crisis? Those that say these derivatives have diversified the risk in the system might be being too complacent. Has a bank which has sold its debt on in a CDO package, but is lending money to the hedge fund that has bought that debt, really reduced its risk? Does anyone remember what happened in the equity crash of 1987, when all the strategies that were supposed to insurance portfolios against such an eventuality failed? Some of the world's regulators are belatedly waking up to the risks of some of these products. Let us hope that they get on top of them subtly, and before they become those financial weapons of mass destruction. We say subtly, because we don't want heavy handed regulation which actually creates the problems, rather than solving them. Finally, these products have enabled investors to be able to participate in bond markets for a fraction of the money that would be needed to actually buy the bonds. This has therefore helped increase the liquidity in the system. It is very easy to see how this could reverse itself into a liquidity crisis.

Paul Warner
Investment Director
& Editor of the
Minerva Report