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Recent Developments in the Credit Default Swap Market

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Introduction and market overview

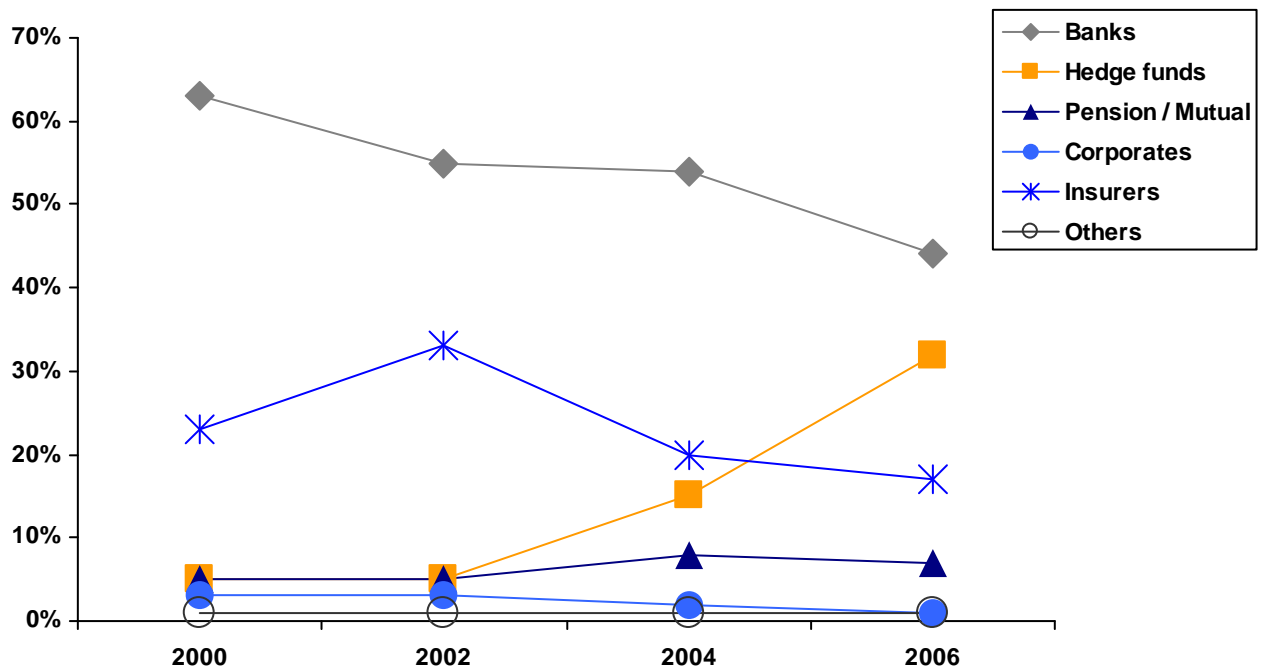
Recent surveys of the credit derivatives market by ISDA and the British Bankers Association (BBA) suggest that outstanding transactions are now above US\$ 20 trillion. This exceeds even the most optimistic forecasts made by informed market commentators. Part of this performance can be attributed to the same market drivers that year on year have contributed to the market's exponential growth:

- the inefficiencies of the credit markets;
- the need for banks to hedge credit risk; and
- the demands of investors.

However, an increasingly important contributor is the trading activities of the dealers and hedge funds. Over the last two years the market has achieved a critical mass that opened the door to increasingly sophisticated trading strategies.

This is borne out by the data that came out of the 2006 BBA Credit Derivatives Survey (The Survey):

Chart 1: Sellers of Credit Protection - market share by type 2000 - 2006¹



¹ Source: BBA Credit Derivatives Survey 2006

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As chart 1 illustrates, hedge fund activity has grown considerably over the last four years. The decrease in banks (sellers of protection) as a percentage of the whole is interpreted by market commentators as an indication of the extent to which credit risk is leaving the bank sector - a phenomenon that is pleasing to the regulators. However, whilst this risk was previously being taken by the insurance sector it is now transferred to hedge funds. Given the leverage of both hedge funds and the products that are being used and the fact that hedge fund credit lines are provided by banks, it is likely now that even more risk is actually staying within the banking sector.

Hot Topics

The last year in the credit derivatives market has been pre-occupied by a number of issues. Many of these stem from the challenge of building infrastructure to support a rapidly growing and evolving business. In addition, the question of suitability continues to rear its head. Are the right deals being done with the right clients with the right motives? Preparing for the next credit event has become topical as users realise that the process is actually quite complicated. These issues are discussed in turn below.

The challenge of growth

The challenges differ depending on whether one is running a trading business, setting up risk management infrastructure or is an investor engaged in credit derivatives. For traders the challenge has mainly been with operations. As volumes grow the manual intensity of booking and clearing new trades and dealing with assignments and early terminations have become very burdensome. This has probably been the market's main focus of the last year. Risk managers have a different sort of operational problem; how to fit and indeed finance a system that allows private side debt instruments - mainly loans - to be hedged with public side derivatives. For investors the initial problem relates to product approval - a long and drawn out process for most institutional investors - but then moves to infrastructure and people. Building a credit derivatives platform is complicated and expensive and all aspects of investing in credit derivatives require people with specialist skills, who are currently in short supply.

Deal and customer suitability

The credit derivative market has worried about "suitability" from its outset in the mid 1990s. The issues are as important today as they were then. Product suitability should be less of an issue as the main mechanism for risk transfer e.g. the Credit Default Swap (CDS) is now well established, well understood and under constant scrutiny. Whether this mechanism is used in single name, basket or CDO trades, the CDSs time tested robustness is likely to ensure that trade performs as advertised most of the time. Whether the product is suitable for the user introduces the question of customer suitability.

As with all derivative products, a new counterparty is checked:

- For authorisation - can they use the product in question?
- For sophistication - do they understand the risk?
- For creditworthiness - are they financially strong enough to act as counterparty?

This process is now well established and it seems unlikely that trades will fail for reasons of authorisation or sophistication. Credit risk however, is less certain. Counterparties credit risk, is the commodity being traded and often any collateral posted also contains credit risk.

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Calculating this package of risk, which is likely to be correlated, still presents the market with a challenge. With 30% of users taking risk on margin the question that remains unanswered is whether the dealers could unwind fast enough following a severe market shock.

Credit Event Preparedness

As the universe of traded names grows into the thousands, the credit derivative market meets a new challenge; how to monitor credit events? Whilst a default by a large well known corporate is unlikely to be missed, a restructuring or even a failed payment by a smaller corporate could be overlooked by the main-stream media sources. The solution for an increasing number of users has been the use of electronic news feeds and intelligent search engines. Nevertheless, this still throws out a considerable amount of data that will have to be further filtered by human intervention.

This, however, is not the end of it. Many of the credit events of the last few years have opened user's eyes to the fact that key commercial decisions need to be made before and after a credit event is called, if indeed it is called. The decision to call is part of an increasingly complex process that has to assess the legality of the credit event, settlement options and the timing of any security or loan transactions that need to be completed and the implications of calling a credit event on the counterparty, the reference entity and the market as a whole.

Market Direction

Despite the significant issues that face the market, growth and development continue. The direction that the market is taking is driven by various factors.

New Users and New Products

Part of the credit derivative market's growth can be attributed to the arrival of new users and new products. The new users are drawn primarily from banks and fund managers. The former represent the next tier of banks after the top twenty who currently dominate the market and the next forty who have a well developed business. This "third tier" is made up of large regional banks who have most of the component parts of a credit derivatives business and who, over the last year, have started to put those to use as they build out their investment, risk management and trading business.

The traditional fund sector - representing non-leveraged institutional money - continues to extend its participation in the credit derivatives market. The process is slow due to the real obstacle of needing new authorities to use credit derivatives and the self-imposed obstacle of moving slowly into a market that is frequently perceived as being opaque, illiquid and structurally risky. Despite this there is a growing "wall of money" that is now approved for credit derivative investments but is waiting for better market conditions.

One more new user group worth mentioning is retail. Around the world there are examples of credit derivative products being sold to retail users. Outside of the high net worth sector - where relatively complex and risky products are being sold - most of the products being sold to retail are low risk with principal protection. This sector is very small when compared to others but is likely to grow as a percentage of the whole.

The new products being sold are, in many cases, catering to a change in market circumstances or a change in investor demand. When tight spreads challenge the ability of banks to deliver target returns through the standard synthetic CDO structure, the market introduced more

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leverage and hence higher returns through the “CDO Squared” structure. When tight spreads in the mezzanine and senior sectors of the CDO market pushed more value into the equity tranche, the market introduced a range of products where the principal was low risk but the coupon was linked to the performance of CDO equity tranches.

New Risks and Opportunities

New products and new underlyings present credit derivative users with new investment and risk management opportunities. For the investor the pool of underlying assets continues to grow and a wide variety of risk sharing mechanisms give the investor improved choice; for the risk manager the range of hedging tools is growing and the fit between the underlying asset and its hedge continues to improve. This results in a higher proportion of assets being hedged with more robust products.

Whilst this is a positive development for all involved, these new opportunities do come with new risks, in addition to the obvious issuer risk. One of the main risks relates to documentation; not only do these new structures require modifications to the standard confirmation but the users need to understand the implications of these changes and modify their risk management system accordingly.

Furthermore, whilst the investment grade single name and index sectors can now boast impressive standardisation, liquidity, data and market practice, the same cannot be said for the rest of the market. There is a danger that less experienced users will assume that the high standards prevalent in the established sectors apply across the board.

One last risk that continues to plague the market relates to credibility. Whatever problem is currently being addressed by the market, tends to be addressed by the media as if the whole credit derivatives market is in turmoil. The knock-on effect can result in an over-reaction by many; credit derivative businesses are audited again, new approvals are turned down and yet more layers of control are introduced. What the market needs is more transparency and better statistics so that each new problem can be explained in the context of which part of the market it affects.

Standardisation versus Bespoke

The market continues to take on a “polarised” character. Most trades fit into a very standard template where market practice is becoming increasingly standardised i.e. fixed contract sizes, maturities and payment dates, standard documentation, electronic trade affirmation and settlement, automated assignments and early termination. An important part of the market is still referred to as bespoke and exhibits little that could be described as standard. This is unlikely to change. The very nature of the products allow investors to ask for increasingly specific needs (portfolio mix, risk participation, minimum returns) and the market is able to provide the required risk-reward package.

The Move towards Exchange Traded Credit

In addition to new developments and the growing polarised nature of the market, the third significant market direction is the move towards exchange traded credit. The arguments in favour of it are compelling. Many more users can use exchange traded products than OTC products, a significantly smaller contract size (perhaps less than 1% of the current standard sizes) which will encourage more participation. Market activity will be significantly more transparent but at the same time more anonymous and the operational benefits are considerable, given current market issues.

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More users, better liquidity and less operational intensity can only be good for the credit derivatives market and informal feedback from market participants suggests that the addition of exchange traded products will be well received. The benefits for new participants are most notable. Negotiations with only one central counterparty, a transparent market and reduced infrastructure needs, could tip the balance for the more sceptical onlooker and, once committed, time to market will be dramatically reduced.

Conclusions

Year after year credit derivative market commentators have endeavoured to find more original ways of describing a perennial phenomenon; a derivative market that continues to grow and evolve. Both the rate of growth and the extent of evolution continue to defy expectations. This success story has not been without setbacks; documentation risk, operational challenges, suitability and private side issues continue to frustrate market growth and development. But for every setback the market moves quickly with solutions that in most cases result in an improvement. Behind the established bank and dealer infrastructure there is now a plethora of third party front to back office products and services adding value to the whole market process. However, these do not represent a comprehensive solution and in the standardised and liquid sectors, the market can only benefit from exchange traded products.