Azure Kingfisher

A sharp eye on structured finance

International Derivatives Law & Practice

University of Sydney

Faculty of Law, LAWS 6911

March 14-18, 2011

Lecture 10: Credit Derivatives (selection of slides)

Lecturer: JJ de Vries Robbé

March 17th, 2011

Contents

The basis concept, different ways to get there

A. CREDIT RISK TRANSFER

Credit Risk

- **Credit risk** is the risk that a counterparty will not comply with its obligations (whether to pay or to deliver) in whole or in part, when due

CRT Instruments

- Insurance
- Guarantee
- Securitisation
- Syndicated Lending
- Risk participation
- Credit Derivatives

Differences?

- Who is interested / licensed?
- Which risk(s) is (are) (also) transferred?
- Flexibility?
- Is consent or other action required?
- Recognition for regulatory purposes?
- Documentation process?
- Secondary market?

Definition, market and products

B. CREDIT DERIVATIVES

Definition

- A **credit derivative** is a financial instrument that facilitates the transfer of *credit risk* between two counterparties in *isolation* from other risks (such as market and interest rate risk)
- It enables a transfer of credit risk without a transfer of the underlying loan

Credit Derivatives Market

- Phenomenal growth before the crunch
- Ugly duckling of the global financial crisis?
- Comparison with the emergence of IRS in 1980s
- Macro level: banks, insurance companies, hedge funds

Credit Derivatives Products

- OTC market
  - credit default swaps
  - total return swaps
- Capital market
  - credit-linked notes
  - synthetic collateralised debt obligations (CDO) (discussed in next lectures)

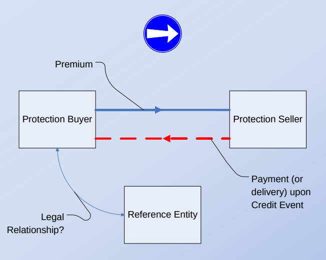
Structure, risks and benefits

C. CREDIT DEFAULT SWAPS

Credit Default Swap (CDS)

- unfunded notional financial instrument
- isolates and transfers credit risk of a ‘reference entity’ from one party (the ‘protection buyer’) to a counterparty (the ‘protection seller’)
- against the payment of a fee or premium
- ownership is unchanged
- *but conceptually it still feels like a guarantee!*

Cash flow



CDS Market

- Database for reference entities (http://www.markit.com/cds/cds-page.html)
  - 400 – 500 liquid names, 2500 total
  - Market determines the fee (premium)
  - for liquid corporates, banks (Lehman) and sovereigns
  - Single-name or multi-name (*tranched* products)

Bank Perspective

- Banks may look at the pricing of a CDS as an indicator of risk and amend their limits accordingly
- A CDS is a derivative and thus its valuation impacts on the P&L (more CDS > more uncertainty in P&L)

Drivers

- Credit risk management
- Arbitrage
- Regulatory capital relief
- Flexibility
- Leverage (!)

Leverage

- House insurance: only once, no leverage
- CDS: conceptually no limits

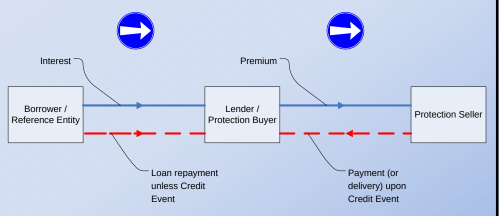
Re-cap: risks

- Counterparty risk
- Correlation risk
- Basis risk
- Concentration risk
- Liquidity risk
- Market risk
- Documentation risk

Highlighted Risk

- A (bank) lends to B (corporate).
- B's creditworthiness is slowly deteriorating
- A buys credit protection on B from C
- B's creditworthiness becomes precarious and requests a restructuring of its loan
- What will A do? (Which risk?)

CDS Risk: Moral Hazard



Sovereign Debt & CDS

- Pattern the same: CDS spreads on sovereign go through the roof, as the market (hedge funds) speculates on a default
- ‘We do not want help, we only want to be able to borrow at the same level as our European brethren’
- EU bail-out: moral hazard?

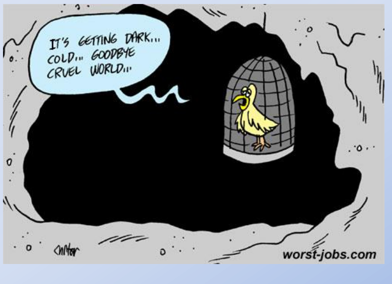
Sovereign Debt

Sovereign Debt

Role CDS in Crisis?

- Are CDS to blame for making a crisis worse (volatility) or simply proving an early warning trigger?
  - The financial crisis
  - The sovereign debt crisis

Canary in the Coalmine



Or a Cat Among the Pigeons

'Shadow economy'
Major reform
Impact on the market?

G. CONCLUSION

References

- www.isda.org
- www.insol.org
- www.mark-it.com