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The swaps emperor's new clothes

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Do credit derivatives work when they are most needed?

THE rate at which American companies are defaulting on their debts is soaring. Things have not yet come to such a pass in Europe, though rating agencies wonder if they will, because credit quality is declining. At times like these, bankers reach for credit derivatives, instruments that allow lenders to parcel the risk of default and pass it to somebody else. Record levels of so-called credit-default swaps, the most widespread form of credit derivative, have been bought and sold in recent months. Yet a huge and nagging doubt remains. Will credit-derivative instruments work at the crucial moment, the one they were designed to cope with—when a company (or country) defaults, or comes close to doing so? The future of a market worth \$600 billion hangs on the answer.

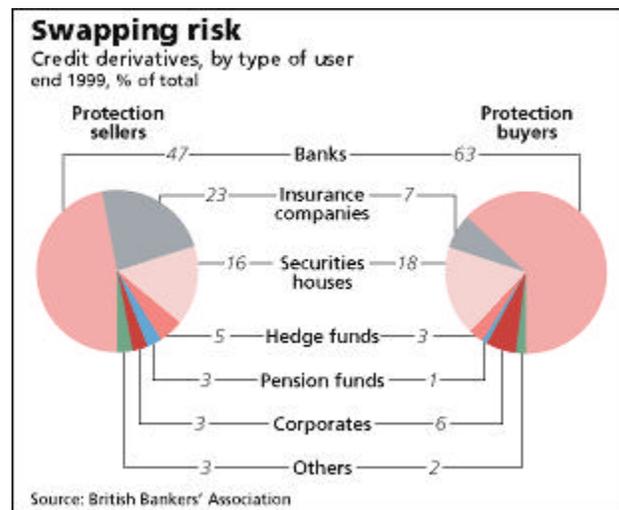
Ten years ago the market for credit derivatives barely existed. It came into being partly because new international rules, introduced under the Basle Accord of 1988, required banks to set aside more capital against their loans. On the other hand, if banks could get another bank, for a fee, to bear the risk of a "credit event"—such as a borrower's defaulting on interest payments—then they would need to set aside only a fifth of the sum that would otherwise be required. That freed capital that could be used more profitably elsewhere.

The five banks that dominate trading in credit derivatives in London and New York talk of a time when banks will be mere originators of loans and temporary holders of credit risk. For example, an Italian bank, lending only to Italian companies, may pocket the origination fees and then quickly sell the risk; in its turn, it might then accept exposure to, say, Singaporean corporates. That could be sensible, for it diversifies the bank's assets.

Institutions can use portfolio swaps to rid themselves of the credit risk on entire classes of loans. Last year, for instance, Schroder Salomon Smith Barney arranged a transaction in which Prudential, a British insurer, got rid of the credit risk on £840m (\$1.2 billion) of residential mortgages that had been sold by its Internet bank, Egg. Banks can shed credit risk in other ways too. They could, for instance, package loans as securities, and sell them to others. An advantage of credit derivatives is that banks do not have to spoil good relations with borrowers who might otherwise be offended. Borrowers need never know that the lender has bought credit protection.

Credit risks are now being shifted outside the banking sector altogether, as other kinds of financial institution are getting into the market. According to the British Bankers' Association, insurance companies accounted for 7% of the credit protection bought and 23% of what was sold in 1999 (see chart). The association expects those numbers to jump in future. Pension funds are also increasing their exposure.





Do credit-default swaps work? In practice they have sometimes failed under pressure, as the parties concerned squabbled over the definition of a "credit event". In 1998, for instance, when Russia defaulted on its domestic debt, some buyers of default protection brought lawsuits in order to claim the payments they believed were rightfully theirs. Indonesia's rescheduling of its sovereign debt caused similar legal tussles. In response, the industry's trade body, the International Swaps and Derivatives Association (ISDA), came up with a new "master agreement" in 1999. This aimed to standardise credit-derivative contracts and prevent litigation breaking out again.

Misgivings about the effectiveness of credit derivatives during times of financial stress have permeated through to regulators. Richard Boulton, in charge of credit risk at Britain's Financial Services Authority, points out that in the benign stage of an economic cycle, "It doesn't matter so much if a bank has one or two credit-default swaps that don't work. The regulatory concern is for a period of economic downturn when a bank may be highly dependent on them."

Under proposed new Basle rules, therefore, credit derivatives are to receive less favourable treatment than before. Previously, in most countries, if a bank owned a credit-default swap sold by another bank, the swap would be treated like a bank guarantee, an older kind of credit protection. Now the Basle proposal says that credit derivatives need higher capital charges than bank guarantees. The ISDA is indignant.

Many of the difficulties of credit derivatives are thanks to the fragmented, heterogeneous nature of lending markets. Credit derivatives attempt, perhaps impossibly, to standardise the markets. Historical series on patterns of default do not go back far enough for accurate assessment of the risks involved; the law is unclear, because no body of rulings has been laid down; and the ISDA's pro forma credit-derivative agreements need to be improved. But progress on such matters can do only so much. The risks underlying credit derivatives will always be idiosyncratic. Unlike other derivatives, whose payouts are triggered by movements in prices or interest rates, credit derivatives are driven by the necessarily vague notion of a credit event. Besides, a constant tension exists between the sellers of protection, who want the terms of the contracts to be as narrow as possible, and the buyers, who want them to be wide.

In the case of Conseco, a life insurer based in Indianapolis, the tension has escalated into an outright fight. When Conseco announced last September that it would restructure \$2.8 billion of debt, buyers of protection called this a credit event and demanded their money. Faced with large losses, the sellers of protection decided that restructuring should no longer qualify as a "credit event". At issue is whether the restructuring of a loan (as opposed to a plain default) should constitute such an event. The buyers of protection, which are mostly commercial banks, think it should. The sellers of protection complain that it is unfair for a lender with the power to sanction a loan restructuring to use that as a reason to demand payment on a credit-default swap. If such tussles drag on, says Simon Morris, the joint head of credit derivatives at Goldman Sachs in London, they could hamper the market's hitherto extraordinary growth.

Restructuring is not the only area of dispute. Demergers are another. When a British utility, National Power, split into two at the end of last year, there was confusion in the credit-derivatives market over which of the two new entities the sellers of credit-default swaps were now exposed to. The market in credit derivatives has grown

enormously in recent years. With bumpy times ahead, it still has a lot to prove.

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