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The Merits of Credit Derivatives

These instruments act as risk management tools and investments.

Over the past two years stock market returns and interest rates have declined noticeably. Corporate bonds offer better yields but there have been a number of high-profile defaults in the last year. Fortunately, credit derivatives are promising.

They offer institutional investors a variety of ways to manage the credit risk of corporate bonds and to invest in diverse, synthetic credit-risky investments. The most common of these vehicles are the total-return swap, the credit-default swap (CDS) and the collateralized debt obligation (CDO). There are many variations on these instruments but here are the basics.

A total return swap allows a fund manager to exchange the total return earned on a bond, stock or a portfolio for a floating interest rate, plus a spread. The total return includes all payouts on the investment as well as all capital gains or losses. By choosing to pay the total return, the investor transfers the risks and returns of the portfolio to a counter party without actually selling it. By choosing to receive the total return the investor makes an indirect investment in the risky portfolio.

WHAT IS A CDS?

A CDS is essentially credit insurance on a particular issuer. In many ways it's similar to term-life insurance. The life of the credit protection can be between three months and 10 years, with most contracts lasting for five years. Investors make payments every three or six months for the length of the agreement or until the issuer defaults. If there is a default before the contract expires, the provider of this protection service pays out the face value of the bonds.

Since the CDS eliminates the credit risk, it is not surprising that payments are about equal to the extra yield earned on the risky bond. Investing in the money market and selling credit protection is roughly equivalent to making an investment in credit-risky bonds. This strategy achieves higher yields on the risky investment but incurs the costs that arise if there is a default.

SIMPLE STRATEGY

A CDO is perhaps the most interesting credit derivative for investors. The structure is simple. A bond portfolio is put into a trust and claims on the income earned are sold to investors. The unique nature of this structure is that three or four different types of claims are issued by the trust. The claims are differentiated by how much credit risk they bear. The riskiest set of claims, tranche number one, absorbs all of the default losses that occur up to some specified limit. If the total credit losses for the portfolio exceed this limit, further losses are borne by the second set of claims, tranche number two, again up to a second specified limit, and so on.

The unique structure allows the trust to create a variety of investment instruments with widely varying credit risks and corresponding yields. Typically the highest quality tranche is rated Aaa/AAA while the riskiest is almost like equity. Often the CDO manager holds the riskiest tranche.

There are a variety of credit derivatives currently available that allow institutional investors to modify the risk characteristics of their portfolios or to invest in synthetic credit-risky assets. Interested institutional investors can explore these options further by talking to their bankers, as all banks issue these contracts. ∎