

DERIVATIVES AND CREDIT RISK

*Credit default swaps and securitisation
add up to an overlay strategy.*



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INCREASINGLY, INVESTORS CAME TO VIEW CREDIT RISK AS AN ASSET CLASS DISTINCT FROM THE FIXED INCOME MARKET

In recent years, financial institutions have radically changed their approach to credit risk. The driving force for this has been the changing attitude that commercial banks have taken towards corporate credit risk.

Increasingly, banks have moved away from the traditional model of holding static portfolios of credit risk originated from their corporate relationships towards a more dynamic approach where the credit portfolio is viewed as an approximation to an efficiently diversified investment pool. By viewing the credit value chain as being composed of three distinct functions—origination, funding and taking credit risk—the way is open for different institutions to participate in selective functions rather than for banks to “own” the entire process.

Two technologies have grown dramatically over the last five years, facilitating the management of credit risk and allowing the new bank approach to be implemented: the credit derivative market, and securitisation. Combined, these techniques allow the separation of the various functions in the credit value chain. The credit default swap (CDS) and the synthetic securitisation (CDO) markets are not small: CDS volumes are expected to top \$4 trillion by 2004 and the funded pieces of CDO issuance may exceed \$230 billion by year-end. The flow of credit risk is from the banking sector to the insurance and fund manager sectors.

Investors, therefore, are also changing their approach to credit risk. Traditionally, the credit element was almost an afterthought to the primary currency and duration decision and was constrained by the availability of corporate bonds that fit the curren-

cy and duration view. As absolute interest rates declined and credit spreads widened, the proportion of the total return represented by credit risk grew. Increasingly, investors came to view credit risk as an asset class distinct from the fixed income market; in their search for yield, they began to participate in these growing credit markets.

Attitudes to the growth of these markets have been wildly divergent: U.S. Federal Reserve chairman Alan Greenspan is encouraged by the development of a useful risk management tool, whereas Berkshire Hathaway founder Warren Buffett is concerned that this represents hidden risks for unsuspecting investors.

Part of the problem lies with the reliance that some investors place on the ratings of these instruments, and hence on the appropriateness of rating agency models, without independent analysis. These models, which apportion risk to the various tranches of a synthetic securitisation, rely on some central assumptions, one of which is that a value for the probability of default of a company can be determined from its rating. An analysis of historical performance suggests that the timing of the credit cycle and the market price for a credit risk are important factors in the probability of default of a class of credits.

In conclusion, credit risk is now being transferred from the banking sector to investors like never before using the CDS and CDO markets. These markets offer institutional investors the possibility of treating credit risk as an independent risk overlay and consequently of improving the risk-reward profile of their portfolio. Some independent analysis is required to understand the assumptions of rating agency models, but these markets are not so complex that they cannot be understood. ■