

Evolution of Canadian Credit Markets



FIELD NOTES

BY MICHAEL DURLAND

Over the past half decade there has been a significant development in financial products designed to manage credit risk. Intense competition among commercial lenders and a prolonged expansion in the world economy have led to significant compression in credit spreads. As a result, many commercial lenders, in an effort to generate an acceptable return on equity, have moved down the “credit curve” to less creditworthy counterparties. However, more important to the evolution of the credit markets is the trend among the major lenders of re-engineering their approach to lending, away from the traditional buy and hold to maturity model, toward a new originate and distribute model.

The effort by commercial lenders to increase their ability to distribute credit risk has been the principal driver behind the rapid development in the U.S. and Europe of the credit derivative and collateralized debt obligation (CDO) market. Credit derivatives and CDO products are fundamentally changing the way major commercial lenders originate loans. These new products have also brought to the credit market brand new participants in the form of willing buyers such as mutual funds, pension funds, hedge funds and insurance companies.

The market for credit derivatives and CDOs in Canada is, as expected, lagging the market in both the U.S. and Europe. However, these products are so fundamental to the global credit markets that it is inevitable they will evolve and evolve quickly in Canada.

CREDIT RISK

Credit risk arises from the possibility that a counterparty may fail to repay a specific debt obligation. An example of a debt obligation is a bank loan, a bond or an account payable. Credit derivatives and CDOs allow

parties exposed to credit risk to mitigate the potential of loss due to the failure of a specific counterparty to repay its debt. These products complement traditional mechanisms for mitigating credit risk, such as guarantees, letters of credit and asset sales. Credit derivatives enable sellers of credit risk (such as commercial banks and corporate treasuries) to customize products that satisfy the demands of buyers of credit risk (such as pension funds and hedge funds). CDOs enable banks to mitigate the credit risk inherent in large baskets of debt obligations.

CREDIT DERIVATIVES

Credit derivatives are bilateral contracts that allow two counterparties to transfer the credit risk inherent in the debt obligation of an underlying issuer or basket of issuers. Buyers and sellers of the credit risk can achieve various objectives, including reduction of risk concentrations in their portfolios and access to a portfolio without actually making the loans. Credit derivatives offer a flexible way of managing credit risk and provide opportunities to enhance yields by purchasing credit synthetically.

There are three basic credit derivative products: Total Return Swaps, Credit Default Swaps (and other spread products such as credit spread options), and Credit Linked Notes.

A Total Return Swap is a derivative instrument that allows an investor to receive the return of an underlying asset (positive or negative) without actually buying and taking physical possession of the asset.

A Credit Default Swap is a derivative instrument in which one party pays a regular fixed premium to a second party in exchange for a compensation payment in

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the event that losses are incurred from the default of a specified underlying issuer.

A Credit Linked Note is a note issued by one party but whose performance is linked to the default of the underlying issuer.

The following table provides an indication of the estimated market share of each of these basic credit derivative products, as well as hybrid credit derivative products.

In *Risk Magazine*, March 2000, Hargreaves, T., "Default Swaps Drive Growth," estimates the market size of credit derivatives to be between US\$400 million and US\$1 trillion of total notional outstanding.

a diversified pool of debt obligations with the following composition: 85% senior secured bank loans, 10% high-yield bonds and 5% asset-backed bonds. On Dec. 20, 2000, Citadel Hill issued 355 million of AAA notes, 45 million of AA-, 35 million of A-, 21 million of BBB-, 15 million of BB- and 38 million of equity. The yields range from approximately 7.77% to 13% on the rated notes and a projected 21% of residual excess spread from the pool to the equity class.

The heightened pace of development of this market has gone unabated since the mid-1990s. For all of 2000, Moody's rated 189 similar transactions for a total of US\$120 billion, up from 166 transactions and US\$92 billion in 1999. The robust growth in 2000, in light of the recent stresses in the U.S. high-yield market and syndicated loans, shows that CDO obligations have become good investment alternatives.

CREDIT DERIVATIVES' SHARE OF THE MARKET

By Product	1996 Estimated Market Share (%)	2000 Predicted Market Share (%)
Credit Swaps and Spread Products	50	56
Total Return Swaps	17	19
Credit Linked Notes	27	16
Hybrid Products	6	9

SOURCE: British Bankers' Association

DEBT SECURITIZATION

A CDO is a special purpose vehicle (SPV) that purchases a pool of debt obligations from financial institutions (typically banks) and then issues two or more classes of securities in the capital market. The notes issued are ranked in progressive seniority, starting with the equity class, which is the one bearing first losses. It is customary for all the other notes to be rated by two credit rating agencies.

Bank of Nova Scotia's Citadel Hill, structured in 2000, is a representative CDO investment vehicle. Its collateral is composed of US\$500 million face value of

opportunities to both Canadian lenders and investors. These product developments promise to provide liquidity and capital efficiency for traditional lenders such as the Canadian commercial banks. Equity investors, speculative-grade debt investors and investment-grade debt investors in Canada will be provided with improved returns, diversification and access to foreign markets. Overall, the development of the market for credit derivatives and collateralized debt obligations should result in improvement in the efficiency, transparency and liquidity of Canadian credit markets. ♦

CONSEQUENCES

Credit markets throughout the world are in a stage of rapid development that will provide new opportu-