The Corporate Use of Credit Derivatives: Will the Post-Crisis Environment be a Catalyst for Expansion?

A Structured Approach to Financial Risk Management

April 2011
Whitepaper Series - Volume V

Originally published in gtnews - Jan 2011

VALIDUS RISK MANAGEMENT

Executive Summary

Frequently portrayed as the "next big thing" in corporate risk management, credit derivatives have never really taken off within the corporate marketplace. Despite rapid uptake amongst institutional users, the corporate market has remained reluctant to embrace credit derivatives for a number of reasons, including basis risk and accounting constraints.

This white paper examines the potential for credit derivatives as corporate risk management tools in light of the increased focus on credit and counterparty risk following the credit crisis, and also identifies some alternative applications of credit derivatives to facilitate access to affordable sources of funding and liquidity.

An increased focus on credit and counterparty risk has undoubtedly been one of the main implications of the banking crisis for corporate treasurers. In fact, the PWC 2010 Global Treasury Survey highlighted that the number of treasurers who considered credit risk management of "high importance" has more than doubled since before the crisis. This is perhaps unsurprising, as corporates normally have a huge amount of credit exposure arising from a number of different sources, and one of the memorable lessons of the financial crisis is that even a high credit rating is no guarantee of continued solvency. However, despite the significance of credit risk to the non-financial firm, the corporate use of credit derivatives has remained limited, notwithstanding the significant volume growth and product developments that have occurred in the market since its inception in the early 1990's. It is therefore perhaps an opportune moment to revisit the potential of credit derivatives for the corporate treasurer, review why the corporate market has yet to really embrace these tools, and ask whether the current environment, characterized by an increased awareness of the importance of credit risk management, will prove to be a catalyst for increased corporate demand.

Frequently portrayed during the late 1990s and early 2000s as the "next big thing" in corporate risk management, credit derivatives were expected to follow in the footsteps of FX and interest rate derivatives, and become essential elements of the corporate treasurer's risk management toolkit.

While credit derivatives such as Credit Default Swaps (CDS) and Total Return Swaps (TRS) were first introduced to allow banks to lay off excess credit risk (resulting largely from the counterparty credit risk associated with interest rate and foreign exchange derivatives, as well as normal lending operations), it was not long before investment banks began marketing these products to the corporate market. Frequently portrayed during the late 1990's and early 2000's as the "next big thing" in corporate risk management, credit derivatives were expected to follow in the footsteps of FX and interest rate derivatives, and become essential elements of the corporate treasurer's risk management toolkit. Whilst the logic behind such expectations may have been sound (after all, credit risk could certainly be argued to be as great a risk to most non-financial corporates as either FX or interest rate risk), this promise has not been realized to date. Despite rapid growth in the global credit derivatives market (which rivalled the FX derivatives market prior to the credit crisis), non-financial corporations have thus far played a negligible role in this growth. A 2009 ISDA study showed that of the Fortune Global 500, only 2% of non-financial corporations used credit derivatives (whereas over 80% used Interest Rate and FX derivatives).

At first glance, the potential benefits of credit derivatives for the corporate market seem compelling. Corporates are exposed to credit risk in several different ways, such as customer accounts receivable, vendor financing and counterparty exposure resulting from other derivative transactions. These exposures can be large (one study showed that for large European corporates, credit risk existed on over 20% of their total balance sheet assets), and in many cases highly concentrated, as many companies have customers clustered in a relatively small number of sectors and / or geographies. While there are a number of existing credit risk management tools available other than credit derivatives (such as credit insurance, receivables factoring or securitization, and surety bonds), these tools all have major shortcomings when compared to credit derivatives. Credit insurance, for example, requires proof of loss prior to any compensation payment (which credit derivatives do not), and the buyer tends to retain a portion of the risk (due to first loss provisions), while credit derivatives ensure a complete risk transfer. Perhaps most importantly, providers of credit insurance often have the right to revoke or reduce coverage in the event of a credit downgrade, thus eliminating protection when it may be most required, whereas credit derivatives do not carry this risk. Factoring and securitization can be an expensive method of managing credit risk and are often also subject to first loss provisions, and may be seen more as sources of working capital financing rather than risk management tools. Finally, all of these tools tend to be restricted in terms of duration, and getting protection for longer than one year can prove difficult, providing little protection against longer term exposures. As such, credit derivatives appear to be a potentially attractive and cost-effective credit risk management tool, without many of the drawbacks of the existing alternatives.

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So, why has the credit derivative market remained an unappealing one for corporate risk managers? Perhaps the biggest impediment to the use of credit derivatives by the corporate market is the basis risk caused by an often imperfect relationship between the exposure and the hedging instrument. As credit derivatives were initially designed to enable banks and financial institutions to manage credit risk, it is perhaps unsurprising to find that such basis risk exists, which reflects a mismatch between the usual corporate credit exposure and the parameters of a typical credit derivative. A common source of such basis risk relates to the conditions which govern a credit derivatives pay-out (i.e. the "credit event"), and true credit exposure facing the corporate purchaser of the derivative. If the purchaser is a corporate hedging its receivables book, it is possible that a default would take place on the receivables side without the occurrence of the specified credit event (e.g. bankruptcy, bond default). Basis risk also occurs due to timing mismatches (the most liquid CDS markets are for durations of at least 5 years, far longer than a typical receivable credit exposure). A second obstacle, related to this basis risk, is the impact of credit derivatives on income statement volatility. Due to mark to market requirements, credit derivatives can create significant P&L swings, without an off-setting P&L exposure.

Despite the increasing corporate focus on credit risk management in the wake of the financial crisis, these key impediments to the development of a corporate market for credit derivatives are still very much relevant. In addition, as the reputation of financial derivatives in general (and credit derivatives in particular) was not helped by unflattering media exposure during and after the crisis, it seems unlikely that many corporates will decide that now is the time to position themselves as pioneers in the use of credit derivatives for corporate credit risk management. Instead, it is perhaps more likely that the tried and tested approaches to credit risk management, such as rigorous credit analysis and monitoring, and the maintenance of strong relationships with key customers, will increase in priority and rise up the corporate agenda. The role of the corporate derivatives market as a risk indicator will undoubtedly grow, however, as more and more corporates look to enhance their credit monitoring capabilities and prevent an over-reliance on 3rd party credit ratings. Many corporate treasuries have already begun to implement internal credit and counterparty risk monitoring dashboards which incorporate various market indicators, including credit derivative market data such as CDS spreads.

One area of corporate financial risk management which may offer more potential for the future of credit derivatives relates to their use by corporates to facilitate access to future funding sources, and / or to manage existing liabilities. Such applications had already begun to show some promise before the onset of the crisis, with corporates beginning to use credit derivatives to free up credit lines and protect themselves against future increases in the cost of funding. As the issue of corporate liquidity risk has risen in profile along with credit risk following the financial crisis, it is very possible that corporate treasurers will revisit the credit derivatives market in the months ahead, as a means to ensure access to affordable funding sources in a period where lenders remain cautious and the risk of material future increases in funding costs remains high. Such strategies can involve corporates taking positions in their own credit derivatives, and either buying protection to hedge against future increases in funding costs or even selling credit protection to lower current funding costs should the company believe their current credit spread is unnecessarily high (an undoubtedly aggressive strategy).

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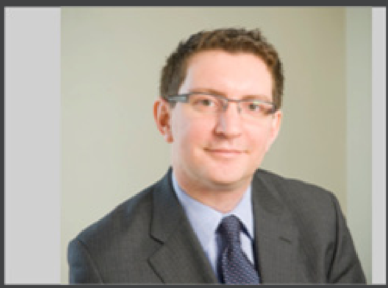
As the credit derivatives market continues to evolve, and as corporate treasurers look for new and more effective approaches to managing credit risk, it is increasingly likely that greater corporate applications for instruments like CDSs as credit risk management tools will be found. However, although the financial crisis has heightened awareness and concern about corporate credit risk, the drawbacks of the corporate usage of credit derivatives have not gone away, and the likelihood of a sudden growth in the market for credit derivatives as a solution for corporate credit risk management appears remote. Despite this, the increasing importance of the credit derivatives market for the corporate treasurer should not be discounted. At the very least, it will continue to provide treasurers with timely and market-driven credit indicators for both customers and financial counterparties, and credit derivatives could even facilitate the implementation of innovative approaches for managing liquidity risk and funding costs. In an era where both credit risk and liquidity risk remain high on the corporate treasurer's agenda, a market which offers potential solutions for the management of both of these risks must be carefully considered.



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Validus Risk Management focus on helping clients to design and implement robust strategies and processes to measure, monitor and manage financial risk. Our main services include:

- Foreign Exchange Risk Management
- Interest Rate Risk Management
- Commodity Price Risk Management

The Validus team has decades of experience in the field of financial risk management and has worked successfully with leading multinational corporations and financial institutions around the world.

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