



The **real risks** of credit derivatives

Good risk management is crucial for companies in this opaque market.

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In a financial world where yields are relatively low and risks high, it's no surprise that insurers, hedge funds, and commercial banks are keen on credit derivatives. For buyers, such instruments offer a way to manage portfolio risk; for sellers, they promise high-yield returns. And for the global financial system as a whole, they could diversify and diminish risk, at least in theory.

In practice, though, some players—among them insurance companies and commercial banks—are pushing too aggressively into the market, distorting prices and raising the possibility that one company's large, unexpected losses could upset the entire system. Many have entered the market opportunistically, tempted by the attractive yields and trusting that their portfolios can absorb the risk. Too few of the newcomers sufficiently understand the potential dangers of credit derivatives. Some companies have learned the hard way: at the French reinsurer SCOR, for example, credit derivatives contributed to net losses totaling €769 million in 2002 and 2003, prompting it to exit this market.

A credit derivative, in its basic form, is a contract purchased by a bank or other financial institution to protect itself if a borrower can't repay a loan or fulfill a lease obligation. For the buyers, these products—typically sold by insurance companies, hedge funds, commercial banks, and investment

banks, which agree to pay if the borrower or bond issuer defaults—diversify risk or reduce the amount of capital that institutions must set aside to cover possible defaults by customers. For the sellers, credit derivatives represent a new investment vehicle with attractive yields. Small wonder, then, that the market’s volume hit \$3.6 trillion in 2003 and, by our estimates, could reach \$10 trillion in 2007.

Unfortunately, however, the growing use of credit derivatives is transferring risk on an increasingly large scale in ways that are mostly opaque to investors and regulators. In the past, it was clear which party took on the credit risk—a bank holding a commercial loan, for example, or an

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insurance company buying corporate bonds. By contrast, credit derivatives typically cover a broad portfolio of debt from numerous corporations rather than a single

company’s bonds or loans. The portfolio is divided into “tranches” according to levels of risk. Companies that eventually end up holding the credit risk find it difficult to uncover the identity of the underlying businesses and to assess their financial health.

That opacity stands in contrast to the more mature market for interest-rate derivatives, where the risks are well understood and often closely linked to macroeconomic trends, for which information is widely available. Even so, as this market expanded, some companies, including Gibson Greeting Cards and Procter & Gamble in 1994, suffered high-profile losses, and the market was derailed substantially several times—for instance, in 1998 by Russia’s currency and debt crisis.

In our judgment, many insurers and commercial banks are taking on too much risk in the credit derivatives market without fully understanding their exposure. In search of better returns, some companies, according to our research, have focused on what is the market’s riskiest segment. The situation is particularly unsettling because insurance companies don’t face the rigorous capital requirements that the Basel Capital Accord imposes on banks. Moreover, credit-rating agencies and regulators worry that some insurance companies lack the experience and know-how to guard against significant unexpected losses. The Financial Stability Forum, which includes representatives from central banks and supervisory authorities around the world, has called for a rapid increase in the amount of information regulators have about who is transferring credit risk to whom.

While this developing market creates interesting new opportunities for skilled participants, we believe that many insurance companies and banks, to protect themselves and their shareholders, will need to beef up their risk-management capabilities significantly by focusing on these essential skills.

Measuring credit risk. Investors should be able to estimate the likelihood of default by individual companies in an investment portfolio as well as the potential loss. They should understand not only the market forces that influence credit spreads and pricing but also the way correlations among individual credit risks can significantly influence a portfolio's overall risk profile. And they must be able to assess the individual risk-return profile of selected tranches of bundled credit derivatives. All of this knowledge requires skills in high-quality credit underwriting and detailed technical credit modeling.

Understanding derivatives. Companies should have a clear picture of how and to whom derivatives shift risk—including factors such as the potential impact of legal challenges to obligations set forth in derivatives contracts and the possible effect of a string of defaults at a number of companies. They must also understand the complexity that derivatives bring to correlations among various credit risks in their portfolios.

Gauging the impact on capital allocations. Companies should understand the way hedging an investment with credit derivatives changes the level of risk they face and the capital they need to cover it.

In most cases, building new risk-management capabilities requires sizable investments in people and equipment. The software and IT systems needed to track and manage credit risk comprehensively can cost a large global company as much as \$50 million. For those companies wishing to participate, that's a sound investment. The use of derivatives is expanding, and we believe that the ability of companies to manage risk will largely determine the winners and losers in the financial-services industry over the next few years. **Q**

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