

Just what exactly is a credit derivative?

Credit derivatives hinge around two concepts – **CDOs** and **CDSs**. A CDO is a collateralised debt obligation. A bank collects together a bunch of debt instruments and parcels them together into a freestanding financial instrument or special purpose vehicle – the CDO. These debt instruments can be corporate bonds, mortgages, corporate loans – pretty much any kind of debt.

Investors can buy into the CDO in several ways: senior notes, which have the lowest rate of interest but are first in the queue to get paid; mezzanine notes, which pay higher interest but come after senior notes; and equity, which gets all the return that doesn't go to the senior and mezzanine notes, but comes bottom of the pile in protection terms. The CDO uses the money it raises from these investors to pay the bank for the debt.

It's easy to see how the bank has benefited from this transaction; it's managed to shift the risk of this debt off its balance sheet and onto the investors in the CDO. But what's in it for the CDO's investors? Well, since the debt the CDO owns is generally higher risk (for example, junk bonds), it pays a reasonable rate of interest, which means the return on the notes issued by the CDO is good compared to what can be found elsewhere in this low interest-rate, yield-starved investment climate.

As you would expect, higher risk means there is a higher chance of the bonds defaulting. But because the CDO is a pool of debt, if one bond defaults it won't affect the CDO's ability to pay interest to its senior and mezzanine investors – the equity investors will have to cover it instead. Of course, if enough bonds default, it will eat into the income available to pay the interest to the mezzanine investors. For taking this risk, the mezzanine receives a higher rate of return than the senior notes.

The other part of the story is the CDS or credit default swap. This effectively insures against a debtor being unable to pay his debt. One party to the CDS pays the other a premium. If the debtor doesn't default, the premium-payer gets nothing.

But if the debtor fails to pay up, then the premium-payer gets a payout from the CDS seller in compensation. CDSs started as a way for those who own debt to insure themselves against the risk of default. But today, a buyer of the CDS doesn't necessarily own the debt; they are bought and sold as investments in their own right. For example, an investor who expects Ford to default on its debt might buy CDSs on Ford bonds to profit.

But this is by no means the end of it. CDSs and CDOs combine together in something called the synthetic CDO. The demand for CDOs is so great that it is hard to find enough debt to create enough CDOs to meet the demand. This is partly due to the complexity of putting together a CDO in the traditional way; many types of debt require the debtor's consent if ownership of his loan is to be moved from the bank to the CDO.

Thus the synthetic CDO was born – a vehicle that doesn't buy real bonds or mortgages, but instead puts its investors' money into safe bonds such as government debt and also sells CDSs on the type of debt it represents. The premiums it receives for selling the CDSs together with the interest on the government bonds meet the interest payments to its investors. If one of the debts on which it has sold a CDS defaults, then the CDO pays the CDS buyer compensation and the CDO investors see their returns cut – just as they would if the CDO really owned the debt that had defaulted.

These are the basic building blocks of credit derivatives. After that, you get lost in a forest of acronyms. An ABCDS is a CDS on asset-backed securities, such as a pool of mortgages. A CDS of a CDO offers protection against a CDO defaulting. CDO2 is a CDO comprised of notes issued by another CDO. A CDO3 – you get the idea. By now, you may also be rapidly starting to realise why no one really knows just how risky these things are...