FINANCIAL POLICY FORUM
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PRIMER

CREDIT DERIVATIVES

A credit derivative is a financial contract that transfers the credit risk of a reference asset, also known as a "name," from one counterparty to the other in exchange for payment. The protection buyer or originator makes a periodic payment (similar to an insurance premium payment) to the protection seller. In exchange, the protection buyer has the right, upon the occurrence of a credit event, to deliver loans or securities to the protection seller in exchange for an agreed upon amount (typically the par value or original debt principal) – or to cash settle the claim. A credit event is usually defined as the failure to perform on a scheduled payment, but might also be defined as a downgrade, bankruptcy filing or other such "event."

There are several different types of credit derivatives. The most common type of contract is the credit default swap, and another popular contract is a synthetic CDO which is a portfolio of credit default swaps.

A credit default swap (CDS) is a contract that is structured so that one counterparty pays a constant payment or "insurance premium" to the other counterparty in exchange for protection from a specified credit event on a particular name or reference asset.

A synthetic collateral debt obligation (SCDO) can be thought of a basket or a portfolio of credit default swaps (CDS). The term synthetic is used to distinguish them from a class of credit-linked structured securities called collateral debt obligations (CDOs). The key difference is that synthetics are pure derivatives – with only notional principal – while CDOs are securities with an actual (as opposed to a notional) principal that is attached to a credit derivative structure. The risks and payments on SCDOs are usually divided into segments called a "tranche" in order that they might better fit the needs of investors. The most junior tranche, known as the equity tranche, covers the first corporate names to suffer a credit event. The next level of risk is the mezzanine or intermediate tranche and covers the portion of names suffering a credit event after the equity tranche as been exhausted. The least risky is the senior tranche and is responsible for the last of such credit events. The premia or protection payments for each tranche are set when the synthetic CDO is issued. In subsequent trading in the secondary market the tranches are priced as a percentage of their notional principle. As credit risk rises, the price might rise from say 5% to 10% of principal for the tranche that pays a fixed number of basis points in exchange for credit protection on that tranche.

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Another good primer on credit derivatives is available here:
www.credit-deriv.com/creprime.htm

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