What to look for when assessing the credit risk of product issuers

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Plan managers, distributors and investors are correct to analyse an issuer's credit risk: it is a vital component when investing in structured products and investors need to give careful consideration to the creditworthiness of the counterparties.

So what should we be looking for when assessing this credit risk? The simple answer would be to go to the credit rating agencies ('CRA') of Standard and Poor's ('S&P'), Moody's and Fitch. CRAs are companies that assign credit ratings for companies in relation to their debt obligations. S&P rates an issuer as 'AAA' if it believes the obligor's capacity to meet its financial commitment on the debt obligation is extremely strong. A 'BBB' rating is the lowest rating given to companies that can still be considered investment grade.

But CRAs have faced the most vehement criticisms for not downgrading companies quickly enough. This was seen in the wake of the demise of US company Enron in 2001. It was rated as investment grade just prior to going bankrupt. More recently, CRAs had 'A' ratings on Lehman Brothers and AIG when the former collapsed and the latter was on the brink during the credit crisis. Indeed AIG was rated 'AAA' by S&P, the highest possible rating, before the Federal Reserve created an $85 billion credit line for the troubled company.

Bearing all this in mind, is it really sufficient to assess credit risk on the grounds of credit ratings alone? At Merchant Capital we monitor a number of other factors along with credit ratings from agencies to assess the stability of an issuing company. Two major factors are credit default swaps ('CDS') and Tier 1 capital ratio.

CDS can be interpreted as a measure of how "risky" an issuer is perceived to be by the market. CDS are derivative contracts between two counterparties, essentially a form of insurance or protection against default. The spread of a CDS is the annual amount the protection buyer must pay the protection seller over the length of the contract. The larger this spread the greater the swap premium the buyer pays and the riskier the buyer is seen to be.

Lehman Brothers' 5 year CDS in the summer of 2008, just before the collapse, was hovering around 400 basis points (for comparison, HSBC's CDS spread as at 19/02/10 was 87 basis points – source Bloomberg). However, at that time Lehman Brothers was an 'A' rated bank. Perhaps this high CDS spread could have been a key indicator to the events that followed.

Tier 1 capital ratio is the core measure of a bank's financial strength calculated using the ratio of a bank's equity capital to its total risk-weighted assets. It is a measure of a bank's ability to pay its debts of all types. Therefore, the higher a bank's core capital, the higher the ratio and in turn the

better capitalized they are. Banks that were hit hardest by recent events are now showing signs of having recapitalized to a sufficient level. Indeed Tier 1 capital ratios for UBS AG and Morgan Stanley are roughly 15% and 17% respectively, the FSA states that a bank should maintain a minimum Tier 1 capital ratio of 4%.

We live in a very different world after the financial crisis and many issuers have had their credit ratings cut. With banks being more regulated and de leveraging one hopes that the past few years will not be repeated.

When assessing counterparty risk, Merchant Capital believes that it is important to consider a number of the indicators discussed in this article and not to rely solely on the ratings from CRAs. In addition, Merchant Capital recommends that investors identify the financial institutions underlying their potential investments. Merchant Capital will provide investors with detailed analysis on any issuer that we may use when structuring future investment plans. It is also important to monitor concentration risk and diversify not only on the issuers of plans but also types of structures and underlyings.

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