

LOS.41.a

SS 10

Explain default risk, credit spread risk, and downgrade risk and **determine** which credit derivative instruments address each risk.

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LOS.41.b

SS 10

Identify and **explain** the types of credit derivatives (i.e., total return swaps, credit default products, and credit spread products) and their uses.

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Default risk is the risk that the issuer will not meet the obligations of the issue (i.e., pay interest and/or principal when due). Default risk can be effectively hedged by transferring credit risk through the use of credit default swaps, total return swaps, and credit options.

Credit spread risk is the risk of an increase in the yield spread on an asset, which is its yield minus the relevant risk-free benchmark. An increase in the spread would cause the asset to underperform relative to the risk-free benchmark. Credit spread risk can be managed with total return swaps, credit spread options, and credit spread forwards.

Downgrade risk is the possibility that the credit rating of an asset/issuer is downgraded by a major credit-rating organization, such as Moody's. If the credit rating is downgraded, the price of the bond will fall as its yield rises. Downgrade risk is an absolute measure of credit risk, while credit spread risk is a relative measure of credit risk. Downgrade risk can be managed through the use of total return swaps, credit swaps, and credit options.

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Total return swaps require the total-return receiver (usually a dealer) to pay periodic (floating) payments in exchange for the total return from an underlying bond or loan, including any cash flows and price changes. The total-return payer (e.g., bondholder) agrees to receive the floating payments and pay the total return on the underlying. If a credit event occurs that makes a bond decline in value, for example, the swap requires the total-return receiver to pay the total-return payer.

Credit default products include instruments from different categories (e.g., swaps and options). They offer a defined payoff when a credit event occurs.

Credit spread products include credit spread options and credit spread forwards. They are designed to make payments when the yield on a reference obligation exceeds the yield on a reference benchmark by some strike amount.