

only this



## THE GLOBAL ECONOMIC CRISIS

### Insuring with Credit Default Swaps: Let the Buyer Beware!

Recall that a credit default swap (CDS) is like an insurance policy. The purchaser of the CDS agrees to make annual payments to a counterparty that agrees to pay if a particular bond defaults. During the 2000s, investment banks often would purchase CDS for the mortgage-backed securities (MBS) they were creating in order to make the securities more attractive to in-

vestors. But how good was this type of insurance? As it turned out, not very. For example, Lehman Brothers might have bought a CDS from AIG in order to sell a Lehman-created MBS to an investor. But when the MBS began defaulting, neither Lehman nor AIG was capable of making full restitution to the investor.

ever, that these bonds are guaranteed by the corporation that will use the funds, not by a governmental unit, so their rating reflects the credit strength of the corporation using the funds.

**Municipal Bond Insurance.** Municipalities can have their bonds insured, which means that an insurance company guarantees to pay the coupon and principal payments should the issuer default. This reduces risk to investors, who will thus accept a lower coupon rate for an insured bond than for a comparable but uninsured one. Even though the municipality must pay a fee to have its bonds insured, its savings due to the lower coupon rate often make insurance cost effective. Keep in mind that the insurers are private companies, and the value added by the insurance depends on the creditworthiness of the insurer. The larger insurers are strong companies, and their own ratings are AAA.

### Bond Ratings

Since the early 1900s, bonds have been assigned quality ratings that reflect their probability of going into default. The three major rating agencies are Moody's Investors Service (Moody's), Standard & Poor's Corporation (S&P), and Fitch Ratings. As shown in Columns (3) and (4) of Table 5-1, triple-A and double-A bonds are extremely safe, rarely defaulting even within 5 years of being assigned a rating. Single-A and triple-B bonds are also strong enough to be called **investment-grade bonds**, and they are the lowest-rated bonds that many banks and other institutional investors are permitted by law to hold. Double-B and lower bonds are speculative, or **junk bonds**. These bonds have a significant probability of defaulting.

### Bond Rating Criteria, Upgrades, and Downgrades

Bond ratings are based on both quantitative and qualitative factors, as we describe below.

1. **Financial Ratios.** Many ratios potentially are important, but the return on assets, debt ratio, and interest coverage ratio are particularly valuable for predicting financial distress. For example, Columns 5 and 6 in Table 5-1 show a strong relationship between ratings and the return on capital and the debt ratio.
2. **Bond Contract Terms.** Important provisions for determining the bond's rating include whether the bond is secured by a mortgage on specific assets, whether the bond is subordinated to other debt, any sinking fund provisions, guarantees by some other party with a high credit ranking, and *restrictive covenants* such as requirements that the firm keep its debt ratio below a given level or that it keep its times interest earned ratio above a given level.