

Counterparty risk in the commodities sector

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MARKIT CDS PRICING



Energy and commodity companies are no strangers to volatility. Those with long memories can remember the oil spikes of the 1970s and the ensuing global recessions.

But in the current era, when China sneezes, the whole energy sector can catch a cold. The fragile geopolitical landscape shows how commodity prices are beholden to existential threats: witness the effect of the conflagration in Ukraine.

This creates considerable counterparty risk management challenges, particularly for firms with trading operations and innumerable links throughout their supply chain. Lower prices of key commodities inevitably affect the credit standing of many firms active in the sector. Many of the larger institutions have faced these issues head on and taken a more sophisticated approach to counterparty risk management. As well as expertise, robust methodologies and systems, this requires one all-important input: data.

Enter CDS

This is where credit default swaps (CDS) can play an essential role.

CDS are increasingly being used as an important indicator of counterparty credit risk, even if firms have no desire to trade the instrument. The product received criticism in the aftermath of the financial crisis, but the industry has taken significant strides to make CDS both more robust and more effective.

Most CDS are now cleared through a central counterparty (CCP). This greatly reduces the systemic risk that was widely perceived to be a feature of the OTC derivatives world. Some single name CDS

will probably remain uncleared, but rules set out by IOSCO in 2013 on posting bilateral initial margin are scheduled for implementation in September 2016, thereby reducing single counterparty exposure.

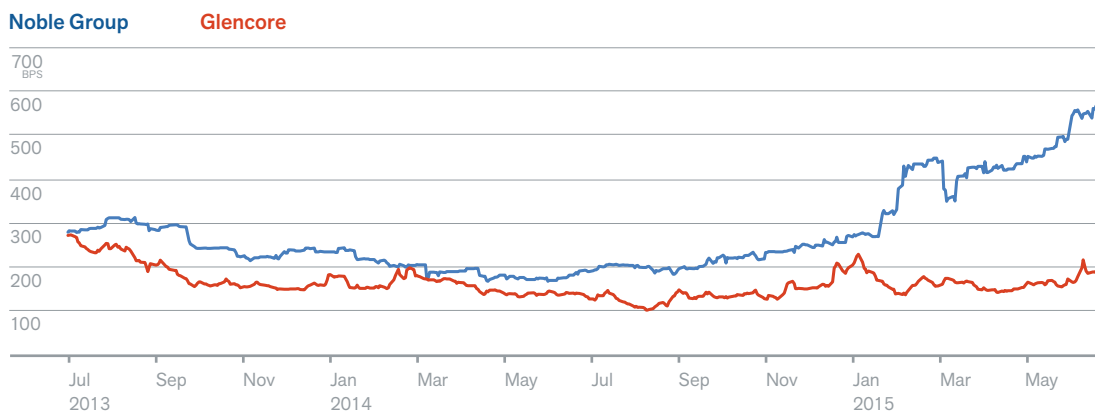
The International Swaps and Derivatives Association (ISDA) also revised the definitions governing how CDS trade. In particular, there is now a specific credit event for bank bail-ins. Bondholders now have to share the burden of potential bank failures.

Why should energy groups use CDS?

Fundamental analysis and credit ratings clearly have a role in assessing counterparty risk. But CDS have advantages that make them a critical component for risk management within the energy and commodities sectors. CDS spreads are derived from market activity, which makes them both accurate and, importantly, timely. Financial statements are only published quarterly, and rating agencies tend to be quite deliberate in making credit assessment decisions. CDS spreads on the other hand trade frequently throughout the day and adjust rapidly to macro events and the changing circumstances of a particular company.

Take Noble Group, for example. The Singapore-based commodity trader has been one of many firms in the sector to suffer from falling prices. But it is also an idiosyncratic case, as its accounting practices have been under attack from an anonymous research company.

Chart 1. Noble Group's underperformance



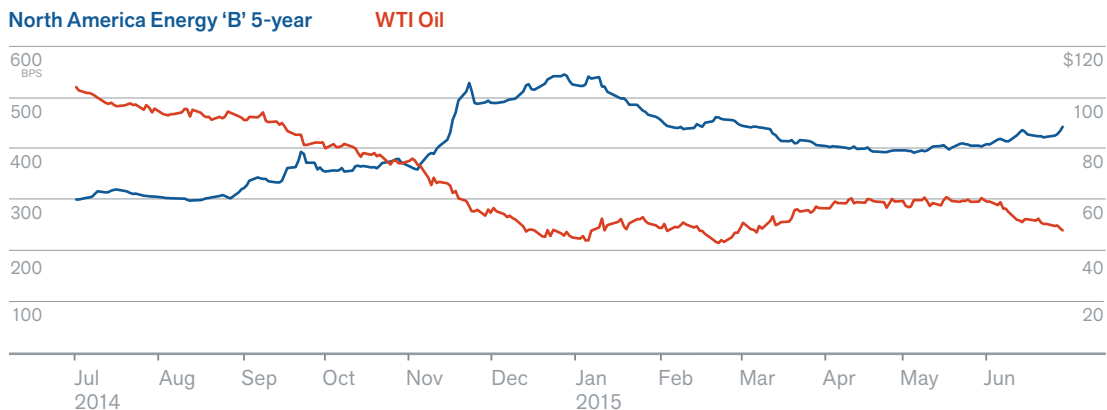
Source: Markit

This has caused the CDS market to reassess the credit standing of Noble Group. In May 2014, Noble's five-year spreads were trading at 158bps. By July 2015, they were trading at close to 600bps, which means that it would cost far more to insure against a possible default of Noble on its debt obligations (a default in this sense can mean bankruptcy, failure to pay or restructuring). Most of the credit deterioration occurred since the negative research was published in February 2015.

To put the spread movement in context, Swiss commodities trader Glencore was quoted at almost the same level as Noble in July 2013.

Two years later it was trading at 220bps, nearly 400bps tighter than Noble. Glencore has clearly been affected by the difficult conditions in the commodities market – hence its recent measures to save its investment grade rating – and this is reflected in its spreads widening. But the stark underperformance of Noble's CDS spreads demonstrates that there are other, specific forces at work. Noble is an investment grade company (rated Baa3/BBB-) but trades with an implied rating of CCC, well into junk territory. This shows how the market can diverge from the rating agencies and is exactly the sort of data risk managers should be aware of when assessing counterparty risk.

Chart 2. North American high-yield energy credit suffers from oil price fall



What if single name CDS data isn't available?

Noble Group has liquid CDS data available. However, this may not always be the case for counterparties in the energy sector, many of which are relatively small. CDS entities tend to have significant amounts of public debt. In that case, it can be appropriate to use a proxy measure. This is the approach that banks use for credit valuation adjustment (CVA), and energy firms are starting to use similar methods.

A suitable proxy when single name CDS data are not available is the Markit Sector Curve. These are constructed using Markit's single name CDS data, employing a methodology that provides regional curves and limits erroneous volatility. For example, the drop in the price of oil in the latter half of 2014 put considerable pressure on North American exploration and production companies. This can be seen in chart 2, where the Markit North American Energy 'B' curve, representing North American energy firms rated

single B, widened significantly in tandem with the fall in the price of oil.

Many companies in this sector and region are in credit distress, and this is reflected in the Markit Sector Curve. Prudent energy groups can use this data to assess the cost of trading with such counterparties and evaluate credit decisions accordingly.

Counterparty credit risk was something of a backwater pre-2008, but the Great Financial Crisis changed the landscape dramatically. It is now a major concern throughout the energy sector, and the events of the last 14 years since the collapse of Enron demonstrate that traditional credit evaluation techniques are not always adequate. CDS are set to be an integral component in measuring counterparty risk in the coming years.

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