Book review

Credit Derivatives: Documenting and understanding credit derivative products
by Edmund Parker
Globe Law and Business, London; 2007; ISBN 978 1 905783 03 8; 558pp; hardback; £145

Timing is everything. In the introductory comments to his book 'Credit Derivatives: Documenting and understanding credit derivative products' Edmund Parker describes how, on 8th June, 2007, he typed the words 'credit', 'derivatives' and 'opaque' into the Google search engine and was provided with 14,700 references as a means of refuting the proliferation of hyperbole associated with the complexity of credit derivatives markets.

Two weeks later, two of Bear Stearns' structured credit derivatives strategies funds were forced into a fire-sale liquidation of collateralised debt obligations, which resulted in the subsequent collapse in confidence of both the credit derivatives market and its myriad of financing markets. The ensuing credit crunch — the most severe in the modern history of capital markets — was brought about by the intractability of subprime risk globally syndicated through credit derivatives products. If one types the words 'credit', 'derivatives' and 'opaque' into the Google search engine today it will return an additional ten thousand new references to ponder. That credit derivatives have subsequently proved to be opaque, complex, difficult-to-value products should not detract from the comprehensive and articulate legal anatomy of the credit derivative product described in this book. Rather, the 2007 credit crunch and what appears to be an ensuing turning point in the credit cycle, provides a timely reminder of the importance of maintaining clarity in understanding both the economics of risk and the legal context of credit derivatives. As such, this book serves as a useful compendium to the existing literature for risk managers, regulators, documentation specialists and practitioners of this rapidly evolving market.

Credit derivatives are, ultimately, strips of cash flows contingent on credit events and, consequently, sit on that tripartite juncture of market, credit and legal risk. In fact, as Edmund Parker makes clear, much of the risk subtleties of the market arise from the legal complications of an obligor in distress: what constitutes a 'credit event' for the purposes of triggering credit derivative cash flows, and what securities are eligible for delivery when such an event is established? Under what circumstances does an obligor's debt or corporate restructuring impact the terms and conditions of these cash flows? Supported by well-chosen examples of the inter-bank litigation which plagued the market's evolution (eg Nomura vs Credit Suisse on the non-contingent nature of deliverable obligations, and Deutsche Bank vs ANZ on grace periods for non-payment of reference obligations), Mr Parker demonstrates how even the most obvious of legal issues can pose challenges to the required standardisation of a derivative market's contractual documentation.

In his book, Mr Parker provides a thorough analysis of the 2003 ISDA documentation which sets out a standardisation of the legal infrastructure of the market. His dissection of ISDA's often turgid legal definitions avoids their dense nomenclature, and instead is backed by a profusion of carefully designed case studies which should allow non-lawyers to gain an intuitive and working knowledge of their meanings. The quality of the book's pedagogical case-study approach is only slightly undermined by a tendency for examples to be of a hypothetical nature. When Mr Parker does reference real examples from history — his excellent reviews of both the implications of Conseco's debt restructuring, and of Rentokil Corp's corporate restructuring, are two such cases — the tangible impact of ISDA's ostensibly abstract legal definitions is placed in an insightful real-world context.

The book provides accurate and contemporary product definitions backed by schematic portrayals of cash flows which exemplify a consistently rigorous treatment brought to both plain vanilla and structured products alike. Excluding self-referencing swaps from an unnecessarily restrictive definition of a credit default swap as a privately negotiated bilateral contract agreement between two parties referencing a third-party credit, is a minor transgression.

While the clarity afforded by the book's case-study approach should suffice to ensure this becomes an essential supporting text for academic courses in both derivative finance and financial law, its exhaustive preoccupation with the legal aspects of the credit derivatives markets, to the exclusion of their market and liquidity risk implications, makes this a somewhat unbalanced treatise of the subject for traders and portfolio managers. Nevertheless, this book provides a critical understanding of the legal issues arising from credit events — and for this reason alone, it is essential reading for the practitioner.

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Note: The views expresssed in this Book Review are those of the Reviewer and not those of his Company, J P Morgan.