

DEVELOPMENTS OF CREDIT DEFAULT SWAP CONTRACTS UNDER THE INFLUENCE OF GLOBAL CRISIS

Lect. Mircea CIOLPAN, PhD student
University of Financial Banking, Bucharest
Cătălin ADAM, PhD student
University of Craiova

1. Introduction

Credit derivatives are the latest tools in the management of the credit risk portfolio. Credit derivatives have grown considerably because they provide an effective mechanism for the exchange of credit risk. While modern banking is built on the sensible notion that a loan portfolio is less risky than a single one, banks still tend to focus too much geographically or in certain sectors: industrial, commercial or financial.

An example could be the credit default swap contracts (CDS).

Credit default swap is a swap that transfers the potential loss of the reserve assets by the occurrence of events related to the counterparty (bankruptcy, failure to pay debts, insolvency, lower credit ratings). The bond is the favourite reference asset, because it has advantages in terms of price transparency and the relation between itself and the debtor's state. Due to the large volume of credit swap contracts undertaken, loans tend to be the main asset of reference because they represent the majority of the interest bearing assets from a bank.

In a credit default swap contract, a protection buyer pays a premium to a protection seller, in exchange for further amounts, if the credit is granted. The premium may be paid initially, with one installment or periodically. Contingent payment is based on a credit event.

The purchaser of a bond can enter a cover operation for default risk

and in this regard CDS can be seen as a credit insurance. A credit insurance is not subject to regulations concerning insurance market. An investor can buy or sell protection without having a debt of the underlying asset.

This article aims to present the overall market for credit default swaps and their regulatory trends worldwide. Over the past year and a half, the states' interest for CDS contracts has grown significantly, due to the global crisis and especially to the speculations on sovereign risks. If for ten years the regulatory discussions on credit derivatives market were only theoretical, the current period showed that a postponement of regulations may destabilize the country's efforts to get out of recession. The most important question is whether CDS should be forbidden or properly regulated. The study of these derivatives or their overregulation won't solve the particular risks across borders. More important, I think it is the commitment of the states to set up a regulated and transparent market for credit derivatives. The role of the CDS contracts is to identify and quantify the risks.

2. Risks which affect the CDS world market

The first identified global issue was that of counterparty risk. In terms of profit credit, the default swap contract, at a level system, is a zero sum game. This is because only one of the two

participants can record a profit from such a contract. The risk of not being able to complete the contract according to the agreement, could generate losses for both parties. This counterparty risk exists because the credit default swap contracts are carried on over the counter market, which makes a contract uncertain till the date of payment. The global economic situation has generated an increased counterparty risk in a market that reaches a level of trillions of dollars.

- **Counterparty risk**

Since a CDS contract has a value which starts at U.S. \$ 10 million, the counterparty risk can become a systemic risk in tensed situation, on international financial markets. Regulators in the U.S. and EU have identified this problem since the day they began to manifest the symptoms of the global crisis. However, no action was taken, and now the credit default swap contracts threaten the construction of the European currency, through speculations on sovereign risks of several European countries.

A solution to this problem may be the creation of a Clearing House, so that transactions could be developed, having as a counterparty this institution, which is specific to the regulated capital markets. Aiming towards the implementation of this system, DTCC has began the accreditation operations of an entity, financially and logistically capable, and able to take over this function.

- **Concentration risk**

This risk is evident when considering the number of dealers for the CDS market. 2008 is the last year for which we have complete data; the present situation tells us that we should focus on five major dealers: JP Morgan, Goldman Sachs Group, Morgan Stanley, Deutsche Bank, Barclays group. From the preliminary data for 2009, we can conclude that the situation remains the same. An important aspect related to the sovereign debt crisis refers to the big players on the CDS market, which are

banks that have received substantial financial packages from the governments of the mother countries. The governments have saved the banking systems and as we speak, large corporations speculate the financial "collapse of the national economies".

- **Interconnection risk**

CDS contracts have proved to be a growth factor for the interdependencies from the banking system. After studying the effects of the current economic crisis on the credit default swap contracts' market we can identify three issues related to the macroeconomic interconnections.

A first aspect is that of the underlying assets belonging to the banking system. Since banks are the main intermediaries, as shown in the previous paragraph, and because system-level problems may spread very easily, the CDS contract risk is very close to the counterparty risk. This way, the investors find very hard to estimate this risk. That's why some of the regulatory authorities prohibit such credit default swap transactions.

The second aspect is related to the sovereign risk and to the banking shares which tend to speculate the public deficits, after they are financially supported by the governments. I mentioned this aspect in the previous paragraph, because besides the aspects related to ethic, the deterioration of the country risk negatively influences the banking activity. The increasing correlation between the underlying asset market and the protection sellers through CDS, reduces the risk of transmission efficiency and therefore the effect of hedging transactions. This risk is called "wrong-way risk" and occurs when an entity or more are affected by the link between the credit quality and the partner's capacity (from the credit default swap transaction) to make the payment. One way to identify this risk is to use stress tests within the banking institutions.

The third issue concerns the links between participants. Such an entity which does not have a significant weight in the system, can generate a significant systemic risk, because of its size and because of the type of the transactions conducted through. An important example would be the AIG case, an entity which held the 20th international position among the participants on the credit default swap market and had a gross exposure of only 10% of the largest participant's exposure on this market. However, the company's size and the fact that it did not carry out coverage operations for the CDS contracts, has forced the U.S. government to interfere and to support the company financially, because the financial system wouldn't have survived to such a shock.

Straight through processing

This issue was identified by the International Bank of Settlement following the reports received from various national authorities. This situation was noticed in practice when many operators on CDS market have not been able to record the CDS contracts settled during the same working day. This is a very dangerous situation as the participants on the market may not know exactly which are the related risks. In order to solve this fact, the Bank for International Settlements has proposed for each participant on the CDS market to introduce a standard procedure, based on automated computer operations. Using such a system requires investments both for the participants in order to be able to manage automated transactions and also for the new international institutions which will regulate and control the market. At the international level it is necessary to take to a new level of standardization the CDS contracts for a better evidence of the contracts.

- **Lack of transparency risk**

Credit default swap market is characterized by a worrying lack of transparency both for participants and

also for the authorities from all countries. Since the size of the credit derivatives market exceeds the global gross domestic product, it is a worrying fact that the price is not formed in a clear way. This lack of transparency is given by the fact that over the counter markets to price is formed by direct negotiation between the two trading participants.

Lack of consistent regulation

There are no credit default swap market regulations both at a national and international level. This is indeed the Gordian knot of CDS transactions. Innovation in the market was more rapid than the ability and willingness of the States to create the institutional framework for the new occurred transactions. As we cannot conclude that a car itself is quite dangerous, following the same logical way we cannot say that the use of CDS contracts generates serious problems internationally, but it is obviously that the lack of adequate regulatory framework does that. A more clear matter that arises is the lack of international engagement in order to regulate the use of credit derivatives in general. From my point of view this lack of real action has two causes. The first cause may be the inability of current national and international structures to mobilize themselves in more vigorous actions for control and crisis prevention. This assertion is supported by the incapacity of the central banking system to predict this current crisis and to find internal resources in order to solve the chronic problems which appeared in the banking system. The second question may be the lobbying system created by the international financial community, lobby which is very influent in the political area. This assertion is supported by the observation that politicians, in industrialized countries have focused on helping the banking system and not on restructuring it. If for the first moments of the global crisis, the helping programs have been logical, for the current time,

nearly two years from the beginning of the crisis, restructuring and adapting to the new realities ought to be strongly supported and not maintained at a declarative level. From this point of view I consider that the current situation with speculations on the public debt defaults from several EU countries cannot be charged on the behalf of the financial banking system, as the first intention was to hedge the exposure on that countries, and after that it was the pursuit of a legal and logical yield. Responsible for the present situation are those who have administered these countries, e.g. Greece authorities, who forged over many years the statistics about the real macroeconomic situation, and not those who speculated on public debt default in order to obtain a profit.

3. Credit default swap market by the end of 2009

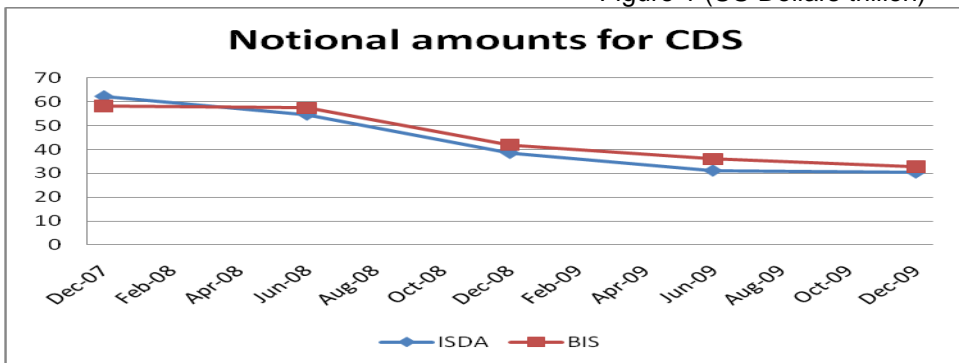
CDS market information is published by three international institutions. These are the Bank for International Settlements (BIS), International Swaps and Derivatives Association (ISDA) and The Depository Trust & Clearing Corporation (DTCC). Figures published by these three international bodies are not identical and therefore they could generate confusion

because of the differences between them. The explanation for these differences is given by the number of operators which report the CDS transactions to each of these three major institutions. Among them, the most accurate values belong to ISDA and BIS, as their statistics include global contracts and agreements, not just their own contracts, as DTCC does.

Global volume of CDS at the end of December 2009, according to the figures published by BIS, is 30.4 trillion dollars. For the same period the volume of global exchange capitalization is U.S. \$ 444 trillion, according to the data published by BIS.

Gross market value in December 2009 was 1.8 trillion dollars. This is the amount which participants take into account if they have to replace current contracts. This amount is much smaller than the total volume of 30.4 trillion dollars of CDS. The analysis of these figures proves us the fact that the danger of CDS is highly exacerbated as the real payment for CDS contracts would be only a part of the insured sum. For example, in the case of Lehman Brothers, for the auction made by ISDA was paid a contribution of 8.625% of the contracts. This percentage represented the value of the actual losses by those who had exposure to that bank.

Figure 1 (US Dollars trillion)



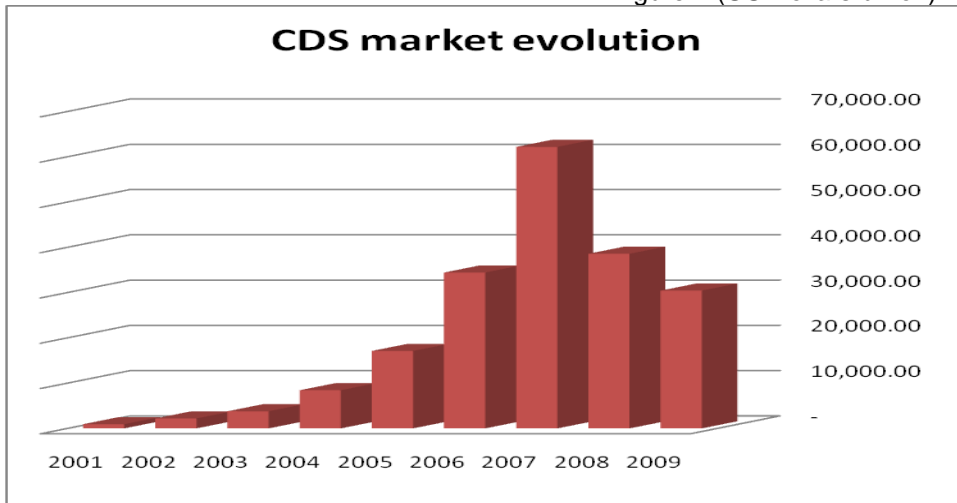
Source: www.bis.org; www.isda.org

According to data published by ISDA, we notice that the CDS market has

evolved a lot between 2001 and 2007; during this period of time the central

authorities didn't see the potential trading. dangers of the unregulated derivatives

Figure 2 (US Dollars billion)

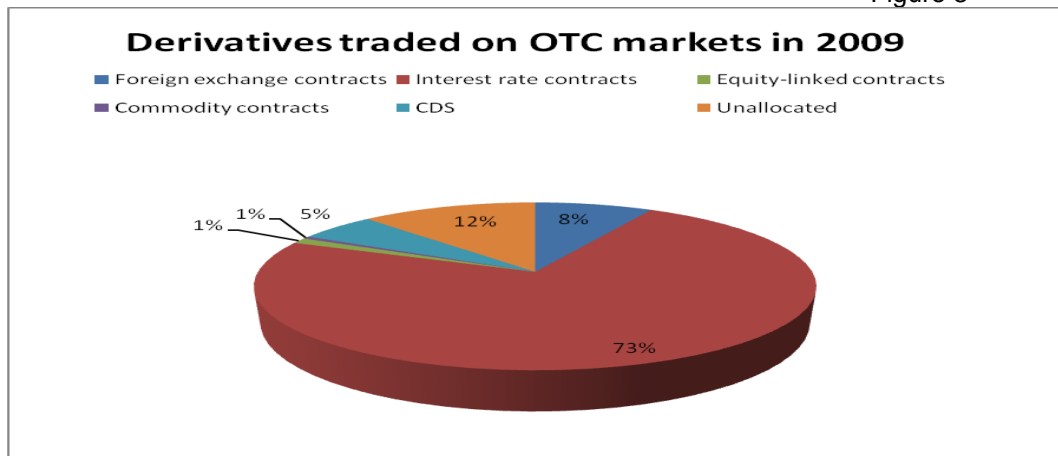


Source: www.isda.org

The value of derivative contracts concluded on the OTC markets in 2009 was U.S. \$ 614.7 trillion. From this amount the largest share was the interest rate contracts, with a value of U.S. \$

449.8 trillion. Compared to these amounts, the 32.7 trillion dollars of the CDS contracts represent only 5% of the total market.

Figure 3



4. Conclusions

Following the analyzed figures and the theoretical observations on the development of CDS contracts, I may conclude that these contracts show the fear of the investors regarding the

possible credit default. The problems which arose from trading this kind of credit derivatives, are inherent and I consider that it is the states' duty to implement the lines between legal and illegal. I think the question is wrongly put in terms of sovereign debt, namely that

states have reached the limit situations because of the actions of the speculators. The problems were fueled by the speculative actions, but they weren't generated by them. Practically, the inability of the States to reorganize themselves under the pressure of the global crisis, has generated and also increased the tensions in the CDS market, regarding the possibility of the

public debt default. Also, the slowness of the regulatory process for OTC derivatives allowed the participants on CDS markets to exploit the system weaknesses (e.g. no clearing houses, ambiguous price formation, etc.). From my point of view a regulatory action will eliminate the problems mentioned during the article and the CDS market will be more fair and transparent.

Chacho George	Credit derivatives: a primer on credit risk, modeling and instruments, Wharton School Publishing, 2006;
Stancu Ion	Finante, Editura Economica, Buucresti, 2002;
Depository Trust and Clearing Corporation	Clearing the way, 2009;
European Central Bank	Credit Default Swaps and Counterparty Risk, 2009;
*****	www.bis.org ;
*****	www.isda.org .