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CREDIT DEFAULT SWAPS AND REGULATORY REFORM

By Houman B. Shadab

MERCATUS CENTER
George Mason University

A CREDIT DEFAULT SWAP (CDS) is a type of non-exchange-traded derivatives contract that obligates a protection buyer to pay a fee to a protection seller in exchange for the seller agreeing to compensate the buyer upon the happening of a negative credit event, such as a third party defaulting on a loan. Although the use of CDSs by certain banks and insurance companies to trade mortgage-related risks exacerbated losses from the financial crisis, CDSs were not a fundamental cause of the crisis and in important ways even helped to reduce its impact. Stricter limitations on the use of CDSs by banks and insurance companies may help to prevent large risks from building in the financial system. However, recent efforts to increase the stability and transparency of derivatives markets by market participants acting under supervision of the Federal Reserve Bank of New York call into question the extent to which regulatory reform is necessary.

THE PROBLEM OF CREDIT RISK

CREDIT RISK IS the likelihood that a lender will suffer a loss when a borrower fails to pay back a loan. In the early 1990s, banks began to use a new type of contract, later called a “credit default swap,” to transfer the credit risk of some loans. A CDS requires a credit protection buyer (such as a bank) to make periodic payments to a protection seller. In return, the protection seller agrees to pay the protection buyer the amount of the loan if the borrower defaults and will demand a higher fee as the risk for the underlying loan or other debt instrument referenced by the CDS increases. In this sense, a CDS is a type of insurance for credit risk that can help banks and other companies better manage their credit risks.¹ A CDS was particularly attractive to banks because, under the regulations at the time, using a CDS meant that a bank could decrease the amount

of capital it was required to hold in reserve against its loans, thereby freeing money for the bank to use for other purposes.² CDSs also allowed banks to discretely transfer credit risk to third parties without jeopardizing their relationships with borrowers or having to go through the process of selling loans.³

The use of CDSs exacerbated losses from the financial crisis in some respects and reduced them in others.

THE CREDIT DEFAULT SWAP MARKET

OVER A DECADE after first being utilized, the CDS market greatly broadened in terms of who used CDSs, the different types of CDS products available, and how CDSs were utilized. By 2006, hedge funds and insurance companies were also significant CDS users.⁴ There are a variety of types of CDS contracts. A common type is a single-name CDS. These CDS require a protection seller to pay the protection buyer if a single company or country defaults on its loans or experiences some other type of negative credit event, such as a downgrade on its bonds by a credit ratings agency. Another type of CDS is an index CDS, which are similar in form to other financial indices such as the Dow Jones Industrial Average in the sense that the price of a CDS index tracks the prices of group of underlying CDSs that constitute the index.

The CDS market grew very rapidly after 2000. According to the Bank for International Settlements, the notional value of CDS contracts peaked at year-end 2007 at \$57.8 trillion.⁵ The “notional value” of a CDS contract is the amount of the loan referenced by the contract. For example, a CDS contract that references a \$1 million loan has a notional amount of \$1 million. The notional amount typically greatly overestimates the risk to the CDS seller. This is because CDS sellers often also buy CDSs that offset their overall risk exposures, and even loans that are defaulted on will have some value, which decreases the total payment the protection seller must make. As of June 2008, the maximum potential losses to CDS market participants was estimated to be approximately 5.5 percent of the notional value of the CDS market, or \$3.2 trillion.⁶ CDS market participants also typically post collateral to ensure they can fulfill their CDS obligations.⁷ Due to offsetting CDS trades and collateral management, when Lehman Brothers declared bankruptcy, sellers of CDS protection on Lehman bonds were only required to pay protection buyers 7.2 percent (\$5.2 billion) of the notional value of CDS contracts referencing Lehman.⁸

CREDIT DEFAULT SWAPS AND THE FINANCIAL CRISIS

THE USE OF CDSs exacerbated losses from the financial crisis in some respects and reduced them in others. First, the use of CDSs by banks likely led them to sell more mortgage-related securities because banks believed they were able to reduce risks related to such activities with CDSs.⁹ However, banks earned substantial fees from underwriting mortgage-related securities and probably would have, and often did, sell mortgage-related securities even without being able to purchase CDS protection. Accordingly, the growth of CDS referencing mortgage-related securities was more of an effect rather than a cause of the rapid growth in mortgage-related securitization.¹⁰ Second, CDSs allowed more mortgage-related risks to be spread throughout the economy than otherwise would have been the case. CDSs were often grouped together and repackaged into securities and thereby allowed investors to gain “synthetic” exposure to mortgage-related securities when they were unable to locate and purchase the actual underlying securities.¹¹

Third, in part because CDSs were not regulated as insurance contracts, some insurance companies were able to sell CDSs through non-insurance affiliates and became overexposed to mortgage-related credit risk.¹² By 2005, a subsidiary of the financial services conglomerate AIG had sold so much CDS protection on mortgage-related securities owned largely by banks that AIG was unable to meet the approximately \$32 billion in collateral obligations it was required to post in the fall of 2008 as the value of those securities decreased and AIG’s bonds were downgraded.¹³ The collateral obligations ultimately caused the Federal Reserve and the U.S. Treasury to coordinate a series of taxpayer-funded rescue measures for AIG. However, to the extent government assistance to AIG was necessary to protect AIG’s bank counterparties from suffering mortgage-related securities losses, government assistance would have been necessary even if AIG never sold banks CDSs. Importantly, not all CDS users fundamentally misused the instruments. Relatively less-regulated hedge funds, for example, did not disrupt the financial system with their CDS trades and, unlike AIG, used substantial amounts of collateral to manage CDS risk.¹⁴

On the other hand, CDSs helped companies to manage the risks and losses that resulted from the financial crisis. Despite the size and large number of corporate bankruptcies beginning in the fall of 2008, buyers of credit protection were generally able to collect on the credit protection they were expecting.¹⁵ The prices of CDS contracts also give investors unique information about the credit risks associated with various companies or particular debt instruments.¹⁶ This means that CDSs helped companies make better investment decisions because they were able to utilize CDS prices as a tool to measure credit risk. CDS prices in particular provided an early warning signal of the problems in the market for mortgage-related securities and led some banks and investors to begin to curtail their exposures to such risk before the market collapsed.¹⁷

Because unmanageable losses arising from CDS obligations were limited to the small fraction of the CDS market that was tied to mortgage-related securities,¹⁸ the losses do not primarily reflect inherent weaknesses in the risk management and infrastructure of the CDS market. Rather, unmanageable CDS losses were a reflection of the widespread underpricing of the risk of mortgage-related securities. Had it not been for the rapid growth of mortgage-related securitization after the turn of the century, it is unlikely that CDSs would have posed any noticeable problem to the financial system.

CDS REGULATION AND REFORM PROPOSALS

CDSs ARE REGULATED by the Securities and Exchange Commission (SEC) pursuant to the federal securities laws as “security-based swaps.” CDSs are subject to federal prohibitions on fraud, market manipulation, and insider trading. However, the SEC is prohibited by statute from requiring that CDSs be registered or imposing reporting or record-keeping requirements on CDS users. Most large CDS dealers are owned and operated by regulated depository institutions and, accordingly, their utilization is subject to oversight and supervision by federal bank regulators. For example, the Office of the Comptroller of the Currency has the authority to examine how commercial banks’ utilization of CDSs impacts bank safety and soundness.

On June 17, 2009, the U.S. Treasury Department released a comprehensive financial regulatory reform proposal that would impact the way CDSs and other non-exchange-traded derivatives are regulated and utilized by market participants.¹⁹ Among its other goals, this reform proposal seeks to increase the stability and transparency of the CDS market. The proposal seeks amendment of the securities and commodities laws to require all standardized CDS trades to be cleared by a regulated central counterparty, which would stand ready to fulfill the obligations that any one party was unable to make, and require that all financial institutions with large CDS risk be subject to capital requirements and strict oversight. The proposal would also require all customized CDS transactions to be recorded in a regulated trade depository which, in turn, would report the information in aggregate to the public and in a more detailed fashion to regulators. On July 30th, House legislators issued a statement of principles on derivatives-market reforms that shares these goals but also leaves open the possibility of prohibiting CDSs used to speculate.

Ongoing improvements being made by CDS market participants under the supervision of the Federal Reserve Bank of New York complement these reform proposals’ goals. In April 2009, CDS market participants agreed to standardize the terms of CDS contracts, which would make them easier to clear through a central counterparty that takes on each party’s risk of default.²⁰ Market participants have also begun reporting CDS agreements to the central trade depository operated by the Depository Trust Clearing Corporation (DTCC) and

has expanded access to central counterparties.²¹ Since January 2009, the DTCC has made publicly available aggregate information on CDS trades on a weekly basis and, even more recently, data provider Markit has made freely available pricing and other information on CDS transactions. In addition, market participants have already begun to centrally clear CDSs through clearinghouses operated in the U.S. and Europe and will likely also expand CDS clearing over time.

CONCLUSION

TO PREVENT CONCENTRATIONS of CDSs from building in the financial system, regulators should require that regulated financial institutions use collateral, set aside capital, or otherwise limit their use of CDSs, particularly when written on structured securities that are difficult to value. Given the improvements already being made by market participants under the supervision of the New York Fed, the full extent of the regulatory reform proposals being considered by lawmakers likely do not need to be enacted to achieve the goals of greater stability and transparency in the CDS market. Before proceeding, any additional regulation should take into account the recent improvements and also the complexity of the derivatives markets.²² Market participants and regulators should also be aware that the use of central counterparties may not fully address counterparty risk and, if not properly utilized or overseen by regulators, may add new risks to the system by creating new concentrations of CDS risk in clearinghouses or reducing the ability and incentives for parties to manage counterparty risk.²³

To prevent concentration of CDSs from building in the financial system, regulators should require that regulated financial institutions use collateral, set aside capital, or otherwise limit their use of CDSs.

ENDNOTES

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Houman B. Shadab is a senior research fellow in the Mercatus Center's Regulatory Studies Program. His work focuses primarily on financial markets and securities regulation.