

Credit Default Swaps and Counterparty Risks

Credit Default Swaps – Blessing or Curse?

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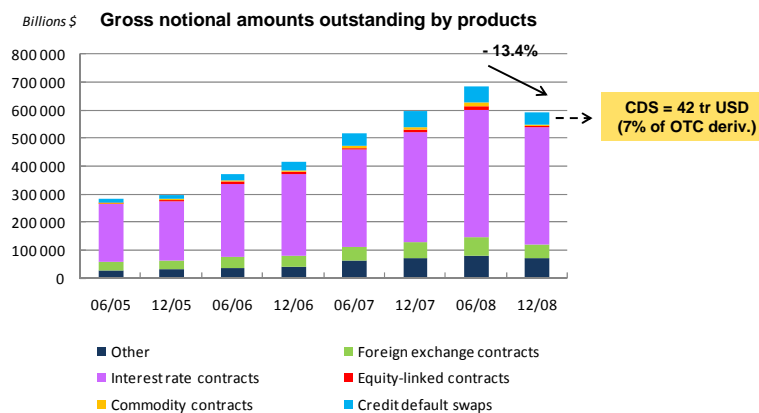
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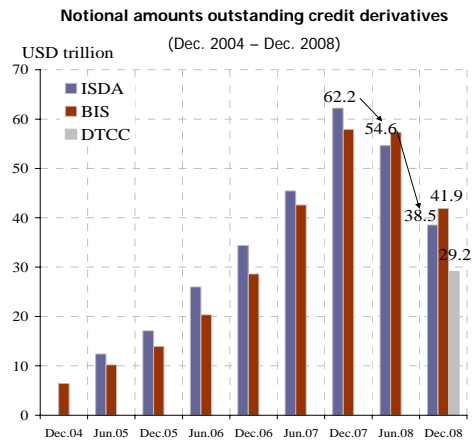
Limited current market data

- General contraction in OTC derivatives positions during the crisis : -13.4%

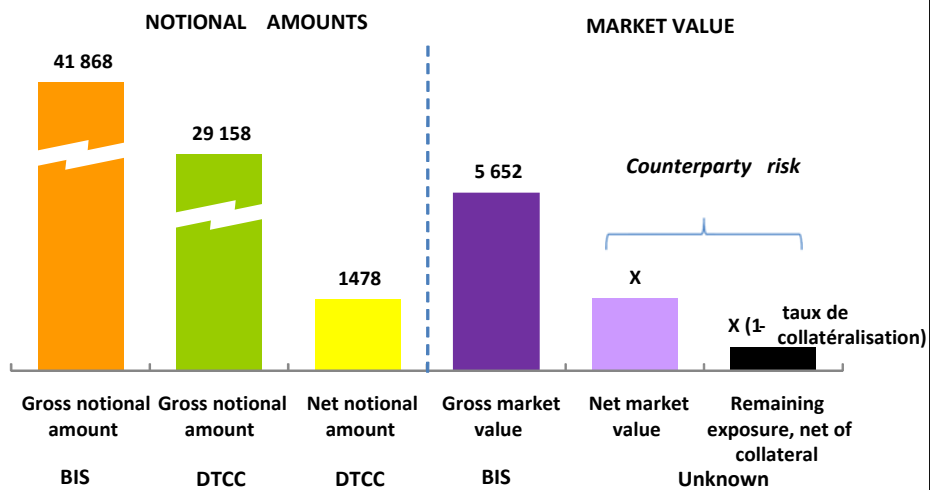


Limited current market data

- After years of exponential growth, the size of the CDS market shrank significantly
 - Banks have taken part in so called termination cycles (impact: 30.2 bn USD in 2008)
 - Decrease in volumes of new trades
 - A smaller number of participants



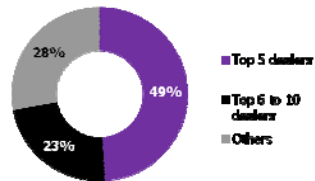
Limited current market data



1- Increasing concentration risk

- The CDS market remains concentrated in the hands of a small group of dealers
 - As of April 2009, top 5 dealers are counterparties to 50% of the notional outstanding;
 - And top 10 dealers account for 72% of trades

Concentration of gross notional outstanding amounts of CDS sold by largest dealers
(as percentage of total)



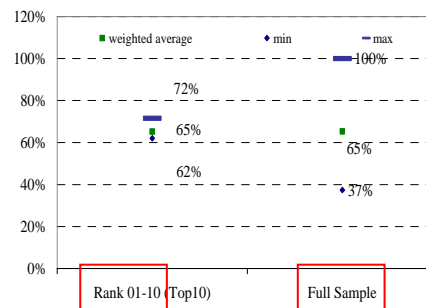
Source: DTCC, 17 April 2009



1- Increasing concentration risk

- A concern for large EU banks
 - Top 10 counterparts account for 62 to 72% of their CDS exposure

Concentration of CDS gross market value to individual top 10 Counterparties

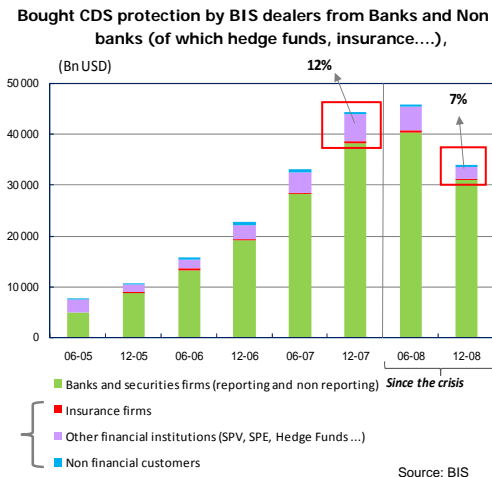


Source: WGMA quantitative survey



1- Increasing concentration risk

- Exit of major players
 - Dealers (Bear Stearns, Lehman Brothers)
 - **Sellers of protection (monolines, CPDCs, hedge funds)**
- A possible scarcity of sellers
- Increased liquidity risk in the event of another dealer failure



2- Limited risk transfer

- Major CDS players trading primarily among themselves
- Dealers mainly guarantee risks for financial reference entities

Buyer Type \ Seller Type	Seller Type		Total
	Dealer	Non Dealer / Customer	
Dealer	21.3	2.5	23.7
Non Dealer / Customer	2.7	0.0	2.7
Total	24.0	2.5	26.5

DTCC August 2009

Top 10 reference entities by net protection amounts
(USD billion; December 2008)

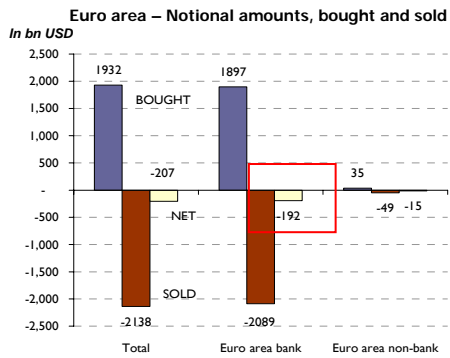
GE Capital	11,074
Deutsche Bank	7,163
Bank of America	6,797
Morgan Stanley	6,318
Goldman Sachs	5,211
Merill Lynch	5,147
Berkshire Hathaway	4,632
Barclays Bank	4,358
UBS	4,311
The Royal Bank of Scotland	4,271

Source: DTCC

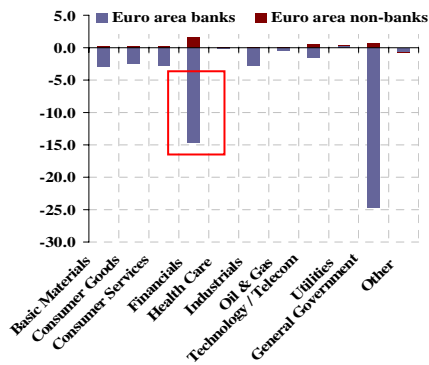
7 dealers in the top 10 reference entities as per the end of 2008
Risk Circularity: banks replacing credit risk with counterparty risk?

2- Limited risk transfer

- Euro area banks are currently net sellers, compared to a traditional net buyer position in the past..
- ...on Euro area banks (and sovereigns)



Euro area banks net CDS single names positions



DTCC, April 2009

3- Collateralisation on OTC derivatives lower than expected

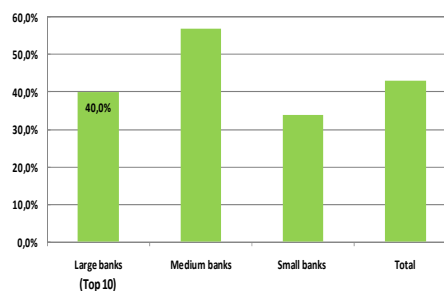
- Surveyed EU banks exposures on OTC derivatives are on average collateralized 44%

- Reliability of the data made available by private bodies questioned
- Need for more data counterparty risk: financial disclosure or regulators' reportings

- Proper collateralisation is all the more important than not all trades are not going to be cleared

- CDS case: Turner Report: between 55% and 75% likely to be eligible
- Currently around 4% of total CDS notional are being cleared

Collateralisation of positive net market exposure



Source: WGMA Special Survey on 31 EU banks

4- CDS has become a leading indicator: preserving market integrity

- Price discovery function in several markets, of which credit markets:

- **CDS and bonds**

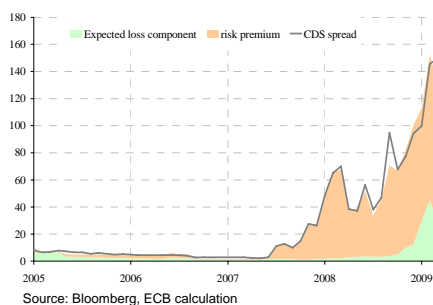
- « the » indicator looked at by investors in credit markets
- Looked at Credit Rating Agencies (Market implied rating)

- **CDS and loans**

- Pricing guidelines for new loans
- CDS covenants, CDS indexed loans
- => Impact on funding cost, ie on Real Economy

What reliability in times of reduced liquidity?

Decomposition of CDS spreads of euro area banks



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Mitigating Systemic risk

- **COUNTERPARTY RISK:** Data, standardisation and establishment of Central of counterparties
- **MACRO SURVEILLANCE:** IMPACT ON REAL ECONOMY (pricing power in funding costs, cross market arbitrages, feedback effects on credit ratings)



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