65th East Jour Fixe
Credit Default Swaps – Blessing or Curse?

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On September 28, 2009, the Oesterreichische Nationalbank (OeNB) hosted the 65th East Jour Fixe (EJF) on "Credit Default Swaps – Blessing or Curse?". Almost 100 participants took part in the event organized by the OeNB's Foreign Research Division, which reflects the great interest in issues related to credit default swaps (CDS). All in all, by bringing together regulators, economists, market participants and representatives of academia, the EJF greatly benefited from a wide range of different perspectives. The lively debates on the various topics attested to the relevance of developments on the CDS market and the timeliness of the event. The scope of the 65th East Jour Fixe was broader than usual,[1] since the topic has gained a lot of interest during the global economic and financial crisis and since regulatory issues are still under permanent debate. Representatives of a number of important institutions discussed various issues ranging from structural shortcomings of the CDS market and regulatory proposals to the behavior of CDS spreads during the global crisis. The event was divided into four parts:

– Keynote Session: Credit Default Swaps – Blessing or Curse?
– Session 1: Sovereign Credit Default Swaps – Functions, Pricing and Interpretation
– Session 2: CDS-Driven Crisis or Crisis-Driven CDS? Are CDS a Prerequisite or an Obstacle for Macrofinancial Stability?
– Session 3: Credit Default Swaps – What Role for Emerging Europe?

OeNB Governor *Ewald Nowotny* made an introductory statement and chaired the Keynote Session. In his statement Governor Nowotny pointed to the increasing use of CDS spreads as indicators in macroeconomic analyses and even in the mass media. In particular during the global financial and economic crisis, many economists have started to interpret CDS premiums as a leading financial market indicator in addition to or instead of "traditional" indicators like stock market indices and Eurobond spreads. Moreover, Governor Nowotny highlighted the sharp rise and high volatility of CDS spreads of various Western European and CESEE countries during the crisis. Finally, he stressed the importance of regulatory reforms to counteract structural weaknesses of the CDS market.

In the first keynote speech, *Hans-Helmut Kotz* (Member of the Executive Board, Deutsche Bundesbank) gave an overview on the CDS market. In sketching the underlying economic functions (mainly hedging and diversification opportunities as well as market completion) Kotz pointed to the high growth of the CDS market, in particular between 2005 and 2007. He drew attention to the opaqueness and intransparency that surrounds over-the-counter (OTC) derivatives markets (including the CDS market) in general. Opaqueness would arise somehow endogenously – being strongly correlated with high margins for major market players. As an upshot, margins would most probably decrease if CDS contracts would get more standardized (as envisaged in all major current reform proposals). In addition, he noted that the establishment of central counterparties (CCPs) would be beneficial, that is, welfare enhancing from a stability as well as from an

[1] *Usually, the EJF focuses on CESEE only.*

allocative angle: CCPs would – via collateralization, margin accounts and variation margins – allow to manage and absorb counterparty risks. Moreover, via systematic netting the absolute level of risk should also be reduced. Finally, operational risks (like confirmation backlogs, etc.) could also be controlled more effectively. In concluding and in reference to the title of the event, Kotz held that CDS could be both blessing and curse, depending on the way they were utilized and handled. Moreover, possible systemic issues might arise depending on the economic context (or regime). In this vein, when assessing possible benefits and drawbacks related to CDS, one should distinguish between normal times and times of crisis. In a crisis environment CDS, inappropriately used or managed, might reinforce instabilities.

Willi Hemetsberger (President, Ithuba Capital AG) started his keynote speech by stating that rules and regulation would be necessary to make CDS more useful. He also stressed shortcomings related to market transparency and highlighted the interrelations between the CDS market and other markets. For example, if a company took out a CDS-linked loan, an increase in the company's CDS spread would automatically increase interest rates, which could in turn lead to liquidity problems. He also mentioned possible conflicts of interest in cases in which a bank participates in a syndicated loan arrangement and at the same time holds a short position on the receiver of the syndicated loan. Moreover, Hemetsberger underscored pricing inefficiencies in the CDS market, especially in times of crisis. According to Hemetsberger, the widening of Austrian sovereign CDS spreads was associated with Austria being used as a "proxy-hedge" and with the attempt of some market participants to insure themselves against CESEE-related risks. Furthermore, he said that CDS have been the most liquid credit instrument throughout the crisis. When the corporate bond market stopped working, CDS were the only remaining instruments that could be used to actively manage credit risk. He also highlighted the importance of CDS in facilitating portfolio diversification and risk distribution (hedging).

Peer Ritter (European Commission) reported on the state of play of the European Commission's reform proposals. In October 2008 (one month after the collapse of Lehman Brothers), EU Commissioner McCreevy called for concrete proposals how to mitigate the risks arising from credit derivatives; in particular, he called for ambitious plans for moving CDS on to CCPs. More generally, the intention of the European Commission was to have a systematic look at derivatives markets. Meanwhile, ten market participants have committed themselves to using one or more EU CCPs for clearing European-referenced CDS (index and single name) as of July 31, 2009. Since then, two European clearing houses (ICE Clear Europe and Eurex Clearing) have started operations. To conclude the public consultation on OTC derivatives markets, the European Commission hosted a high-level conference on September 25, 2009. Ritter summarized the main results of this conference as follows: There was a broad consensus that a close cooperation between Europe and the U.S.A. was necessary to prevent regulatory arbitrage. The panelists also agreed that a broad use of CCPs would be beneficial and that central data repositories are essential. However, some issues still have to be discussed in more detail, including the questions: Should central clearing be mandated or incentivized? How will the cost of hedging by corporate end-users be affected by more regulation?

Session 1, which was chaired by *Rudolf Trink,* Director of the OeNB's Treasury Department, provided insights into particular segments of the CDS market. A range of speakers spotlighted differences and interlinkages between these segments.

Dawid Zochowski from the ECB's Financial Stability Division, scrutinized developments of CDS spreads on euro area banks and sovereigns. A decomposition of CDS spreads into a risk premium and an expected loss component shows that the risk premium was the major driver behind the sharp increases of euro area banks' CDS spreads during the crisis. Turning to the sovereign sector Zochowski first pointed to the strong impact of the collapse of Lehman Brothers on sovereign CDS spreads. He then went on to stress the strong linkage between bank and sovereign spreads after the collapse of Lehman Brothers. According to Zochowski, this linkage has possibly been related to a transfer of contingent or actual credit risk from the financial sector to the governments of several EU Member States following the rollout of national rescue packages for the banking sectors. In this respect, he also pointed to the possible occurrence of wrong-way risks (or risk circularity). An extreme example of wrong-way risk would occur if a bank sold CDS on its host sovereign reference country and at the same time benefited from state rescue packages. Another critical aspect is that counterparty risk-dealers and other financial institutions are tied to each other through chains of OTC derivative contracts, which makes it difficult for investors to separate credit risk from pure counterparty risk.

Burkhard Raunig (Economic Studies Division, OeNB) presented a paper he had prepared jointly with Martin Scheicher (ECB), entitled "Are Banks Different? Evidence from the CDS Market" (OeNB Working Paper 152). The paper aims to shed light on how CDS traders discriminated between banks and other types of firms and how their views changed over time, in particular, during the crisis. The paper uses regression analysis to compare the market pricing of the default risk of banks to that of corporates. CDS premiums are decomposed into expected loss and risk premium by means of a panel analysis. The authors conclude that CDS traders saw banks differently (namely as constituting lower risk) in the benign period before August 2007. However, since then a very strong repricing became evident in an environment of higher risk and uncertainty.

Session 2, chaired by *Philip Reading,* Director of the OeNB's Financial Stability and Bank Inspections Department, was dedicated to the financial stability implications of past and present developments on CDS markets. In particular, the speakers addressed the role of counterparty risks in CDS markets and the related structural and regulatory issues.

Richard Metcalfe, Deputy Regional Director at the International Swaps and Derivatives Association (ISDA), tried to put the current debate on CDS in perspective by stressing that despite the strong growth dynamics evident in recent years, the global derivatives market remained fairly small (at USD 5 trillion (net) as at end-2008) in comparison to other financial market segments, such as stock markets (USD 33 trillion), domestic bond markets (USD 60 trillion at face value), international bond markets (USD 24 trillion) and cross-border bank positions (USD 22 trillion). Adjusted for collateral, the size of the global credit derivatives market is estimated to be much smaller still (USD 1.25 trillion). Moreover, Metcalfe stressed that while global stock and domestic bond markets have recorded

considerable losses in 2008, the credit derivatives market grew by 180%. In assessing the size of the CDS market, he underlined the need to focus on "net" instead of "gross" values. According to Metcalfe, the case of American International Group (AIG) was a good example illustrating the need to distinguish between "gross" and "net" exposures to the CDS market. In fact, the net view revealed a more "dominant footprint" of AIG in CDS markets than gross values would have otherwise suggested.

The second speaker in Session 2, *Jacob Gyntelberg,* Senior Economist at the Bank for International Settlements (BIS), presented his views on CCPs for OTC derivatives. With a view to financial stability, according to Gyntelberg, the current crisis revealed several systemic risk factors related to OTC derivatives markets, in particular the lack of transparency (by making large exposures difficult to detect), insufficient financial resources to cover potential losses, and increased procyclicality. In light of these shortcomings, more recently there has been a strong push to introduce CCPs for CDS. In this regard, according to Gyntelberg, the introduction of well-designed CCPs can help to lower systemic risks by mitigating counterparty risks, increasing operational efficiency and improving market transparency. However, in his view there are certain challenges related to the introduction of CCPs, i.a. the need for (1) strong risk management standards, as CCPs by definition concentrate risks, (2) public support in crisis periods, (3) stepped-up international coordination of the oversight of systemically important CCPs, and (4) complementing the introduction of CCPs with improvements in the trading and settlement infrastructure.

Finally, *Nadège Jassaud,* Deputy Head of the Banque de France's Financial Stability and Markets Research Division and Chairwoman of the ESCB's CDS Task Force, presented the main findings of the Task Force report on "Credit Default Swaps and Counterparty Risk." In the first instance, Jassaud sketched the developments global CDS markets took in recent years, highlighting the difficulties in properly assessing the size of the CDS market given considerable differences in estimates between available data sources (BIS, ISDA, Depository Trust and Clearing Corporation). Against this background, Jassaud pinpointed four main features of the CDS market that play a role for financial stability: (1) the high and – due to the market exit of important players – increasing concentration of CDS markets, which is a major concern as regards counterparty risk, (2) the interconnected nature of the CDS market (i.e. strong trading ties between major market participants), which implies limited risk transfer and thus higher contagion risks, (3) the low degree of collateralization in banks' OTC exposures and (4) the price discovery function of CDS as a leading indicator for different markets, which raises the question of its reliability for pricing purposes in times of distress. In concluding, Jassaud highlighted some factors – such as improved data availability and quality, standardization and the establishment of CCPs – that might help mitigate counterparty (and systemic) risks.

The final session of the OeNB's 65th East Jour Fixe was chaired by *Peter Mooslechner*, Director of the OeNB's Economic Analysis and Research Department, and dealt with aspects related to emerging markets. In particular, Session 3 aimed to improve the understanding of the fundamental factors driving CDS spreads and markets in CESEE.

First, *Manmohan Singh* from the IMF's Monetary and Capital Markets Department dealt with CDS spreads in emerging markets in times of distress. In his presentation, Singh underscored the important role of CDS spreads as a leading indicator for sovereign risk compared to the EMBI+ subindex for individual countries. In this context, he stressed that CDS mispricing might magnify the financial distress of a sovereign. He then provided some evidence from Argentina and Brazil that reveals inconsistency between theory and practice in pricing CDS spreads in emerging markets. Subsequently, he argued that the process of deleveraging in the aftermath of the collapse of Lehman Brothers led to a negative basis (i.e. CDS spreads are below the bond spread curve), although crisis situations usually entail a positive basis. Moreover, this process of deleveraging was characterized by an acute shortage of high-quality collateral, rising costs of funding, worsening relationships between banks and hedge funds due to increasing counterparty risk and a lack of funding and liquidity in the course of the unwinding of the "shadow banking system." However, according to Singh prevalent bank regulations have also contributed to a negative basis.

The second speaker of this session, *Sergiu Manea,* Head of UniCredit Group's EEMEA Markets Department, talked about recent developments on the CDS market for CESEE sovereigns. He argued that the collapse of Lehman Brothers triggered a process of deleveraging and market exit, while at the same time increasing the need for hedging. As most markets lost liquidity, CDS very quickly turned from the "most fashionable investment product" to the "most fashionable hedge product." Given these adjustments, CESEE CDS markets temporarily stopped operating, with trading volumes collapsing and spreads skyrocketing. In this context, Manea, according to the degree of CDS market tensions, grouped the CESEE countries into three categories: (1) Russia, Ukraine and Kazakhstan (with CDS spreads temporarily reaching values of over 1.000 basis points), i.e. countries with generally low levels of sovereign debt, but experiencing severe banking sector problems with a feedback loop on sovereign default risks, (2) Hungary, Bulgaria and Romania (with CDS spreads of some 700 to 800 basis points), and (3) Turkey, the Czech Republic and Poland, which have been less affected (300 to 400 basis points). At the same time, Manea stressed that often CDS on Austria and Sweden were used as proxies for the CESEE region. In Manea's view, CESEE CDS markets are slowly starting to return to normal operation, an indication of which is that contracts are now again being traded over the full maturity range (one to five years).

Last but not least, *Lóránt Varga,* senior economist at the Financial Analysis Department of Magyar Nemzeti Bank, presented a case study on Hungary, focusing particularly on the information content of Hungarian sovereign CDS spreads. By way of introduction, Varga provided an overview of the structure, characteristics and functioning of the Hungarian sovereign CDS market, which is more important (in terms of outstanding amounts) and liquid than the secondary market of underlying Hungarian sovereign foreign currency bonds. In assessing the information content of Hungarian sovereign CDS spreads, Varga stressed the co-movement of Hungarian sovereign CDS spreads and foreign currency bond yield spreads in the long run (implying a basis close to zero), while admitting that the two rates may temporarily deviate from one another due to microstructural factors. On this note, the speaker underlined that Hungary's credit risk premium is primarily

defined in the Hungarian sovereign CDS market, implying that any new information pertaining to Hungary's credit risk is captured in the CDS spreads first and that foreign currency bond credit spreads merely adjust to the changes of CDS spreads afterwards. Based on a comparative international analysis controlled for credit ratings, Varga argued that the sharp increase of Hungarian CDS spreads in October 2008 seems to have been largely determined by adverse country-specific factors, while the considerable drop in CDS spreads since March 2009 can be mainly attributed to the improving global risk appetite.