

Chapter 20

The Rise of Credit Default Swaps and Its Implications on Financial Stability

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ABSTRACT

The credit default swap market has experienced an exponential growth in recent decades. Though the first credit default swap contract was negotiated in the mid-1990s, the market has enjoyed a surge of popularity beginning in 2003. By the end of June 2013, the outstanding amount reached 24.3 trillion dollars. It is mostly used to transfer or to hedge credit risk. Concurrently with the global credit crisis, several shortcomings in CDS markets have appeared. One of the obvious questions is whether they affect the stability of financial markets. In this context after broader exhibition of credit default swaps market, speculative use of CDS, inception of central counterparty, and transparency of CDS market is handled. As a conclusion, it is true that the CDS market still has some weaknesses, but it is no more prone to be destabilizing than other financial instruments. This is shown in this chapter.

INTRODUCTION

Credit derivatives are a kind of financial innovation in financial markets that allow investors to trade and manage credit risks (Hull, Predescu and White, 2004). A derivative is an instrument whose financial value depends upon the value of another asset. Derivatives is used either to take a position on the underlying asset, or to transfer or hedge risk. Depending on the asset class and type of instrument, derivatives can be traded through an exchange, or they can be traded in the over-

the counter (OTC) market. OTC trading enables market makers to customize transactions and serve the specific needs of users. Moreover, the absence of transparency requirements in the OTC markets has historically facilitated the ability of market makers to execute and hedge large sized trades in the OTC markets (Federal Reserve Bank of New York, 2011).

Credit default swaps are the most popular of all the credit derivative contracts traded. A credit default swap (CDS) is a financial agreement used to transfer credit risk between two parties. In a

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CDS, one party that is said to be protection buyer pays a periodic fee to another party that is said to be protection seller in return for compensation of default by a reference entity (Chaplin, 2005)

To evaluate stabilizing effect of credit default swaps, it important to understand how CDS market achieves an efficient risk management. Financial institutions, especially banks trade CDS for hedging and diversifying or allocating credit risks and for low-cost means of taking on credit exposure. Liquidity of CDS enables a suitable marketplace for trading or offsetting credit risk and allows allocation of financial market risks efficiently. Also trading of CDS increase the capital that is available for financing and leads to lower rates as risk premiums are reduced. For these and more other reasons CDS strengthen the financial system and deliver incredible value to the global economy. (ISDA, 2014) However, credit default swaps pose some risks and challenges to financial markets and stability of the financial system (Brown, 2010).

Especially after the financial crisis, some questions have arisen about the OTC credit default swaps, notably a lack of transparency to both regulators and the public, counterparty risk and speculative use of CDS. The aim of this study is to Overview the fundamentals of credit default swap market and its impact on stability of financial markets.

CREDIT DEFAULT SWAP FUNDAMENTALS

A credit derivative is a financial contract between two parties that reduces credit risk of bonds or loans. Owing to the standardization of documentation and diversification of participants, credit derivatives have experienced a tremendous growth. The credit default swap (CDS) is the milestone of the credit derivatives market (JPMorgan, 2006).

A credit default swap is a financial agreement between two parties to exchange the credit risk of a reference entity. The buyer of the credit default swap, called protection buyer, usually pays a periodic fee, swap premium, in return for compensation for credit event of the reference entity. The seller of the credit default swap is called protection seller. The seller collects the periodic fee and makes contingent payment upon a credit event (JPMorgan, 2006).

Except protection seller, protection buyer and swap premium other basic elements of credit default swaps are, reference entity, obligation and credit events. The reference entity refers to the issuer of the debt instrument like a corporation, sovereign government or a bank loan. A credit event refers bankruptcy or failing to pay outstanding debt obligations. (Anson et al, 2004). Furthermore, ISDA (2014) defined six different types of credit event in its documentation. These are bankruptcy, obligation acceleration, obligation default, failure to pay, repudiation/moratorium and restructuring.

Upon the occurrence of a credit event on a reference entity, protection buyer delivers defaulted bonds and/or loans to the protection seller. This defaulted bond or loan is delivered with a face amount equal to the notional amount of the credit default swap contract. In return protection seller delivers the notional amount on the CDS contract in cash. The buyer can deliver any bond issued by the reference entity meeting certain criteria in the contract. The value of the bond delivered is called the recovery rate, the price at which bonds or loans are trading when CDS contracts are settled. This CDS settlement process is called “physical settlement”. As an alternative to physical settlement, the buyer and seller can agree to unwind the trade based on the market price of the defaulted bond, for example \$40 per \$100. The protection seller pays the protection buyer the difference between

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