

COVER STORY | BY CLAIRE SPENCER

Regulating credit default swaps



Credit default swaps (CDS) became notorious in the days following the near-collapse of American International Group (AIG) last year, whose affiliate, AIG Financial Products Corp. (AIGFP), sold vast quantities of them during the boom years. A little-understood, and supposedly sinister and mysterious credit derivative contract, CDS soon became an unwitting part of the vernacular of the financial crisis. But it may have been unfairly maligned. CDS products are based on the concept of efficiently sharing and distributing risk, and are as such increasingly relevant in what is still a highly risk-averse market. Furthermore, where other credit markets have all but shut down, the CDS market has prevailed. As such, the position of the CDS market is by no means in jeopardy, although it is fair to say that levels of transparency and standardisation will have to increase to restore faith in the market.

The role of CDS in the financial crisis

The problems precipitated by failures in the

CDS market are one of the clearest examples of poor risk management afforded to us by the financial crisis. This is somewhat ironic, given that the underlying tenements of CDS were the efficient sharing and distribution of credit risk. But if lessons are learned from the financial crisis, there is no reason why it cannot continue to play an important role in the credit derivative market. So where did it all go wrong? “Problems arose when increasing amounts of correlated risk were efficiently shared on a global basis,” explains Julia Lu Fu, a partner at Richards Kibbe & Orbe LLP. “Distributing that risk freed individual participants to take on even more risk. Few thinkers focused on the growing total risk to the financial system, or, more importantly, the hidden risk of key market participants holding over-concentrated risk at central hubs of the system.” Ms Fu characterises the subsequent events as a “perfect storm” of six related elements: the collapse of the asset-based securities market associated with US real estate; the

string of large corporate defaults; the volatility of mark-to-market valuations; the immediate contractual demand for cash and collateral; the widespread liquidity freeze; and finally, the panic that ensued as a result.

However, it would be a stretch to cite CDS failure as a direct cause of the financial crisis, and subsequent analyses such as the Turner Review and the FSA’s paper ‘The Regulatory Response to the Global Banking Crisis’ have stopped short of doing so. Far more instrumental was the weighty presence of toxic asset-backed securities and collateralised debt obligations on the banks’ balance sheets, which led directly to the credit squeeze that floored financial institutions such as Bear Stearns and Lehman Brothers, and ultimately to the widespread turmoil that is only now beginning to calm. “If litigation trends are any barometer, and they usually are, the casualties of the CDS market this past year appear to have been driven primarily by the collapse of the subprime market, and not a systemic failure intrinsic to the CDS market,” confirms Brian Timmons, a partner and national co-chair of structured finance litigation at Quinn Emanuel.

In fact, the only notable case wherein CDS can be argued to have put a major financial institution at risk is AIG. “But the fact that AIG’s unregulated affiliate, AIGFP, was able to amass such a large position as a credit protection seller without adequate capital reserves to cover its obligations arguably represents a failure of AIG’s management and internal risk controls and the insurance regulatory regime applicable to AIG – including the failure of that regime to regulate in its entirety the holding company structure under which many insurance companies exist – rather than a condemnation of credit derivatives,” asserts David A. Trapani, of counsel at Morrison & Foerster LLP. Had AIGFP simply purchased the toxic assets on which it wrote protection, the outcome would have remained ►►

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the same – its real issue was its concentrated exposure to a single asset class without full or accurate knowledge of the associated risks.

Furthermore, unlike other credit markets, the CDS market has continued to function throughout the financial crisis, in spite of the challenges. For example, the surge in credit events that followed the collapse of Lehman Brothers was addressed by a number of successful settlement auctions. In addition, recent trade compression efforts have significantly pushed down the outstanding notional amount of CDS. So while it is clear that some entities have fallen foul of CDS in one way or another, there is no evidence of a systemic collapse. The CDS market is here to stay, but this is not to say that improvement is not required to address the conflict between its use and purpose – clearly, an instrument that has been designed to manage risk should not be increasing it.

Currently, both the use of CDS products and the infrastructure of the CDS market create a certain level of counterparty risk. When selling a CDS product, the seller (knowingly) takes on the risk that it will be making a pay-

ment to the buyer in the event that the reference entity defaults. To offset that risk, CDS dealers tend to maintain both long and short CDS positions, creating a network of potentially interdependent dealers. Naturally, this worked very well when defaults were rare but, as it happened, spectacularly badly when they occur en masse. However, things were even worse for AIG – they sold CDS products but did not generally buy them, and the ensuing calamity was only exacerbated by the downgrade in its credit rating, which left it unable to meet its collateral posting obligations. Had AIG been allowed to fail, it is highly likely that the web of interconnectivity would have also caused a number of its counterparties to fail, and a number of their counterparties, and so on.

As such, it can be assumed that the majority of CDS dealers, like AIG, did not accurately assess their exposure to counterparty risk. The reasons for this will vary, but it is fair to say that a large number of dealers just did not understand the risks involved. The structures of many CDS products are highly complex, and furthermore, few predicted the widespread correlation between defaults. So when sellers ‘knowingly’ took on the risk of a defaulting reference entity, they failed to realise that the risk was, in fact, more correlated than their internal modelling technology assumed, and over-concentrated as a result. “The over-concentration risk is not merely the concentration itself, it is the difficulty of identifying and managing the risk,” adds Ms Fu. “This is true at the levels of an individual institution, the regulators, and the market as a whole. The impact of over-concentration is not merely at time of defaults, but also the increased level of collateral requirement which puts an immediate strain on the capital resources.” She also warns that these risks are compounded by operational inefficiencies in trade processing – but it is almost impossible to determine the extent to which this occurs due to the opacity of the market.

Critics of CDS say that governments and regulators should have kept closer tabs on the use of CDS products. This is perhaps true to an extent – had governments been more aware of the risks inherent in the banking system as a whole, their eventual intervention would

have undoubtedly been more targeted and effective. In addition, it is arguable that they should have regulated the types of entity that are allowed to participate in the CDS market. “But government regulation is not a panacea,” argues Mr Timmons. “The total post-netting losses attributable to defaulted CDS with Lehman, Bear and AIG combined were smaller than the \$50bn in estimated losses attributable to Madoff’s advisory services firm, which was registered with and regulated by the SEC. There are areas where better government regulation may be warranted, but the CDS market is not one of them,” he asserts.

Improving the future

But clearly, the infrastructure of the CDS market is in need of some refinement to mitigate the risk of systemic collapse going forward. “Robust risk management must be conducted from an institutional and market-wide perspective,” recommends Ms Fu. “To that end, a single regulatory body needs to be established and granted oversight over the CDS market, not just segments of its participants. The oversight function must first monitor the market and its institutions, building upon mandatory record-keeping, and reporting requirements. Furthermore, more useful risk metrics need to be developed and, ultimately, capital reserve requirements may need to be imposed on CDS market participants to ensure their continuing ability to perform their financial obligations,” she says. Mr Trapani agrees in principle, but does not think that regulation is the only way to impose such requirements. “Prudent capital and margin requirements for large CDS market participants would help to reduce counterparty credit risk. However, some would argue that this could be implemented by market participants without regulatory intervention,” he says.

Regardless of whether it is a regulatory imperative or simply a guideline, any risk management framework must respect the interdependence of the CDS market, and will require both institutional and product-specific risk to be integrated into any protocols. Happily, this may already be happening, notes Mr Timmons. “The keys to addressing the risks and inefficiencies in the CDS market are already underway – a centralised exchange, and ▶▶

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greater disclosure requirements mandated by accounting standard boards, regulators and international bodies. As regulators focus reforms instead on the more fundamental aspects of the banking and credit system, the problems facing the CDS market will largely take care of themselves," he says. As such, it is hoped that the CDS market will see slow, organic improvement as a result of these actions.

Of course, there will be some downsides resulting from the increased oversight. "As the CDS markets further evolve and mature, the profitability for CDS dealers is likely to decrease," warns Mr. Trapani. "Increases in standardisation and transparency will result in decreased spreads, and market partici-

pants' costs will increase with the imposition of any new regulatory requirements, such as mandatory clearing for standardised CDS, increased capital and margin requirements, and reporting and recordkeeping requirements," he says. This is, ultimately, the cost of risk management, and is unlikely to change in the near future. Mr. Trapani adds that increased standardisation will facilitate increased use of clearing solutions for CDS. It may even lead to certain exchange-traded CDS contracts, but it remains to be seen whether margin requirements for single name CDS can be set at an economically viable level.

The tenets of CDS, namely, the efficient sharing and distribution of credit risk, are com-

pletely compatible with the post-crisis global economy. Furthermore, CDS can assume relatively little of the blame for the chaos experienced in the second half of 2008 – last year's casualties of the CDS market can be traced to the collapse of the subprime market, rather than a systemic failure from within the CDS market itself. Of course, there is still a chance that the CDS market will be subject to stricter regulation in the future, but there are serious questions as to whether this is worth the time and energy of regulators. Positive changes have already been made, with the eventual goal of creating a transparent CDS industry wherein benefits of CDS products to the global economy are clear for all to see. ■



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Julia Lu Fu specializes in representing investment banks, broker-dealers, hedge funds and other financial institutions in the international derivatives, bank loan and high-yield debt markets. Her practice focuses on derivative transactions and structured products relating to secured and unsecured loans, bonds and other debt instruments utilizing total return swaps, credit default swaps and

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In addition, Ms. Fu practices in the firm's distressed debt and claims trading practice areas where she represents clients in the purchase and sale of par and distressed bank loans, high yield debt securities, swap termination claims and other financial claims against troubled companies in the secondary debt market.