

CREDIT DEFAULT SWAPS AND COUNTERPARTY RISKS FOR EU BANKS

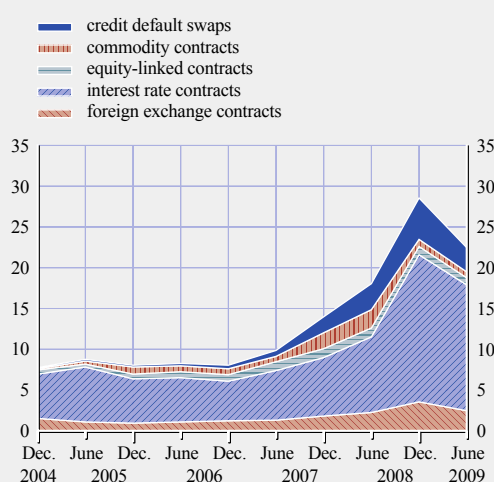
The financial turmoil has highlighted the importance of counterparty risk management for banks. An issue of particular relevance in this context has been counterparty risk that may crystallise through the over-the-counter (OTC) derivatives markets, as shown by the acute difficulties experienced by market participants in the aftermath of the default or near default of Bear Stearns, Lehman Brothers and AIG. These cases have highlighted the typically opaque linkages within the OTC markets, which led to a situation in which some market participants may have become too big or interconnected to fail. In view of these developments, the ESCB's Banking Supervision Committee (BSC) carried out a study aimed at assessing the counterparty risk and the main related risks faced by European market participants that are active in, and exposed to, the credit default swap (CDS) market. The report was based on survey data collected from a sample of 31 EU banks, as well as from a number of public and private data sources, and has benefited from market intelligence. This box summarises some of the main findings and policy measures outlined in the report.¹

In terms of the gross market value, which is a measure of counterparty risks, the CDS market increased from USD 133 billion in December 2004 to USD 5.7 trillion in December 2008 and then decreased to USD 3 trillion in June 2009. It constitutes the second largest financial derivatives market after that for interest rate contracts. Increased volatility and the repricing of credit risk in the market have been the major drivers of the rapid increase in gross market values from mid-2007 to early 2009.² Amid the improving financial market conditions in the first half of 2009, CDS spreads tightened and volatility decreased, which led to a substantial decrease in gross market values for all OTC market contracts (see Chart A).

As an OTC market, the CDS market is dependent on dealers, which provide liquidity to the market by acting as market makers. That said, the concentration risk within the CDS market has increased since the outbreak of the financial market turmoil, in particular on account of the failure of Lehman Brothers and the exit of some major dealers or counterparties that used to be sellers of protection such as "monoline" financial guarantors, credit derivative product companies or hedge funds. Consequently, liquidity risk would also increase in the event of the failure of

Chart A Gross market values for OTC derivatives

(Dec. 2004 – June 2009; USD trillions)



Source: BIS.

1 ECB, *Credit default swaps and counterparty risk*, August 2009.

2 Gross market value is the value of all open contracts before counterparty or other netting. Once CDS spreads widened for many contracts, the current market CDS spread deviated substantially from the contractual CDS spread, agreed at the beginning of the contract. This led to increases in positive market values of contracts held by protection buyers and increases in the absolute value of negative market values of contracts held by protection sellers.

another dealer, which would probably result in higher bid-ask spreads and a reduced ability of market participants to perform transactions on the market.

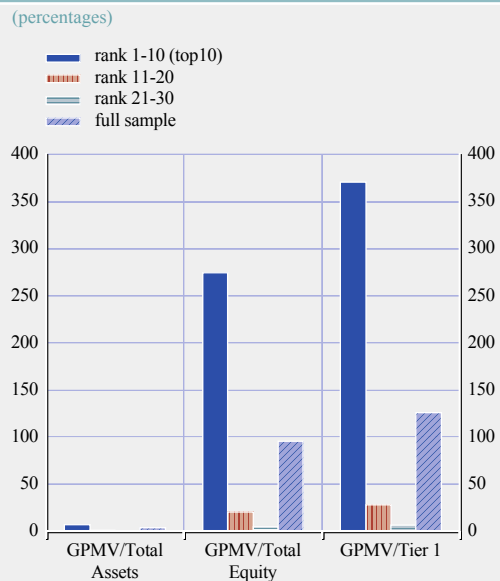
Counterparty risk has uniformly been the main concern of EU banks in their feedback on the BSC survey. In terms of concentration, the top ten global counterparties of the largest EU banks surveyed in the CDS market account for between 62% and 72% of their CDS exposures.

Furthermore, CDS counterparty exposures relative to bank capital are the highest for the largest EU banks surveyed. Gross positive market values accounted for more than 350% of their Tier 1 capital, compared with 125% for the average bank in the sample (see Chart B). The survey results also showed that only approximately 44% of the surveyed banks' exposures to OTC derivatives were collateralised as of December 2008.

Apart from increased market values, this relatively low level of collateralisation may have been caused by a lower participation of hedge fund counterparties – which tend to be regular users of collateral – and by exposures of banks to non-financial corporations and insurance companies, which are not collateralised. Furthermore, several European banks retain exposures to legacy CDS contracts from “monoline” financial guarantors and credit derivative product companies, which are not collateralised. All in all, given the current collateralisation levels of outstanding CDS contracts and outstanding exposures to non-collateralised legacy CDS contracts, the counterparty risks remain substantial.

The report also found that current data sources would benefit from further harmonisation and bridging to allow market participants and regulators to obtain and benefit from a broad and consistent market overview. The gross notional amounts of CDS contracts, such as those reported by the Bank for International Settlements (BIS) and the Depository Trust & Clearing Corporation (DTCC), are total notional amounts of all transactions that have not yet matured, prior to taking into account all offsetting transactions between pairs of counterparties. The net notional amount constitutes the basis for calculating net payment obligations in a credit event, with due consideration of all offsetting transactions between pairs of counterparties. The DTCC provides net notional data for single reference entities comprising the sum of net protection bought and sold across all counterparties. The BIS also produces the gross market values of CDS contracts, representing the value of all open contracts before counterparty or other netting. The marked-to-market value of a CDS on a given reporting date is the cost of replacing the transaction on that date. The gross market value is not an accurate measure of counterparty risk, however, since it does not take into account the effect of netting for each pair of counterparties. The net market value (also referred to as the gross credit exposure) is calculated by banks across all OTC derivative positions and would be a measure of counterparty risk, assuming that there

Chart B Gross positive market values relative to assets and capital



Source: Banking Supervision Committee.
Note: GPMV = gross positive market value.

was no collateralisation. The counterparty exposure that remains after collateralisation, however, would be the genuine counterparty risk. Given the currently regularly disclosed or available data, however, the net CDS exposures of the euro area banks cannot be assessed separately.³

Regarding policy measures, public disclosure should be improved. Although institutions reporting under the International Financial Reporting Standards (IFRSs) report derivatives exposures on their balance sheets, the institutions with highest exposures to the CDS market could regularly disclose their total gross notional amounts and gross market values for bought and sold CDSs, as well as net market values for uncollateralised transactions in derivatives. This information could also be provided on individual institutions' largest counterparty positions, and could be disclosed in their financial statements. Also, improved price information for non-dealers, as well as an enhanced transparency of turnover volumes for trades, would be desirable for both non-dealer market participants and supervisors.

An important way to reduce counterparty risk in the CDS market is to establish a central counterparty, which may reduce the system-wide counterparty risks embedded in the transactions and increase market transparency. Few central counterparties have already been launched and some more are being developed. Given the role that will be played by such central counterparties, it will be crucial to ensure that the stand-alone central counterparties are robust and efficient, operating with appropriate risk management and with a capital and regulatory structure that will minimise risks to financial stability.

³ For US banks, the securities and Exchange Commission collects and publishes detailed information on their CDS positions.