The popularity of credit derivatives first came into play at the early 1990s

Finance, Banking

Introduction

The popularity of Credit Derivatives first came into play at the early 1990s, when Demchak (Team leader at JP Morgan, responsible for creating CDO's) and his team have invented these financial instruments (Eisinger 2008). After thefailureof the Bretton woods system in 1971, the economy faced a stable state with low interest rates. Banks struggled for profits with a low demand for loans. In these financial circumstances, banks lacked methods that avoid them from bankruptcy, and guarantee that they could survive independently and remain solvent on the collapse of the economy. Credit derivatives were born of such concern, allowing bankers, and others, the ability to reduce their risk by selling risk to other parties (Ayadi, Behr 2009). This paper gives a general overview on the concept of credit derivatives. In its opening section, this paper introduces credit derivatives definition, structure, and its usefulness in the financial market will be introduced. The essay then goes on to review the existing credit derivatives markets regulation and explains the need to regulate these markets in light of the recent financial crisis. Although credit derivatives may have beneficial effects, but it can only be obtained if credit derivatives are used responsibly by all market participants. This essay will argue that the current regulatory regime is not sufficient to induce market participants to use credit derivatives in a desirable way.

Credit Derivative Overview

Credit derivatives are financial contracts that effectively shift credit risk, or the default risk, from one party to another. In so doing, for example, Paula

Tkac (2007) describes that if participants default on their bond payment, the bond value decreases. The credit derivative, consequently, transfer this credit risk to another market participant for a specific periodic payment.

Credit derivatives have achieved a marvelous growth throughout the past decades. According to the British Banker's Association (BBA), the global outstanding notional volume of credit derivatives was 180 billion USD in 1996. After a decade, the market size of derivatives had increased 112 times the previous size in 1996 with a 20 trillion USD of derivative contracts. Only 2 years later, by mid-year 2008, and as it is shown in the figure 1 below, the fair value of the outstanding amount of credit derivatives was 53. 3 trillion USD, reflecting the continuous growth of this market.(Ayadi , Behr 2009)

Structure of Credit Derivatives

Credit derivatives can be categorized as portfolio credit derivative (single name) or asset backed security (multiname) (Mengle 2007). The most popular single-name derivative is the credit default swap " CDS". Shah Gilani (2008) illustrates that this is a contract that provides insurance from default risk of a specific party. This party is known as the reference entity and the default risk is identified as a credit event. In a CDS, the buyer of the insurance obtains the right to sell bonds issued by the party for their face value when a default takes place; also, the seller of the insurance agrees to buy the bonds for their face value when the default occurs (Gilani 2008). This face value is known as the CDS notional principal and the periodical payment the buyer of the CDS pays is known as the credit spread (Gilani 2008). On the other hand, the most popular asset backed derivative is the

collateralized debt obligation (CDO). This derivative is created by packaging a pool of similar assets or loans into one single investment that can be traded (Mengle 2007). When a CDO is purchased, the investor ends up with a basket of bonds. This portfolio of bonds generated an income that is used to provide a promised return to tranches. (Mengle 2007)

The significance of Credit Derivatives

According to David Mengle (2007), credit derivatives came out in response to two traditional problems facing the banking system. First, taking a short position in credit was not possible. Thus, a lender cannot fully insure the safety of the loan from default. Second, diversification of credit risk was difficult to achieve and became a problem in the financial market. Given such problems, the only way to enhance the financial world is by the creation of the credit derivative market. These derivatives helped banks to buy ‘ protection’ (insurance) through allowing banks to sell credit and hedge their exposure to credit losses. Moreover, using the single-name derivative CDS do not require any permission from the reference entity (Gilani 2008). Therefore, Mengle (2007) believes that the second problem can be solved when lenders hedge and reduce their exposure to risky investments, and by that they achieve diversification.

Particularly, Ayadi and Behr (2009) researched and found out thatthe increased use of hedge funds provided an essential source of liquidity in credit derivative markets. This helped banks in reducing their credit risk by allowing them to transfer assets and credit risk off their balance sheets. Also,

it improves their liquidity by providing secondary markets for credit risk. (Ayadi, Behr 2009)

Credit Derivatives and the Financial Crisis

It is often argued that the flip side of credit derivatives played a major role in the collapse of the financial market. First of all, critics of credit derivatives, such as Tim Weithers (2007), claim that risk transformation ballooned systematic risk, given the difficulty of identifying participants holding the credit risk. Some complain that the CDS notional amount accounting requirements worsen the credit crisis for many financial institutions (Partnoy 2009). Yet, supporters, such as David Mengle (2007), counter that if banks had properly valued their risk exposures at the beginning, they would avoid crash when crisis hit.

Second, the argument that credit derivatives increase overall risks by transforming credit risk to less experience with less regulation institutions makes an implicit assumption that government regulation automatically leads to more cautious risk-taking (Partnoy 2009). But this argument ignores the potential moral hazard associated with such an assumption. David Mengle (2007) illustrated that where he believed that unregulated institutions are not protected by the government, such institutions are likely to have incentives to manage credit exposures. (Mengle 2007)

Nevertheless, in almost twenty years, credit derivatives have expanded from nothing into a $54. 6 trillion market. Nicholas Varchaver, senior editor and Katie Benner, writer-reporter (2008) found that this increase is because an

investor does not have to own a bond to buy a CDS on it – anyone can place a bet on whether a bond will fail. Indeed, they believed that the majority of CDS now consists of bets on other people's debt.

But, and on the contrary, this problem occurred due to the lack of financial regulation. The supporters of the credit derivatives believe and agree with other critics that these risk financial contracts led to a financial collapse (Mengle 2007). However, the unregulated area of the credit derivatives led to misusing these instruments. For example, during President Clinton phase, the Housing and Urban Development (HUD) secretaries started regulating banks to lend to the poor more (Partnoy 2009). They expected Banks to loosen their lending standards. Yet, Banks undertook investment banking. Specifically, Banks started lending to people whose credit history was suspect and who couldn't afford mortgage payment (Partnoy 2009). Thus, credit derivatives were used in a wrong manner and led to the deterioration of the financial market.

Credit Derivatives Regulation

There has been high level of concern withrespectto what regulatory steps should be taken to use credit derivatives properly. Ayadi and Behr (2009) have demonstrated several methods that help in regulating credit derivatives properly. First, companies and banks should provide higher transparency through additional reporting requirements. Second, systemic risk should be reduced through the creation of central counterparties (CCPs) for standardized contracts. Finally, banks should impose higher capital requirements for at least some of the market.

Yet, these regulations do not mean that credit derivatives are safe from improper use. For example, the creation of CCP's concentrates the risk in a small number of institutions and creates institutions that are too big to fail. Moreover, high transparency has an impact on market quality and in particular on market liquidity. Madhavan (1995) studied the relation between the market and the availability of trading information to market investors. He shows that fragmented markets are highly demanded by some market participants where their trades are unknown. Madhavan (1995) also shows that greater transparency reduces price volatility.

Conclusion

Credit derivatives are financial instruments used for credit risk management purposes. The structure of these derivatives enhanced the world financial market and provided a safer investment for banks especially. However, these complex derivative contracts have led to the recent economic collapse. The regulation measures included a lot of mistakes and have lead to the fact that financial institutions created such complex CDO's and sold them without fully understanding them. Also, the availability of unregulated areas helped in misusing credit derivatives. The true purpose of derivatives was for managing risks and not blind speculation. Thus, if simple derivatives such as put, call options, interest swaps and futures are used wisely, they can be used in productive, safe means. In conclusion, the financial market is exposed always to new participants with new mentalities. Therefore, regulating credit derivatives will not avoid financial crisis in the future if there are no strict control on new participants entering the field.

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