ISDA Research Notes

CDS Market Summary: Market Risk Transaction Activity

October 2013

Summary

Has the CDS market increased or decreased in size over the past several years?

On the one hand, the aggregate level of CDS notional outstanding has decreased. This suggests a reduction in market activity. On closer examination however, it becomes apparent that this decrease in notional outstanding is attributable to portfolio compression[1], which is a widely used tool designed to eliminate transactions and reduce risk. Portfolio compression (also called trade tear-ups) has made a great impression on the CDS market.

A much better way to understand CDS market dynamics is by looking at trading activity in the market, as opposed to transactions outstanding at a point in time. The DTCC measures ***market risk transaction activity*** which refers to the volume of trading (using both transaction counts and notional amounts traded) related to new transactions that affect market risk. It provides a view into current levels of new market activity and enables comparisons of such activity between periods.

An analysis of market risk transaction activity data from the DTCC CDS Trade Information Warehouse (TIW) for the periods of February through July in 2011, 2012 and 2013 shows that:

- CDS market risk transaction activity, as measured by notional amount traded, increased 15% in the 2013 period vs. the 2012 period after dipping slightly in the 2012 period vs. the 2011 period.
- The number of CDS transactions executed increased for the past two consecutive years.
- Growth in notional volumes and trade counts related to new market risk transaction activity was driven by an increase in CDS index trading. Trading in CDS single names declined during the period.
- Aggregate notional outstanding continues to decline, reflecting the success of industry compression efforts.

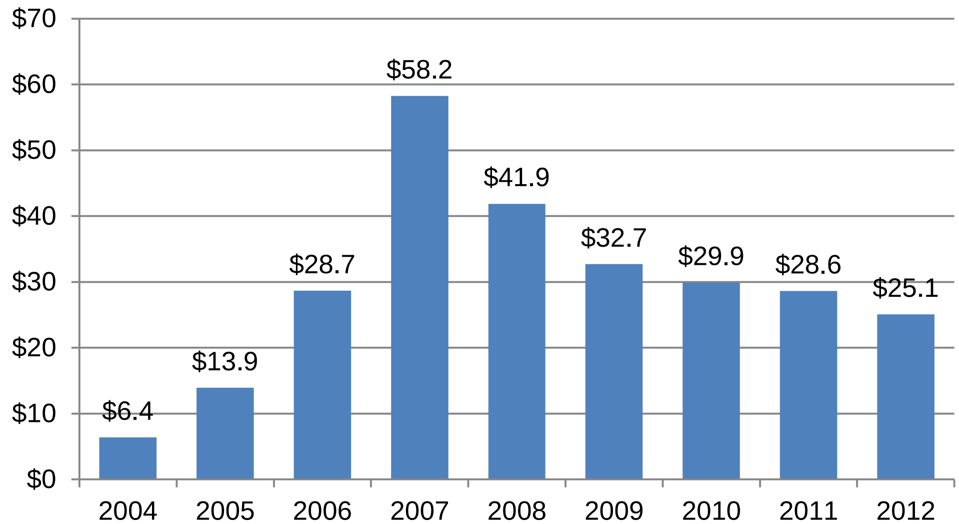
Market risk transaction activity data is available from the DTCC Trade Information Warehouse and is published publicly on their website. A new website being developed by ISDA with DTCC's cooperation is intended to make the data more accessible.

[1] According to the Bank for International Settlements, portfolio compression "is a process that enables early termination of economically redundant derivatives trades without changing the net position of each participant." It does so by terminating existing trades (including on single name reference entities and on indices in the CDS market) and replacing them with a smaller number of new trades with substantially smaller notionals that carry the same risk profile and cashflows as the initial portfolio. In so doing, portfolio compression reduces the overall notional size and number of outstanding contracts in derivatives portfolios, thereby improving derivatives risk management.

CDS Notionals Outstanding

Using raw data based on notionals outstanding, the CDS market appears to have experienced both tremendous growth and tremendous contraction. Chart 1 graphically shows the changes since the BIS first started reporting CDS notionals in 2004. As can be seen, CDS notionals doubled each year from 2004 to 2007. In 2008, and in every subsequent year since then, CDS notionals have declined.

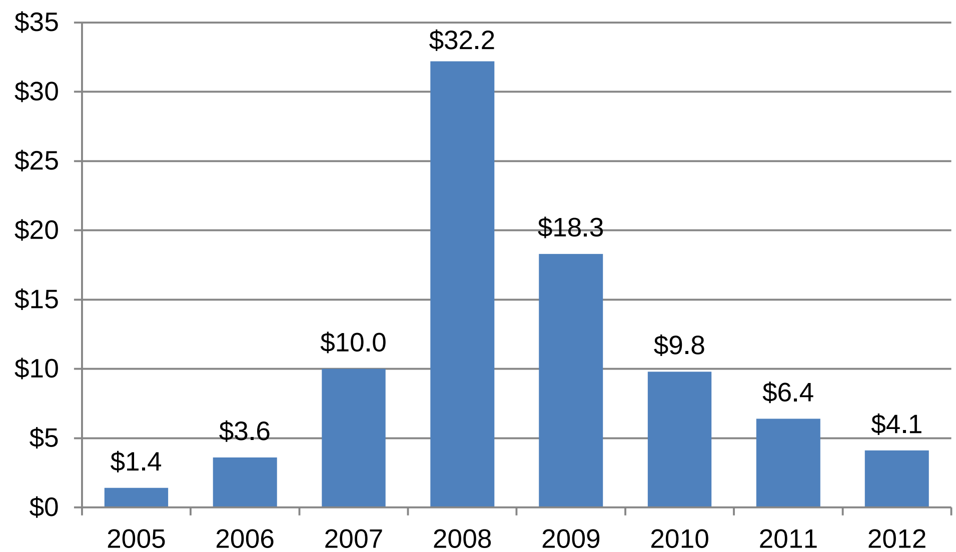
Chart 1: Annual CDS Notionals Outstanding ($tn)



Source: BIS Semiannual OTC Derivatives Statistics

The decrease, however, has been caused by portfolio compression (also called trade tear-ups), which eliminates trades and reduces notionals outstanding. As per Chart 2, portfolio compression has eliminated $85.7 trillion of CDS notional through year-end 2012.

Chart 2: Annual CDS Portfolio Compression ($tn)



Source: TriOptima; Markit

CDS Market Risk Activity

Notionals outstanding, which historically has reflected market activity on a cumulative basis, is one way to measure the size of the CDS market. But compression greatly impacts this number. (Clearing also has an impact, in the opposite direction of compression, as one bilateral trade becomes two cleared trades.)

A better way to look at the relative dynamics of the CDS market is to analyze new market risk transaction activity. Market risk transaction activity includes the following transaction types: new trades between two parties, a termination of an existing transaction, or the new leg of a trade that has been assigned from one party to another.

Market risk transaction activity is available on DTCC's website. This includes historical data files for all published reports; DTCC first began to track market risk transaction activity for single-name CDS in July 2010 and did so for CDS index trades in mid-January 2011.

For the purposes of our analysis, we looked at the period from February to July in the past three years. Doing so enabled us to analyze and compare market risk transaction activity in 2011, 2012 and 2013. The analysis reveals several interesting trends.

- ***The notional amounts of new CDS market risk transaction activity decreased slightly in 2012 and increased in 2013.***

As can be seen in Chart 3, market risk transaction activity was $15.2 trillion in 2011, and was $15.0 trillion in 2012. Market risk transaction activity in the February-July period of 2013 was $17.3 trillion, a 15% increase over the 2012 period.

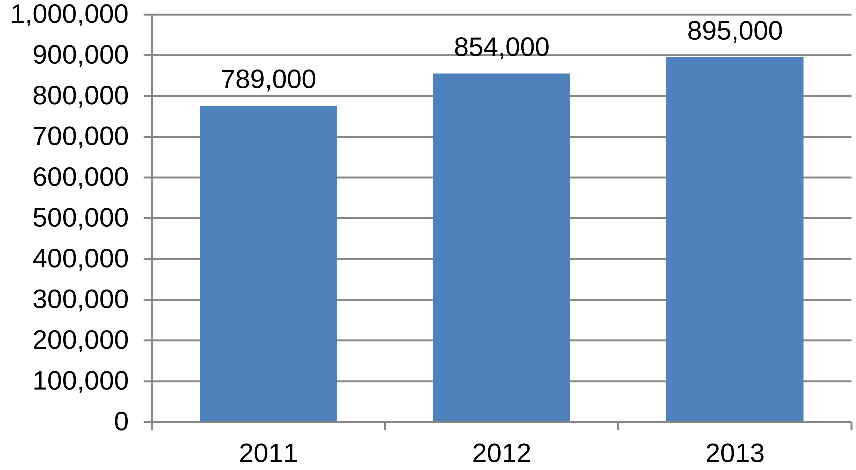
Chart 3: CDS New Market Risk Transaction Activity ($tn)
6-Month Gross Notional Comparison (February - July)

Source: DTCC Market Risk Transaction Activity statistics

- ***The number of trades associated with market risk activity also increased during both periods.***

As shown in Chart 4 on the next page, the number of trades associated with market risk activity rose during the February-July periods from 789,000 in 2011 to 854,000 in 2012 (an 8% year-over-year increase) to 895,000 in 2013 (a 5% year-over-year increase).

Chart 4: CDS New Market Risk Transaction Activity
6-Month Trade Count Comparison (February - July)



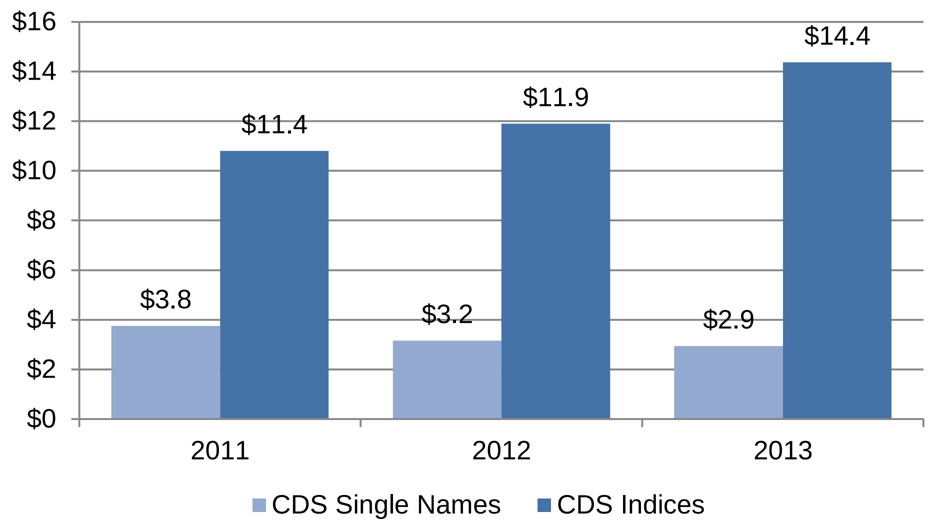
Source: DTCC Market Risk Transaction Activity statistics

- ***Growth in notionals and trade counts related to new market risk activity was driven by an increase in CDS index trading. Trading in CDS single names declined during the periods.***

Charts 5 and 6 below illustrate market risk transaction activity broken out by notionals and trade count for both CDS single-name and index trades.

The volume of credit default swaps measured by notionals associated with single-name CDS market risk transaction activity decreased from $3.8 trillion in February-July 2011 to $3.2 trillion in the 2012 period and to $2.9 trillion in the comparable 2013 period. Notionals related to market risk transaction activity for CDS index trades rose 4% in 2012 over 2011 and increased 21% in 2013 over 2012.

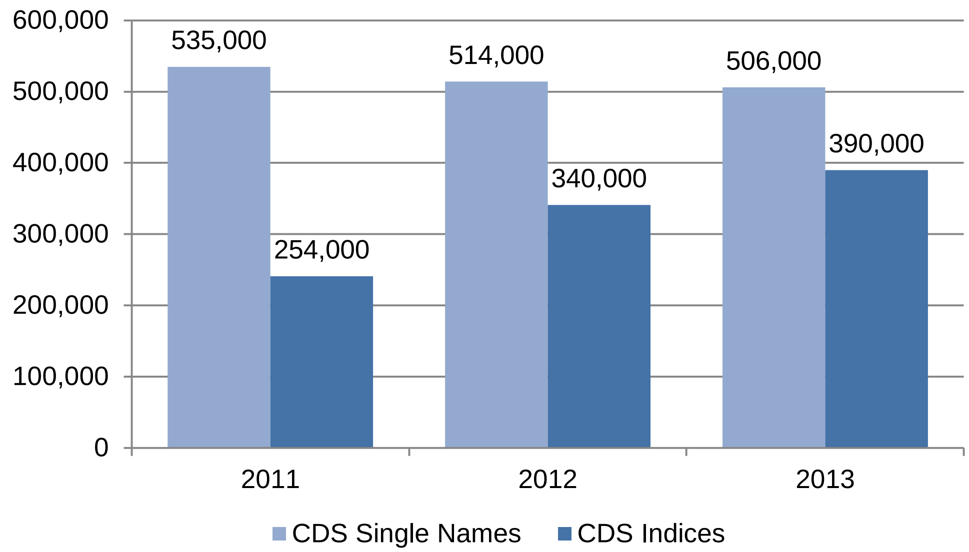
Chart 5: CDS New Market Risk Transaction Activity ($tn)
6-Month Gross Notional Comparison (February - July)



Source: DTCC Market Risk Transaction Activity statistics

A similar trend occurred with regards to CDS single name and index trade counts. Trade counts for CDS single names fell from 535,000 in February-July 2011 to 514,000 in the same period in 2012 and to 506,000 in the same period in 2013. Trade counts for CDS index market risk transaction activity increased 34% in 2012 over 2011 and more than 14% in 2013 over 2011.

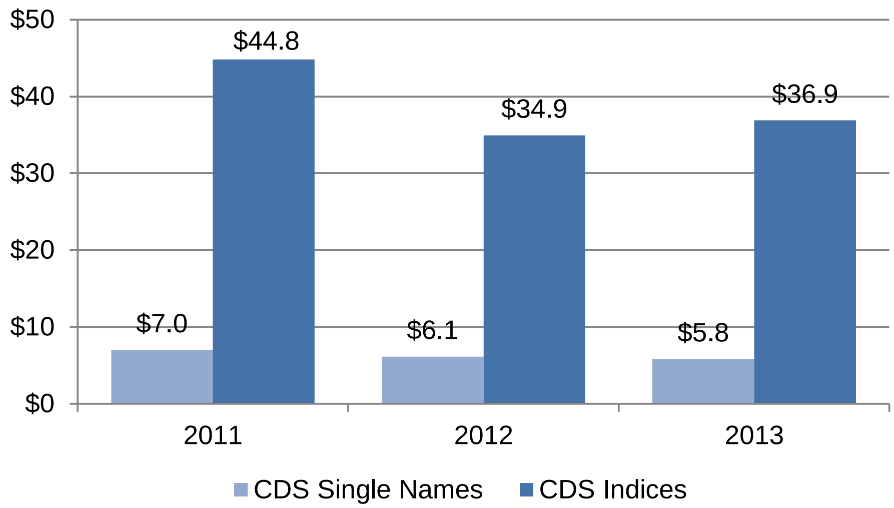
Chart 6: CDS New Market Risk Transaction Activity
6-Month Trade Count Comparison (February - July)



Source: DTCC Market Risk Transaction Activity statistics

Interestingly, as shown in Chart 7, the average size of new CDS market risk transaction activity has changed over the past several years. For single-name CDS, it declined for two consecutive years. For CDS index trades, it decreased in 2012 compared to 2011, then increased modestly in 2013 over 2012.

Chart 7: Average Notional Amount Trade Size of
New CDS Market Risk Transaction Activity ($mn) (February to July)



Source: DTCC Market Risk Transaction Activity statistics

Conclusion

In the post-compression era, market risk transaction activity, which measures trading volume during a period of time, not notionals outstanding at a point in time, is the optimal measure for understanding and analyzing CDS market activity. A review of such activity for a six-month period (February through July) in 2011, 2012 and 2013 shows that CDS transaction volumes as measured by notionals increased during the 2013 period on a year-over-year basis after falling slightly in the 2012 period compared with the prior year. The number of CDS trades executed increased for both periods. Growth was driven by an increase in CDS index trading.

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