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The Study Group for Internationalization of Capital and Financial Markets in Japan

Recent Developments in Credit Derivatives market and the Challenges for Japan

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Agenda

• Overview of Credit Derivatives
• Motivations for using credit default swaps (CDS) and the Recent Developments
• Challenges for Credit Derivatives Market in Japan
Facts about ISDA

• Incorporated in 1985 with 10 dealer member firms.
• April 2007 membership: Total 789
• Offices
  • New York: Headquarters
  • London: 1996
  • Tokyo & Singapore: 2000
  • Also, Brussels & Washington DC
ISDA’s Mission

Primary purpose is to encourage the prudent and efficient development of the privately negotiated derivatives business by:

- Documentation: to promote efficient conduct of the business. Promoting the development of sound risk management practices.

- Fostering high standards of commercial conduct

- Advancing international public understanding of the business

- Educating members and others on key issues affecting them.

- Creating a forum for the analysis and discussion of, and representing the common interest of its members on, these issues and developments.
Overview of Credit Derivatives
What are credit derivatives?

• A credit derivative is a privately negotiated, off balance sheet agreement that explicitly transfers credit risk from one party to another.
  – The buyer of credit derivative protection need not own the defaulted asset in order to receive compensation on a credit derivative.
  – The buyer of protection need not suffer an actual loss to receive compensation

• Types of contract
  – Credit default swap
    • Single name
    • Portfolio and index
    • Synthetic securitization
  – Total return swap
  – Credit spread option
Credit default swaps

- **Protection buyer** pays premium for protection against default by Reference Entity on specified (notional) amount of exposure.
  - Trade confirmation specifies the Reference Entity, the relevant credit events, the underlying notional amount, and the premium paid by the buyer.
  - If reference entity defaults or other credit event occurs, seller compensates buyer with default payment equal to net loss.
- **Protection seller** receives the premium.
- **Reference entity**

- Notionals are typically USD 10–20 million for investment grade credits.
Results of hedging with credit default swap

- **Protection buyer (Short credit)**
  - Gives up exposure to default of Reference Entity without removing reference asset from balance sheet
    - Also reduces concentration risk
    - Gives up opportunity to profit from taking on credit risk
  - Takes on counterparty credit exposure to protection seller
    - Simultaneous default by Reference Entity and protection seller
    - Default by protection seller only, necessitating replacement of protection

- **Protection seller (Long credit)**
  - Takes on exposure to Reference Entity without need for funding underlying position
  - Possible counterparty exposure to default by protection buyer if CDS subject to close-out (i.e., loss of remaining premium income)
Credit derivatives market statistics

All credit derivatives (BBA)

- British Bankers’ Association (BBA) Credit Derivatives Report 2006
  - Notional principal outstanding for all credit derivatives was over $20 trillion at end of 2005
  - Single name CDS are 33% of market, index/tranche trades are 38%, and basket CDS are 2%
  - Most common term is 5 years, with increasing liquidity in 7 years

Credit default swaps (ISDA)

- ISDA Market Survey Year 2006
  - Notional principal outstanding of credit default swaps was $34.5 trillion as of December 31, 2006
  - Sample is 90 ISDA primary members (including all major dealers)
Motivations for using credit default swaps (CDS) and the Recent Developments
Motivations for using credit default swaps

• **Protection buyer (Short position)**
  – Hedging credit exposure through short position (previously not feasible)
    • Reducing credit concentration
    • Free up credit lines
  – Acting on a negative credit view
    • Short a credit (not feasible prior to credit derivatives)
    • Buy protection in anticipation of appreciation in price of protection (or deterioration in reference credit)

• **Protection seller (Long position)**
  – Diversify portfolio by adding desired credits
  – Act on a positive view of a credit (opposite of above)
  – Reduce funding costs (synthetic lending)

• **Additional benefits of credit default swaps**
  – Transparency: CDS provide a source of credit pricing information
  – Flexibility: CDS make it possible to unbundle credit risks from other risks
Increased Flexibility for Banks from CDS

- Traditionally, banks could only lend and hold.
- With securitization and, in some markets, an increasingly liquid secondary loan market, banks can lend and sell, but this can create relationship issues with the borrower.
- With the development of credit derivatives, banks can now: LEND AND HEDGE
Lending and Hedging Interaction

• Two hypotheses about effect of hedging tools on bank’s lending decisions:
  – Banks will, in the aggregate, lend more money
  – Banks will, on balance, lower their credit standards because they know they can lay off the risk through CDS

• Experience has shown that banks will typically lend more by virtue of the ability to hedge credit risk:
  • Frees up lines of credit with valued customers
  • More loans will, most likely, mean more defaults, but not necessarily a higher rate of default.
Do Banks Lower Lending Standards Because They Can Hedge?

- Suggestion is that banks are less rigorous in their credit review because they know they can lay off the credit risk they have taken on.
- Reality is that credit decisions are far more complex now.
  - Lending decision: all the same considerations apply
  - Hedging decision adds layers of analysis
    - Counterparty risk
    - Price of the hedge--hedge is not without cost
    - Give up any gain from an improving credit
- One credit decision becomes many, making it even more important to get it right.
Recent Developments in CDS

- **Operational Issues**
  - Confirmation Backlogs
  - Novations

- **Settlement Process**
  - Movement from physical to cash

- **Diversity of Market Participants**
  - Hedge funds
  - Asset managers
  - Corporates and individuals?

- **Exchange-traded Credit Derivatives**
Challenges for Credit Derivatives Market in Japan
Challenges for credit derivatives market in Japan

• **Market factors**
  - Lack of market volatility and liquidity
    • Corporate bonds/loans secondary markets are still at the early stage of development
      – buy and hold investors --- Strategies taken by end-users are biased
      – absence of hedge funds who do short-term trading
  - Credit Spread is too tight
    • No incentive to hedge with credit derivatives
Challenges for credit derivatives market in Japan

• Regulatory factors
  – Accounting mismatch
    • Loans and lending-related commitments – accrual accounting, with credit loss provisioning
    • Derivative hedging instruments – Mark-to-market accounting
    • Result is interim earnings volatility that is not reflective of a firm’s economic position
  – Regulation to limit big loans to a borrower – banks cannot enjoy benefits if hedging with CDS
Challenges for credit derivatives market in Japan

• Banking Practices
  – “Overbanking” – traditional loan competitions deteriorate the credit spread (→market factor)
  – Relationship banking is still dominant in Japanese banks, which tend to tighten the credit spread (→market factor)
  – In a traditional banking culture, laying off credit risk that a bank decided to take on tend to be considered “not appropriate”
  – Lack of business recognition in trading credit risk
Challenges for credit derivatives market in Japan

• **Human resources**
  – Lack of (or limited number of) specialists in credit market (i.e. Quants, Analysts, Risk Managers)
  – Too quick personnel reshuffle

• **Others**
  – Systems/infrastructure
  – Lack of client knowledge of the product
  – Complexity of documentation (owing partly to the fact that it is in English)