

Credit Derivatives: Tools for Market Efficiency, or Weapons of Financial Destruction?

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The Answer: Both....

....Like many things

- Products invented for hedging
- Evolved in use and in complexity, and created new risks
- Counterparty and infrastructure risk became destabilizing
- Opportunities to address product and market weaknesses

Public Image of CDS and Structured Credit Products

- Widely considered an accelerator of recent market problems
 - Amplified volatility
 - Enabled bear raids
 - Created complex inter-connectedness
- Are CDS useless for risk managers?

Origins of Credit Derivatives

- Natural progression of derivatives technology
- Originated as hedges for bank portfolios
- Helpfully reduced concentration risks
- Provided flexibility for investors
- Made market view of credit risk more transparent

Features

Over-the-Counter Market

- Embedded leverage
- Dealers take counterparty risk
- Easy to customize trades
- Typically have delivery obligation
- So, potential challenges: counterparty, liquidity, basis and settlement risks

Some Uses of Credit Derivatives

- Hedges for bank portfolios
- Risk mitigation for long investors
- Directional investments (Long or Short)
- Raw Material for Retranching Structures

Example: ABS CDS

- Default swaps on asset-backed securities
- “Pay-as-you-go” swaps
- Useful innovation for risk management: Hedge mortgage inventories for securitization issuers
- Key change: no requirement to deliver physical security
- Implications...

New Observations

- Signaling
 - Market spread movements
 - Dealer behavior
- Novation concentrations
- Wrong way trades
- Margin inadequacies

Evolving Risk Mitigants

- Central Counterparty
- Changes in margining terms
- Clear default settlement protocol
- Transparency for bespoke structures