Overview of Developments in the Credit Derivatives Market (2012-2013)

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Substantial changes have taken place in the credit derivatives market over recent past. In fact, the market passed through some of the toughest challenges for any instrument. After taking the brunt of the blame for being the cause behind the crisis, and being dubbed as a weapon of mass destruction, credit derivatives have continued to remain as a potent tool for generalised trading in credit as a commodity. In addition, the market passed through the spasmodic change in the decision of ISDA about whether a credit event had happened with respect to Greece. This article reviews the developments in the global credit derivatives market through 2012 and 2013.

Market Activity

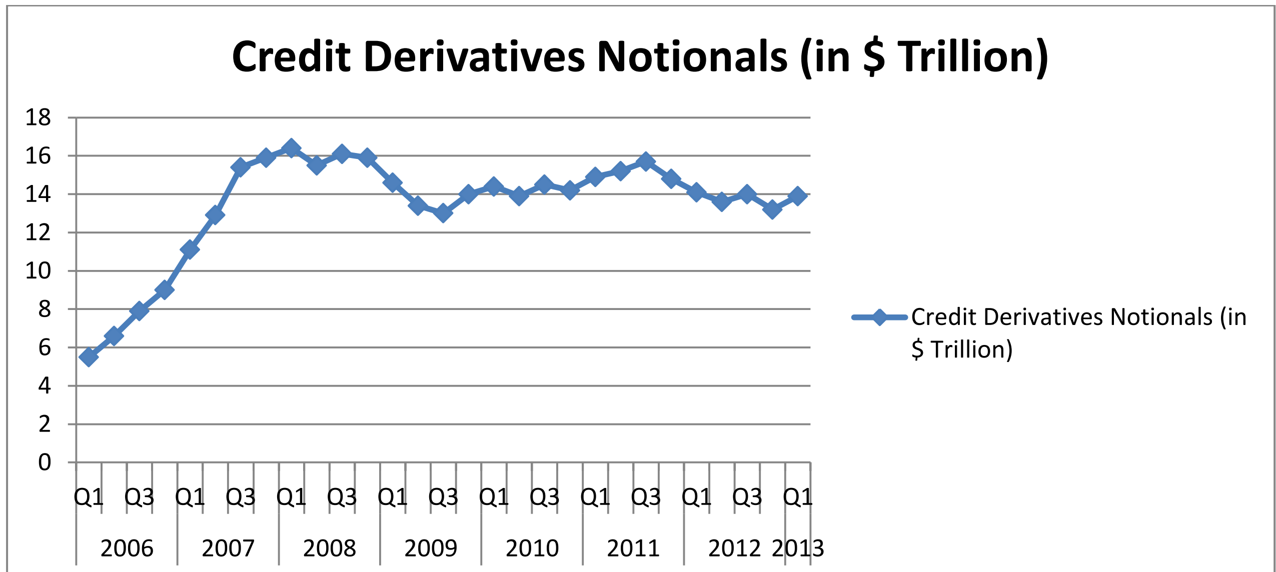
At the end of 2011, the ISDA reported an approximately volume of $ 28.6 trillion. There does not seem to be any substantial increase in volumes in 2012. As stated by the Bank For International Settlements[1], credit default swaps have continued to fall during the second half of 2012, from $26.9 trillion at end-June 2012 to $25.1 trillion at end-December 2012, bringing the cumulative reduction since end-June 2011 to $7.3 trillion. This is caused by the on-going compression of contracts among dealers. In the second half of 2012, the reduction was concentrated among reporting dealers and in maturities over five years. Contracts with foreign counterparties had dropped to $19.0 trillion at end-December 2012, but those with counterparties headquartered in reporting dealers' home country increased from $5.4 trillion at end-June 2012 to $6.1 trillion at end-December 2012.

However, the Quarterly reports of the OCC for US banks, for first as well as the second quarter, only show marginal decrease in volumes. The OCC reported [2] in end-September that credit exposures from derivatives have fallen in the second quarter, decreasing 5 per cent, to $339 billion. Charge-offs of derivatives exposures fell by $22 million to $61 million in the second quarter. The report also says that:

- Collateral covers 88 per cent exposure from banks and securities firms, 325 per cent exposure from hedge funds, and 52 per cent exposure from corporate houses.
- Trading risk exposure, as measured by value-at-risk averaged $376 million across the top five dealer firms during the first quarter of 2013, down by 9 per cent.
- The largest four banks hold 93 per cent of the total notional amount of derivatives, JP Morgan, Citigroup, Bank of America and Goldman Sachs.
- CDSs are the major product in the market, making up 97 per cent of total credit derivatives.
- Credit derivative notional fell by 4 per cent to $13.4 trillion.

1.(Source: http://www.bis.org/publ/otc_hy1305.htm)

2.(Source: http://www.occ.gov/news-issuances/news-releases/2013/nr-occ-2013-153.html)



Sovereign Activity

Sovereign CDS trading volumes and liquidity have fallen drastically since the EU, in an attempt to prevent speculators from using the instrument as an easy way to position for a worsening of the euro-zone crisis, imposed a ban on naked or outright short positions in November 2012. Because of the ban on sovereign CDS, the activity had moved to bank CDS. The net notional outstanding of EU sovereign CDS has dropped by 29% since 2012. Currently Italy is facing huge losses on derivatives restructured in euro-zone crisis.

CDS Settlement in Greece

Credit Default Swaps held by investors seeking to protect themselves from a Greek default caught much attention in the initial phases of the Greek debt crisis. There was a fear that triggering CDS contracts would lead to bankruptcies of the institutions that had written CDS protection, much like the subprime crisis in the United States triggered the collapse of institutions that had written CDS protection on collateralized debt obligations backed by subprime loans. On March 9, 2012—the day Greece announced that the participation thresholds for amending the Greek sovereign bonds had been met—the Determinations Committee of the International Swaps and Derivatives Association (ISDA) declared a triggering credit event, citing the use of CACs to bind in non-participating creditors. A CDS settlement auction was announced for March 19, resulting in pay-outs of €2.5 billion to protection buyers. CDS exposure had dropped sharply over the course of the crisis, as the costs of buying CDS protection kept rising. According to data compiled by the Depository Trust & Clearing Corporation (DTTC), the net notional volume of Greek CDS outstanding fell from more than €7 billion in end-2009 to below €2.5 billion in early 2012.

The CDS settlement process posed a challenge because of the reason that the Greek credit event occurred after a pre-emptive debt restructuring. The credit event was not triggered by an outright payment default. CDS contracts are typically settled through an auction in which bid and offer prices quoted by dealers and requests to buy or sell a defaulted reference bond (the “cheapest-to-deliver” bond) are used to determine a final settlement price. In a cash settlement, a buyer of CDS protection then receives the difference between the auction price and the par value of the defaulted bond.

In the case of Greece, however, the CDS auction took place after the bond exchange. This meant that most of the old bonds had already been exchanged by March 19 and those remaining were insufficient for the purposes of the auction. The ISDA Committee therefore decided to base the auction on the 20 new English-law instruments issued by Greece on March 12. This resulted in a final auction price of 21.5 cents, consistent with the price of the 2042 new bond (the cheapest new bond), in secondary markets prior to the auction. Holders of CDS protection received roughly the difference between the face value of the original bonds and the value they received through the PSI, as they should have.

Major Credit Events and Lawsuits

The year has also seen some major credit events. After the restructuring of Greek sovereign debt in March 2012 wiping out €100 billion ($130 billion) from its debts, the markets saw the failure of SNS REAAL[3], which was nationalised in February 2013 due to continuing losses on its real-estate loans. The Dutch bank's bailout cost taxpayers €3.7 billion ($4.84 billion) and wiped out the holdings of shareholders and subordinated debt investors. Then fell Madrid-based gaming company Codere, by triggering credit-default swaps insuring $445 million of the company's debt by failing to make a timely bond payment. Following this, new versions of all affected Markit iTraxx indices have been issued with an annex date of 19 September 2013.

In July 2013, the European Commission charged 13 top investment with blocking two exchanges from entering the credit derivatives market in the last decade in breach of European Union (EU) antitrust rules. Article 101 of the Treaty on the Functioning of the European Union (TFEU) prohibits anti-competitive agreements. The banks charged are Citigroup, Goldman Sachs, Bank of America Merrill Lynch, Barclays, Bear Stearns, BNP Paribas, Morgan Stanley, Credit Suisse, Deutsche Bank, HSBC, JP Morgan, UBS, and RBS. The Commission opened the antitrust investigation in April 2011 and extended its scope to ISDA in March 2013. The Commission takes the preliminary view that the banks acted collectively to shut out exchanges from the market because they feared that exchange trading would have reduced their revenues from acting as intermediaries in the OTC market.

Overhaul of Credit Derivatives Definitions

ISDA has published a set of proposed amendments to standards governing CDS which are likely to take effect from March 20, 2014. The proposed standards came out on July 14, 2013. The contracts, which are governed by ISDA, include a new credit event trigger for government-initiated forced losses and the addition of delivery of assets for a sovereign reference entity, according to ISDA's official publication.[4]

3.(Source: http://online.wsj.com/article/SB10001424127887323844804578528952977345498.html)

4.(Source:http://www2.isda.org/attachment/NTc0Ng==/20130715%20Cln_Credit%20Definitions%20implementation%20timing%20and%20key%20changes%20revised.pdf ,Copyright ISDA)

The areas that will undergo changes are as follows:

- Bail-in for financial reference entities
- Sovereign asset package
- Subordinated European Insurance reference entities
- Restructuring credit event
- Mod R/Mod Mod R
- Standard reference obligation
- Amendments to successor provisions
- Amendments to qualifying guarantee definitions
- Bankruptcy Credit event
- Deliverable obligation characteristics
- Outstanding principal balance
- Section 4.1
- Article I and III

Regulatory changes

The G20 has provided an important framework for improving the transparency of the global OTC derivatives market. The driver for reducing complexity in the global trade repository community will be market forces rather than regulation. To reconcile data between multiple trade repositories, global standards and common identifiers are critical.

The progress so far

At the request of the G20 leaders, the Financial Stability Board (FSB) will monitor individual jurisdictions' progress in implementing the G20 commitments. The FSB has so far published six progress reports on implementation of reforms to OTC derivatives markets. In the Sixth Progress Report, published in September 2013, the FSB noted that "currently over half of FSB member jurisdictions have legislative frameworks in place to enable all reform commitments to be implemented, though the current schedules for further changes in legislative and regulatory frameworks is uneven across jurisdictions and commitment areas. Where regulatory changes to implement the G20 commitments have not yet been completed, the FSB reiterates that necessary reforms to frameworks should be made without delay. Progress is most rapid in the implementation of requirements to report transactions to trade repositories (TRs): by the end of 2013, three-quarters of FSB member jurisdictions intend to have legislation and regulation adopted, and a little over half expect to have specific requirements in force (these jurisdictions include most of the largest OTC derivatives markets). There has been less regulatory progress in jurisdictions' implementation of central clearing, trade execution and margin requirements; in many instances authorities have indicated they are waiting for more detailed market information to become available through trade reporting, as well as the finalisation of remaining international work in some areas, such as margining requirements, before moving forward with specific regulatory proposals."[5]

5.(Source: http://www.financialstabilityboard.org/publications/r_130902b.pdf)

In response to concerns such as those expressed by the FSB and G20, a group of 12 OTC derivatives market regulators, known as the OTC Derivatives Regulators Group (ODRG), has been meeting to identify and explore ways to address issues and uncertainties in the application of rules in a cross-border context. On 11 July 2013 the United States (US) Commodity Futures Trading Commission (CFTC) and the European Commission (EC) announced a common approach to regulating cross-border OTC derivatives activity. The CFTC and EC acknowledged that their respective rules are sometimes different, and that the compliance dates are not necessarily aligned. They agreed to implement their rules and regulations to resolve inconsistencies, and uncertainty to the greatest extent possible.[6]

The Push for Centrally Cleared Trades

Currently, only a small number of jurisdictions are placing obligations on market participants relating to non-centrally cleared transactions, such as trade confirmation timelines, portfolio reconciliation and compression, and trade valuation practices. The FSB also emphasizes another significant reporting issue, access to trade data by cross-border regulators: "Reporting a counterparty's identity to TRs may be limited by domestic privacy laws, blocking statutes, confidentiality provisions and other domestic laws". The FSB also urges the jurisdictions to "continue to monitor the development of or changes in such laws and their proposed reporting requirements to ensure that any planned reforms adequately address barriers to reporting OTC derivatives transactions." Due to insufficient, central clearing of all standardised products have not been implemented in all jurisdictions and therefore risks remain.[7]

United States: CFTC's New Rules for Swaps

The G20 mandate has led the CFTC to introduce a new system called swap execution facilities, or SEFs. Under the new rules, most swaps must be transacted through registered venues, routed through central clearing houses and reported to data warehouses known as trade repositories. As the rules for trading in swaps are put in place by October 2013, the derivatives markets could face disruptions in trading.

Highlights from Asia

Within the Asian region, Singapore has amended the *Securities and Futures Act* 2012 to establish a regime to mandate central clearing and trade reporting. On trade reporting, Singapore expects reporting requirements to begin from the fourth quarter of 2013. On July 25 2013, the Monetary Authority of Singapore (MAS), published the Securities and Futures (Trade Repositories) Regulations 2013 (the Act) which came into operation on August 1, 2013. An applicant for a trade repository (TR) license will need to demonstrate to MAS that it is able to meet the obligations of, and comply with the requirements

6.(Source: CFTC (2013), 'The European Commission and the CFTC Reach a Common Path Forward on Derivatives', Press Release PR6640-13, 11 July)

7.(Source:http://tabbforum.com/opinions/the-fsb's-report-card-on-derivatives-reform?print_preview=true&single=true)

imposed on, a licensed TR under the Act; and the applicant is able to maintain a minimum base capital of at least $10 million. The MAS also issued a consultation paper on Local Implementation of Basel III Liquidity Rules – Liquidity Coverage Ratio. The MAS is planning to replace the existing Minimum Liquid Assets (MLA) with the Liquidity Coverage Ratio (LCR) framework. Locally incorporated banks, foreign bank branches and finance companies in Singapore will be required to comply with the LCR requirement. Additionally, MAS is proposing that merchant banks be subject to the LCR requirement as well.

Hong Kong's Financial Services and Treasury Bureau published the Securities and Futures (Amendment) Bill 2013 (Bill). The Bill provides a broad regulatory framework designed to implement the proposals set out in last summer's joint Hong Kong Monetary Authority and Securities and Futures Commission consultation conclusions for the new regulatory regime for the OTC derivatives market in Hong Kong.[8] The Hong Kong Securities and Futures Commission (SFC) published its Guidelines on the Application of cuss trade reporting matters in the region. The SFC fully supports the CPSS-IOSCO Principles for Financial Market Infrastructures and will adopt the PFMIs as benchmarks against which to assess recognized clearinghouses in their supervisory, monitoring and regulation. On August 19 2013, Hong Kong Monetary Authority (HKMA) issued a circular on Basel III implementation, setting out the final version of the standard templates to be used by locally incorporated authorized institutions for the purpose of making disclosures in relation to their capital base under the Banking (Disclosure) (Amendment) Rules 2013.

Australia

In Australia, while the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (RBA) have recognised that the efficiency of the Australian OTC derivatives market may be enhanced by using centralised systems. Australia has introduced legislation to impose mandatory requirements for trade reporting, central clearing and platform trading of OTC derivatives, where appropriate and on the advice of the regulators. In order to inform their advice, the regulators are actively monitoring developments in the Australian and overseas OTC derivatives markets.

Regulating Recycled Securities

Financial Stability Board has sought to constrain securities lending and repo – selling securities with an agreement to repurchase later– as part of its crackdown on "shadow banking". At the same time, global regulators are trying to regulate the re-hypothecation of collateral posted as part of derivatives transactions. The regulators are seeking to limit the number of times a security can be passed on to a new counterparty, with the aim of limiting contagion in case of a firm collapse and also ensuring that investors and traders know exactly whose risk they are exposed to.[9]

8.(Source: Hong Kong SAR Government, Press release 'Securities and Futures (Amendment) Bill 2013 Gazetted Today', 28 June 2013.)

9.http://www.ft.com/intl/cms/s/0/88abb51a-160b-11e3-a57d-00144feabdc0.html#axzz2gMfyZhFX

Collateral Management

Dodd Frank brings with it new requirements for derivatives clearing as well as new standards for the collateralization of outstanding derivative positions. The challenge to hedge funds is a liquidity squeeze being caused by the combined impact of a number of pieces of regulation being implemented simultaneously around the globe that includes not only Dodd Frank, but EMIR and Basel III also.

For the same level of OTC trading, hedge funds will need to offer up larger amounts of collateral. This will, in turn, tie up precious capital, increase costs and create a higher operational burden. Hedge funds also face a greater need for collateral transformation and collateral optimization strategies to make the most efficient use of their capital and to compete effectively. Also, hedge funds are faced with the task of keeping track of margin requirements through the lifecycle of a derivative transaction due to new reporting regulations.

New Gold Mine for Credit Strategy Hedge Funds

There are new avenues of opportunities for credit strategy hedge funds as a large basis has opened between cash and synthetic markets. The basis between cash and CDS has widened by about 25bp since iTraxx Main reached its recent wide of 132bp on June 24, 2013. Arbitrage has also opened between index and single-name CDS contracts, as well as the various credit indices. According to a report by Reuters[10], the shift has been caused by buy-side investors who have hovered up USD15bn of net protection on iTraxx Main. On the iTraxx sub financials index, many investors feel that proposed changes to the contracts to incorporate bail-in legislation would turn sub CDS worthless. Arbitrage opportunities remain, including the index skew between the Main index and its underlying single-name constituents, but many of these will probably be ironed out before too long.

What is in the future?

The major policy question for the coming years will be about the special status of derivatives and swaps in bankruptcy or bank receivership. The current regulations in the US give banks inefficient incentives to rely on funding through swaps and repos for their financing as against the more stable sources of funding like long-term unsecured bond financing. This is a major loophole in existing financial regulation and it could make short-term wholesale funding through repos even more the preferred source of cheap funding for banks in the next lending boom.

10.(Source:http://www.reuters.com/article/2013/06/28/hedge-funds-credit-arbitrage-idUSL5N0F433320130628)