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Preface—Credit Derivatives: Where's the Risk?

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Tkac is an economist and associate policy adviser in the Atlanta Fed's research department. *The following text is adapted slightly from an interview with Tkac recorded shortly after the Atlanta Fed's 2007 Financial Markets Conference, "Credit Derivatives: Where's the Risk?" held May 14–16. The interview is part of the Atlanta Fed's* Research Insights *podcast series. To listen to this podcast or to subscribe to any of the Atlanta Fed podcast series, visit www.frbatlanta.org and click "Podcasts" on the home page.*

Moderator: *Welcome to* Research Insights, *a podcast from the Federal Reserve Bank of Atlanta. Our topic today is credit derivatives. . . . Our first question is, What are credit derivatives?*

Tkac: . . . Credit derivatives are a relatively recent financial innovation that effectively shifts credit risk, or the risk of default, from one party to another. The vast majority of credit derivatives are actually known as credit default swaps, and I think it might help if I give you a simple example.

[S]uppose you want a bond, issued by a major corporation, such as GM or IBM. You're exposed to credit risk in the sense that if the corporation defaults on its bond payment, your bond decreases in value or becomes worthless. A credit default swap allows you to transfer this credit risk to another market participant for a price. Essentially, you pay a yearly fee to your counterparty, and they agree to pay you the par value of the debt in the case of default. Credit default swaps can also be written on sovereign debt of a nation, baskets of corporate bonds, indexes of debt-issuing corporations, and even tranches of these indexes. The market has grown rapidly in the past decade or so and has gotten increasingly complex as we've moved ahead.

Moderator: . . . *Why do credit derivatives matter to financial markets?*

Tkac: . . . I think the first reason is, as I mentioned, the large growth in the market. As of 1997, there was $180 billion in credit default swaps traded. That ballooned to over $20 trillion in 2006, so the sheer magnitude of the trade in these instruments reflects the value of this innovation to market participants but also causes us to want to look at them a little more closely.

I should mention [that] the major participants are banks, hedge funds, and insurance companies. Conceptually, any innovation like this that unbundles risk allows

these risks to be priced more efficiently. This [efficiency] allows participants to hedge and allows capital to flow more freely to its highest-valued use [and thus] has great benefits not only for financial markets but for our economy more generally.

However, there are some concerns or potential for what we call "systemic risk"—the risk of spillovers of any kind of adverse event in this market to the larger financial market. The reasons that there are some concerns are, one, that these contracts are largely bilateral. They're under the radar. They're agreed to by two individual counterparties, not regulated through any exchanges. They involve a large notional amount. That means the value of the credit default swaps being traded out there is some fourteen to eighteen times the value of the underlying bonds on which these instruments are written. In addition, the participation of hedge funds causes some concern because, again, hedge funds largely operate under the regulatory radar, and so we're never certain from a policy perspective exactly what risks are being taken and whether they're being effectively monitored.

Finally, this market has largely been untested. We've been through a very positive credit environment recently, and we don't really know what will happen if there is a major credit event on a large scale and how that might ripple through the financial system.

Moderator: . . . *[Y]ou just got back from the Atlanta Fed Financial Markets Conference. Fed Chairman Ben Bernanke spoke there. There were other participants including policymakers, academics, and market participants. What were some of the main points that were raised at this year's conference?*

Tkac: [W]e spent a lot of time talking about both the risk management and, at individual firm level, the important things that market participants need to do to manage and evaluate their risk when trading these instruments. But [we also discussed] the risks at the systemic or macro level in terms of understanding the integrity and stability of the financial system and how credit derivatives and credit default swaps play into those concerns. [T]wo points that I would like to mention as probably most important coming out of the conference [are], first, [that] we heard from many practitioners and policymakers about the role of financial market participants themselves in monitoring and evaluating and managing their own risk—not only the risks of the instruments that they're holding, but importantly, for systemic reasons, the risk of their counterparties and their potential distress. So, when you trade with another . . . entity [that] has distress or losses and can shut down and can't meet [its] obligations, that may spill over onto your concerns, and that's where we worry about this domino effect being more pervasive.

So . . . what we heard was that each individual market participant has a great incentive to evaluate and monitor and manage [his] own risk and exposure, and this is a powerful market-centered force to help us in constraining the potential for systemic risk. And indeed the industry itself has taken steps to improve back-office clearing and settlement, to move to auction and cash-based settlement, away from the physical delivery of bonds. All of these contribute to the integrity and stability of the market for credit derivatives.

Second, I'd like to reference Chairman Bernanke's remarks. He spoke more generally and brought up, I think, some very important points about regulating financial innovations such as credit derivatives. He noted that consistency and a principles-based paradigm for the regulation of innovations is important for achieving three public policy objectives: financial stability, investor protection, and market integrity.

This [approach] is in contrast to a more rules-based approach or an ad hoc approach, which might regulate each instrument as it becomes available. As we all know, regulating in a rule-based fashion only encourages market participants to innovate and behave in response to those rules in ways [that are] sometimes . . . adverse to the initial policy objective. So Chairman Bernanke's remarks, I think, provide a good roadmap going forward as the market continues to innovate.