

Box 15 Credit derivatives markets continue to grow rapidly

The growth of credit derivatives markets over recent years has captured much attention. However, it is useful to recall that credit risk has been shared and transferred between counterparties since at least the 1970s. Loan guarantees and insurance preceded loan syndication, which emerged and became widespread in the 1970s. This was followed shortly afterwards by more traditional forms of securitisation.¹ Credit derivatives emerged in the 1990s, and the market for these products has been growing at exponential rates.² The International Swaps and Derivatives Association (ISDA) has estimated that the notional amount of credit derivatives outstanding globally was USD 3.78 trillion at end-2003. By mid-2004, this figure had grown to USD 5.44 trillion. While the market has been rapidly expanding, it is useful to put its size into perspective: OTC traded

1 See ECB (2004), *Credit Risk Transfer by EU banks: Activities, Risks and Risk Management*, May.

2 Credit derivatives include single-name credit default swaps (CDSs) and different indices, as well as portfolio and basket products embedding credit derivatives, including synthetic collateralised debt obligations (CDOs).

credit derivatives only represent around 2-3% of the more than USD 200 trillion total notional amounts of OTC derivatives outstanding.³

Gauging the size and importance of the credit derivatives markets poses several challenges. For instance, notional amounts, which are frequently used to assess the size of derivatives markets, often have little connection with the actual pricing of underlying risk. A recent report published by Fitch Ratings has complemented existing information by shedding some light on the market values of credit protection positions that were bought and sold by surveyed institutions.⁴ According to this survey, the reported mismatch – or net transfer of credit risk between counterparties – was approximately USD 22 billion at the time of the survey. All in all, these findings suggest that the risk transfer that actually takes place in this market is far lower than the notional amounts imply.

Table B15.1 Credit derivatives

(notional amounts)

Credit Derivatives (USD billions)	1997	1998	1999	2000	2001	2002	2003	2004	Surveyed institutions
British Bankers Association ¹	180	350	586	893	1,189	1,952*	3,548	5,021*	BBA member banks
International Swaps Derivatives Association							3,780	5,440**	ISDA members

Note: Data excludes traditional asset-backed securities, guarantees and credit insurance. Whereas the public sector sources (BIS, OCC) report actual volumes of credit derivatives traded by banks, the other sources report estimates (in many cases market participants are directly asked about their estimate of the size of the market). 1 Data excludes assets swaps. See also British Bankers Association (2004); "BBA Credit Derivates Report 2003/2004".

*End of the year forecast, **H1

While credit risk transfer instruments have enabled cross-sectoral risk transfer, the bulk of market activity in the credit derivatives markets has continued to take place between banks. Intra-dealer activities, it seems, explain a large share of market growth in credit derivatives. It also seems that the market is rather concentrated among a few key intermediaries, including some major financial institutions in the euro area. Even though, on aggregate and globally, euro area banks are reported to be protection buyers, approximately half of all banks, particularly those that are regional, continue to act as protection sellers (see Fitch, 2004). Many of these banks are motivated by the more attractive returns of credit derivatives compared to the domestic markets, in addition to using these instruments to diversify their portfolios. In particular, the credit derivatives markets allow such banks to take on exposures to large corporate names they might not otherwise be able to acquire.

Some important changes have taken place in the structure of counterparties in the credit derivatives markets over recent years. The global insurance industry, which had been an active protection seller in credit derivatives instruments, began to pull out of the market in 2003.⁵ This

³ These mostly consist of interest rate derivatives.

⁴ See Fitch Ratings (2004), "Global Credit Derivatives Survey – Single Name CDS Fuel Growth", September.

⁵ See ECB (2004), "Credit Risk Transfer by EU Banks: Activities, Risks and Risk Management", May.

appears to have continued in 2004. Despite its declining role, the insurance sector continues to be a major seller of protection on aggregate. Taking the place of the insurance industry, hedge funds have become more active in the market. Owing to the fact that hedge funds are not regulated, very little is known about their activities. This means that the transparency of the risk-sharing taking place in the market has been declining. Information on hedge fund activities can be collected from key credit derivatives dealers that have hedge funds as counterparties. On this basis, Fitch Ratings found that, for a number of more active intermediaries, hedge funds can comprise as much as 20-30% of the overall credit derivatives trading volume. Anecdotal evidence also points to hedge funds playing an active role in credit index and other correlation trading.

The growing presence of hedge funds in credit derivatives markets should provide important benefits for the functioning of the market by contributing to its deepening and widening. Over time, this should improve the efficiency of price formation in cash instruments, such as corporate bonds. However, as data are lacking on the credit derivatives positions of hedge funds, this emphasises the need for counterparties in the market to put sophisticated risk management techniques into place and to take a consolidated view on the risks being taken through key intermediaries. Moreover, the growing importance of hedge funds for the functioning of these markets also raises potential concerns related to the possible implications of market liquidity and pricing that could arise from changes in strategies or from market exits. In other words, looking ahead, the financial condition of hedge funds will probably have an important bearing on the future development of the credit derivatives market.