Worries remain even after CDS clean-up

News analysis

There is talk that such a complex derivatives market should not even exist, writes Aline van Duyn.

The near-collapse of Bear Stearns a year ago caused shudders throughout the credit derivatives sector. Now the industry is set to experience another big bang.

On Thursday, the International Swaps and Derivatives Association (ISDA) introduced changes to credit default swaps (CDS), the most common type of credit derivative.

Among other measures, the rules will create procedures that determine pay-offs in the event of a default, avoiding potential lengthy legal disputes. In the US, new CDS will include features such as standard coupon which will make them more similar to bonds.

All these moves will make clearing easier in the US, although European regulators still have to decide on clearing rules.

"The corporate CDS market is the first step through one of its most important structural shifts since inception over a dozen years ago," said analysts at Morgan Stanley.

The demise of Bear Stearns could have made billions of dollars of derivatives contracts worthless and knocked out other banks across the financial system.

A controversial chain reaction could have unfolded, particularly through the credit derivatives market, which had grown in a decade from nothing to a little understood sector with more than $300tn in outstanding contracts.

In the words of one analyst, New York's Federal Reserve bank had to rush to tackle the lax settlement and documentation practices associated with credit derivatives, it was not until the near-collapse of Bear Stearns that these calls were taken seriously.

The bankruptcy of Lehman Brothers six months later finally made reforming systemic risks in credit derivatives a priority for Wall Street.

"Since then, the industry has pushed through 10 years' worth of changes in just a few months," said Athanasios Dipsas, managing director at Deutsche Bank. "This is a complete transformation of the CDS industry."

To address "counterparty risks" numerous steps have been taken.

Outstanding contracts off-setting each other were cancelled, a process called "compression". This has reduced the face value of outstanding CDS contracts to an estimated $3tn.

In the months after Bear Stearns's collapse, banks adopted changes to the way contracts were closed out when the bank backing the contract defaulted. These rules, introduced in 2002 but only adopted last year, allowed similar contracts to be settled all at once, rather than on a case-by-case basis.

The new rules mean the more efficient close-out rules, were adopted just in time to cope with the Lehman, Bear and Dipsas theories.

This week, the process to transfer the bulk of outstanding credit default swaps on banks and companies, which put out the event of the failure of the underlying counterparties, to a central clearing counterparty has begun in Europe.

The first clearing efforts will focus on liabilities of US corporate creditors. Later this year, efforts will move onto clearing CDS for individual companies.

"CDS clearing and transparency will instill confidence with regulators, brokers, investors and taxpayers," said Sumit Hirani, president of Credit Suisse, who still believes the market needs to be examined.

"The most visible symbol of this AIG, which has already almost $1bn in derivatives, is that the US government backing the company has not been enough to cater default due to CDS positions.

"The credit market has been absolutely broken and now we are seeing credit default swaps for the first time in the US."

The challenges involved in clearing and restructuring CDS contracts on a large scale are immense and include: risk management, implementation, and changes to the legal and regulatory framework.

"The change in the way that CDS are traded is a significant step forward, but there is still a long way to go," said Brian Colin, head of credit derivatives at Barclays Capital.

Yet the industry could not now be planning a new phase without government backing of AIG and banks like Citigroup, which are all part of the ICE Trust clearing venture.

"The government's support is necessary to ensure that another Lehman's collapse that could be financially disastrous, " said Brian Colin, head of credit derivatives at Barclays Capital.

"The government's support is necessary to ensure that another Lehman's collapse can be avoided, which is the way that CDS are traded."

Global change

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