

# Credit Derivatives and Risk Management

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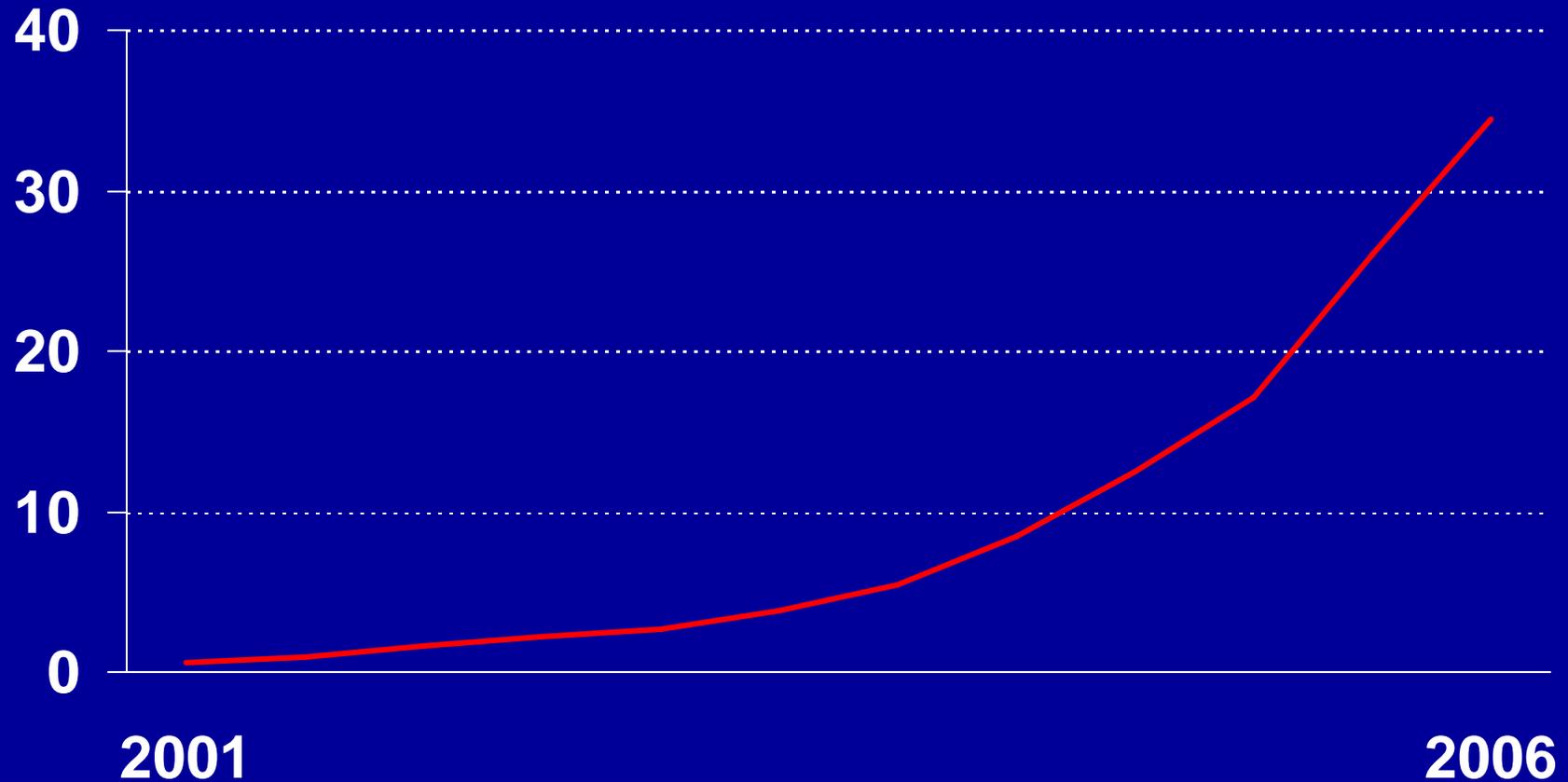
May 15, 2007

# Disclaimer

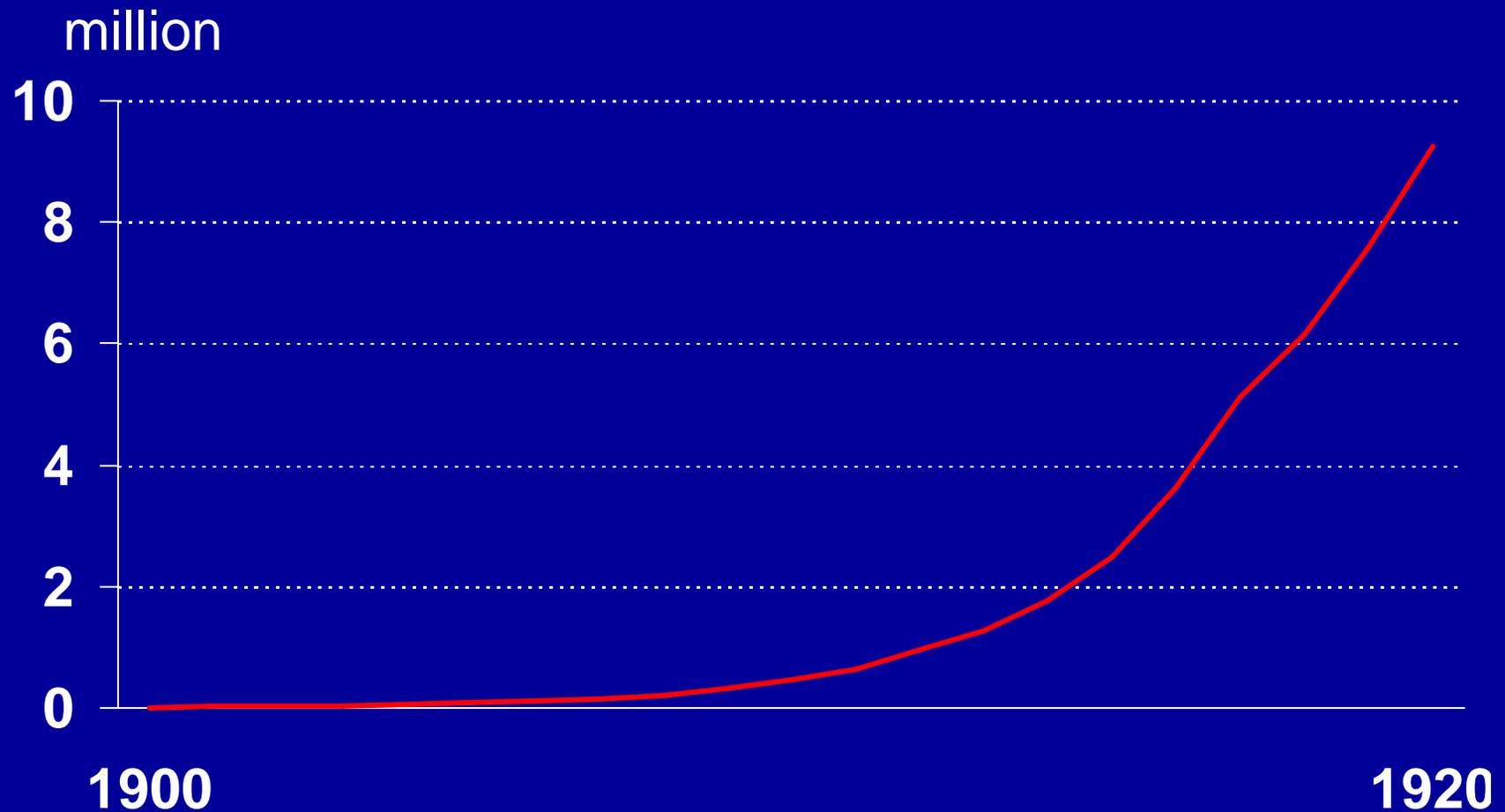
This paper represents the views of the author and should not be interpreted as reflecting the views of the Board of Governors of the Federal Reserve System or other members of its staff.

# Credit derivative notional amounts

\$ trillion



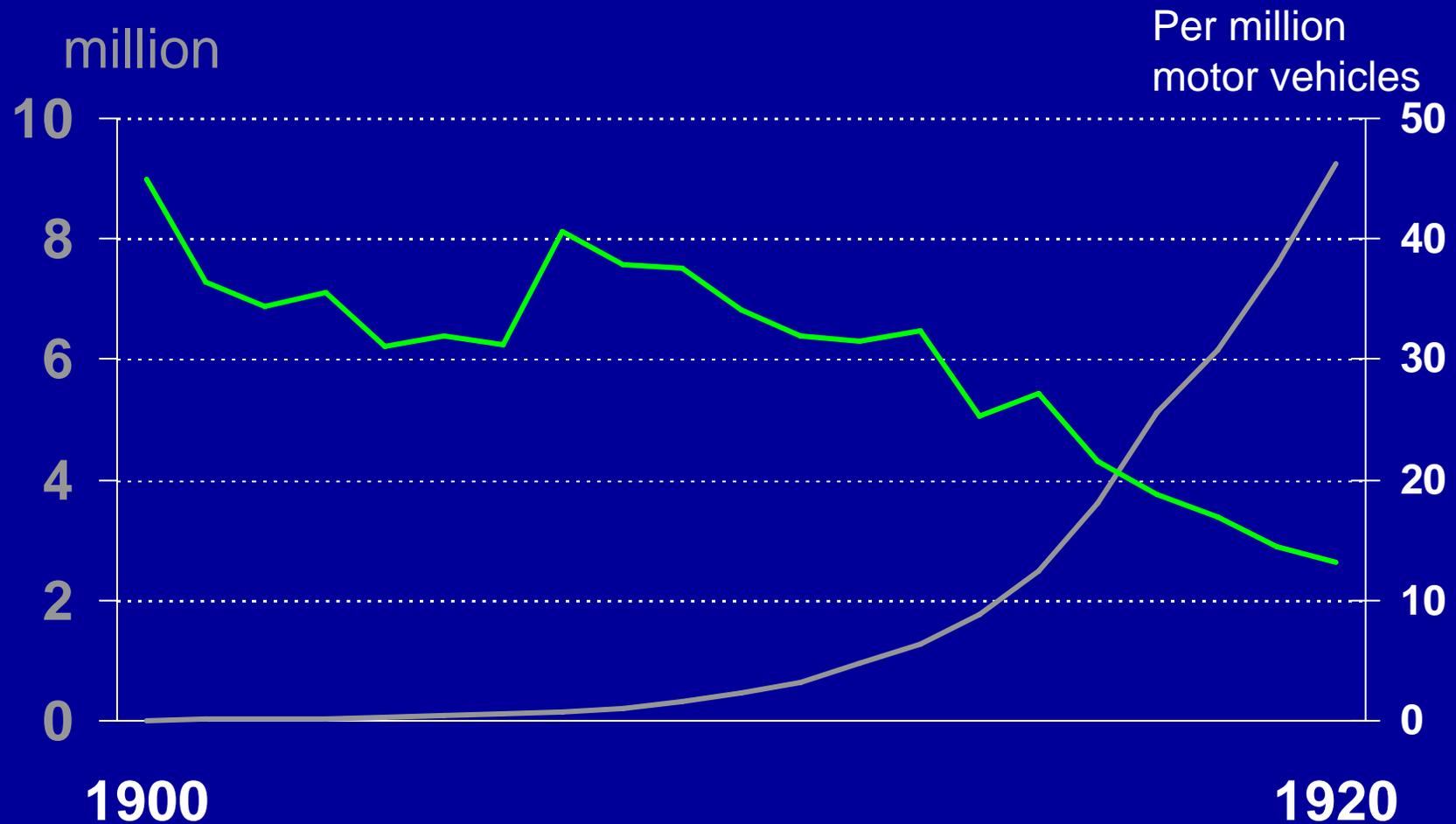
# Motor vehicle registrations

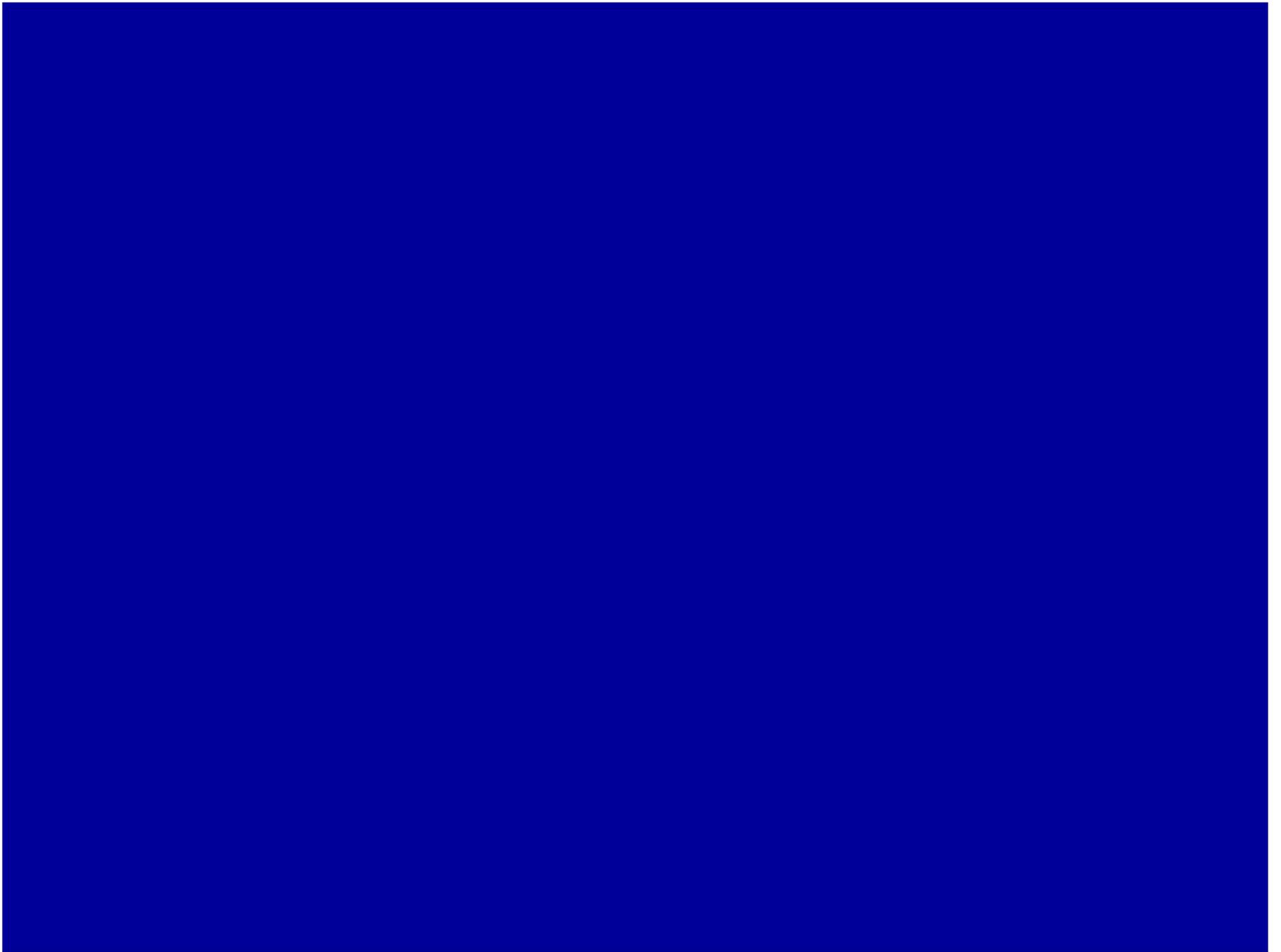


# Risk management!



# Motor vehicle traffic deaths





# Credit Derivatives

Why are they growing?

What are the risks?

# Credit Derivatives



Why are they growing?

What are the risks?

Useful for risk management

# Useful for risk management

- 1.

- 2.

- 3.

# Useful for risk management

1. Commercial banks
- 2.
- 3.

# Useful for risk management

1. Commercial banks
2. Investment banks
- 3.

# Useful for risk management

1. Commercial banks
2. Investment banks
3. Investors
  - buy and hold
  - active trader
  - credit index tranches

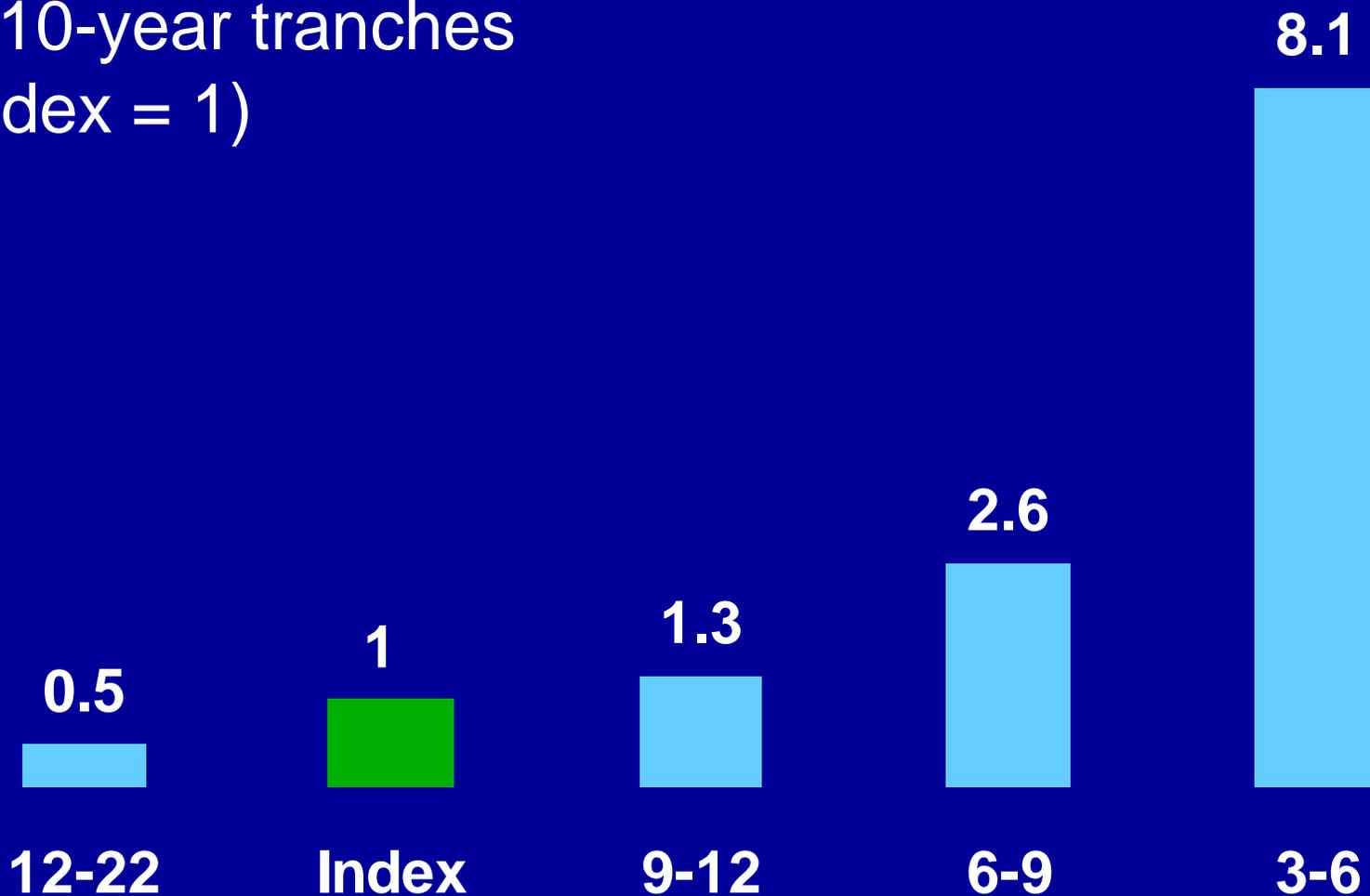
# Credit index tranches



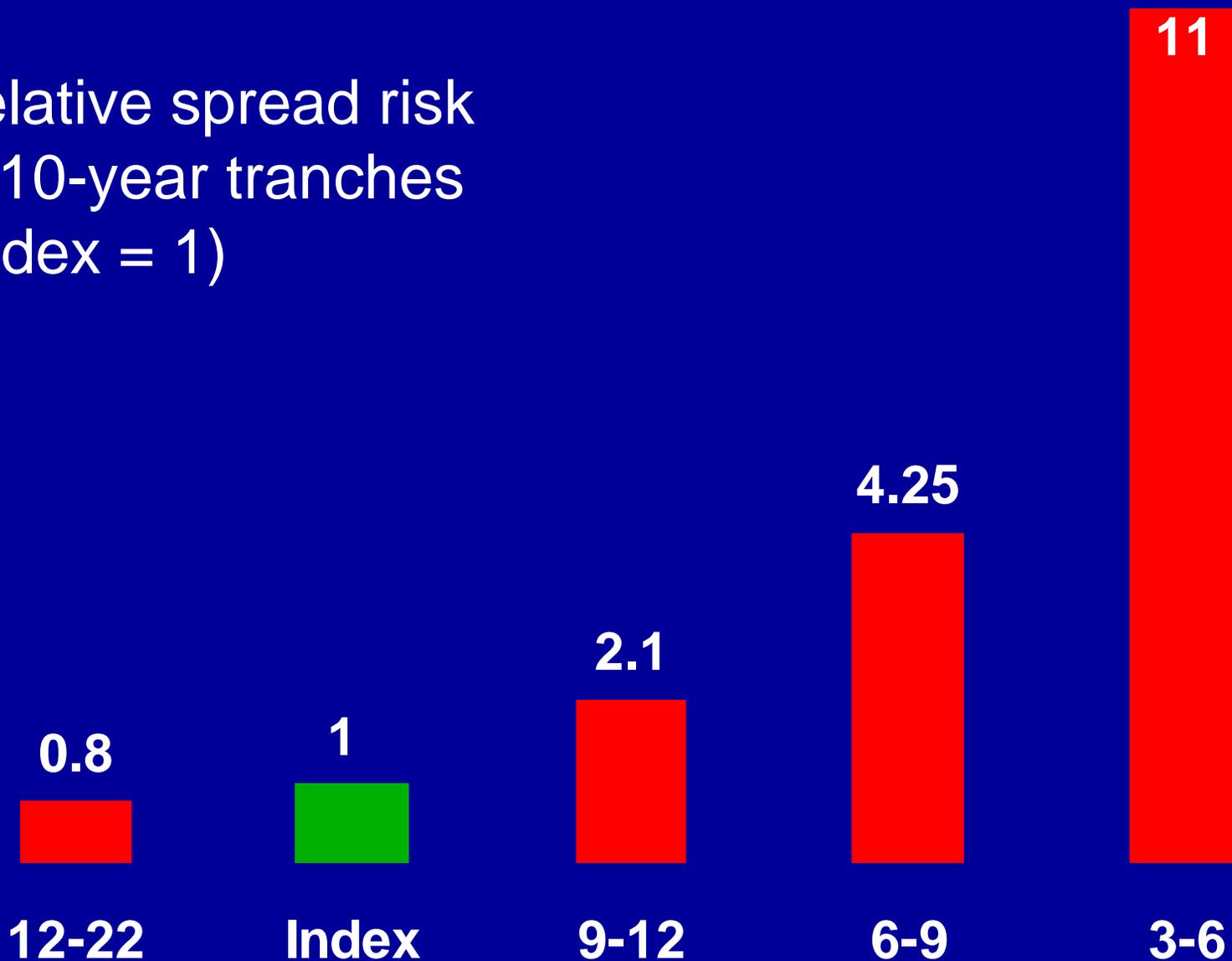
# Credit index tranches



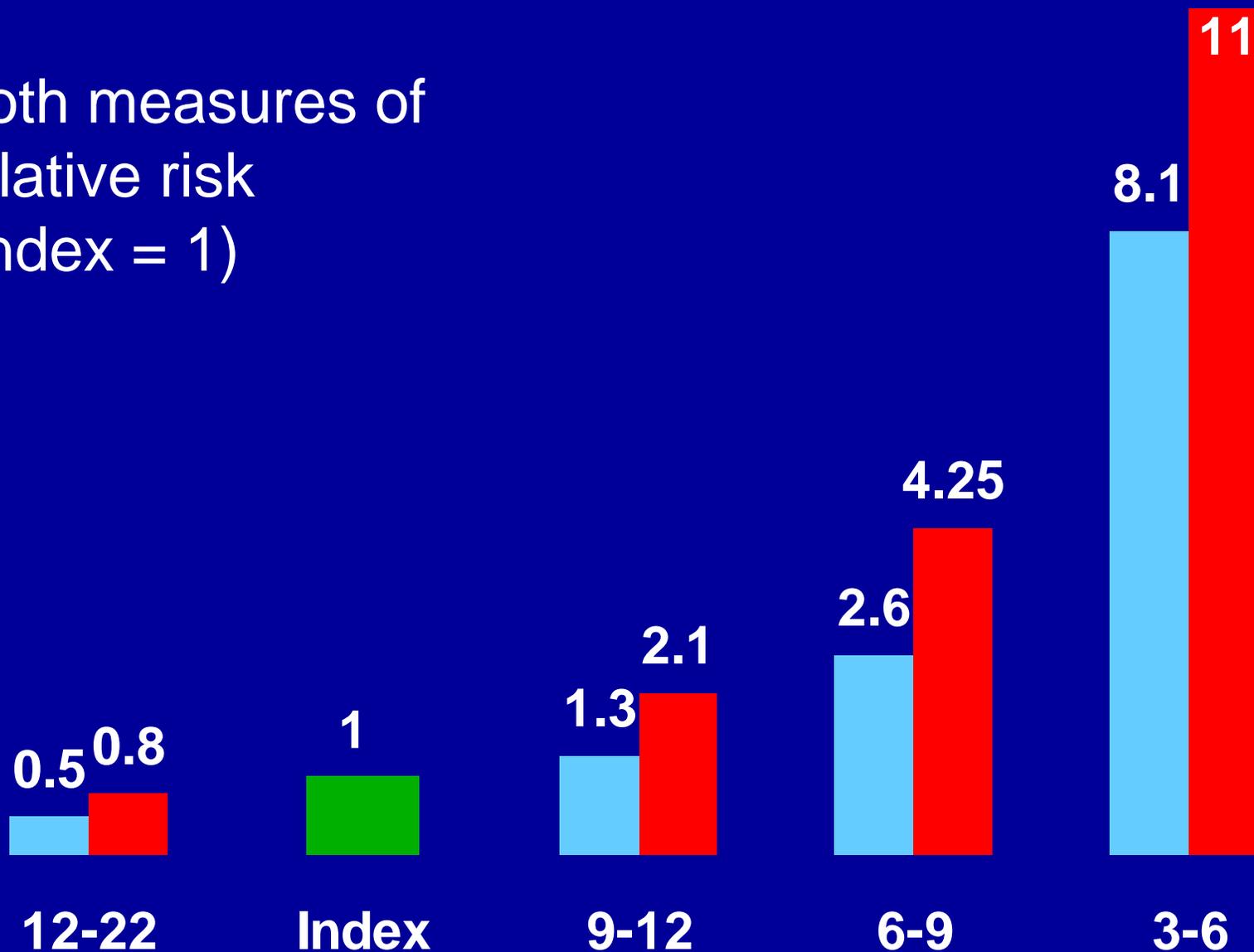
Relative default risk  
of 10-year tranches  
(Index = 1)



Relative spread risk  
of 10-year tranches  
(Index = 1)



Both measures of  
relative risk  
(Index = 1)



# Credit Derivatives

Why are they growing?



What are the risks?

# The risks are:

- 1.
- 2.
- 3.
- 4.
- 5.

# The risks are:

1. Credit risk
- 2.
- 3.
- 4.
- 5.

# The risks are:

1. Credit risk
2. Counterparty risk
- 3.
- 4.
- 5.

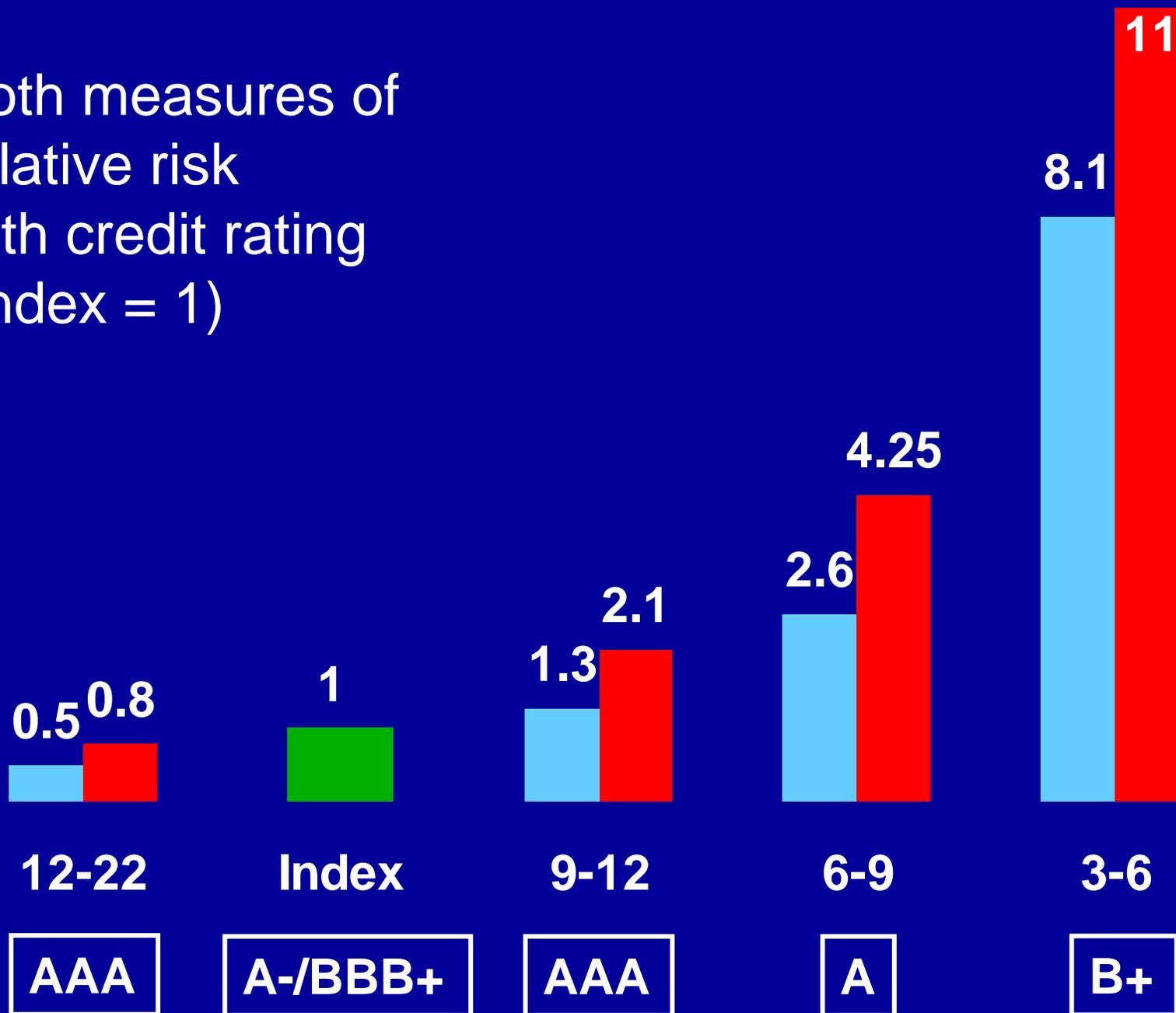
# The risks are:

1. Credit risk
2. Counterparty risk
3. Model risk
- 4.
- 5.

# The risks are:

1. Credit risk
2. Counterparty risk
3. Model risk
4. Rating agency risk
- 5.

Both measures of relative risk with credit rating (Index = 1)



# The risks are:

1. Credit risk
2. Counterparty risk
3. Model risk
4. Rating agency risk
5. Settlement risk

