Credit Derivatives, Macro Risks & Systemic Risks (Tim Weithers)

Comments by Nigel Jenkinson
Bank of England

16 May 2007

BANK OF ENGLAND

- Credit derivatives have many positive features (risk dispersal/distribution, market completeness/efficiency)
- Paper provides good summary of market development
- 4 potentially systemic issues:
  - Credit risk monitoring and screening
  - Risk dispersion and market liquidity
  - Modelling complexity
  - Infrastructure and operational risks

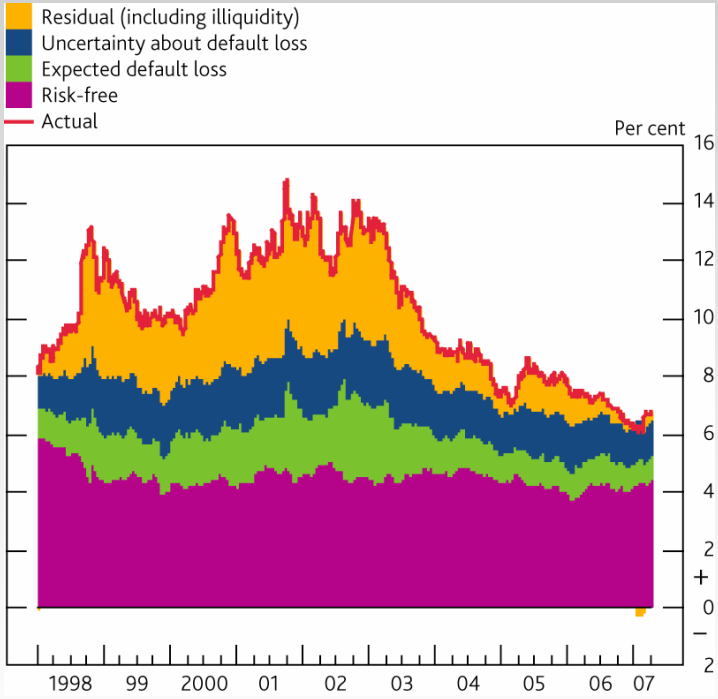
Credit risk monitoring and screening

BANK OF ENGLAND

- Is market delivering improved pricing of credit risk?
- More active market should aid price discovery
- But has ability to distribute credit risk undermined banks' incentives to screen and monitor borrowers?
- Are market mechanisms providing sufficient discipline?
- Reliance on rating agency opinions and models
- Are market participants over-confident that market liquidity will remain high?
- Are credit spreads overly-compressed?

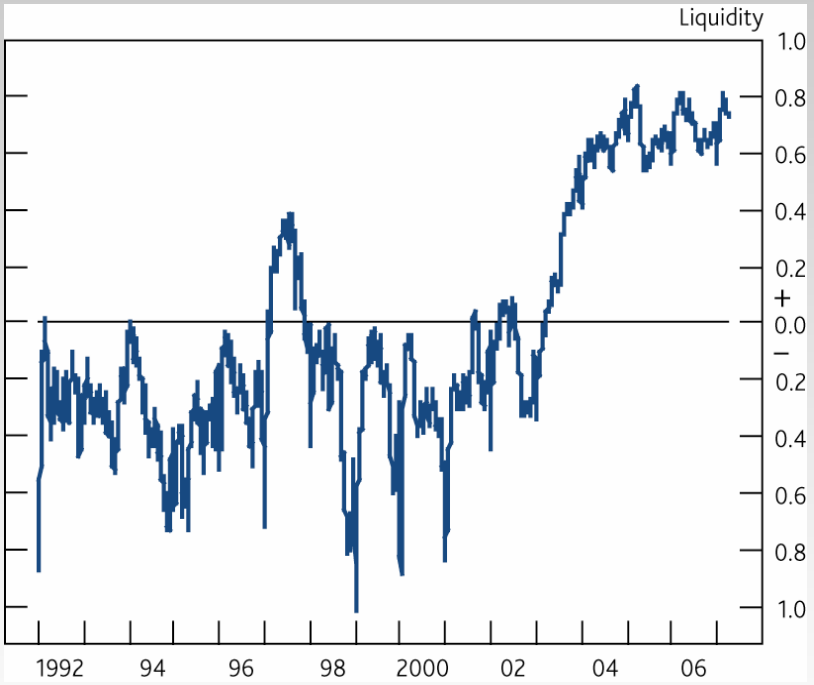
Current Liquidity conditions very buoyant

Decomposition of borrowing costs for UK sub-investment grade corporates



Sources: Bloomberg, Merrill Lynch, Thomson Datastream and Bank calculations.

Financial market liquidity(a)



Sources: Bank of England, Bloomberg, Chicago Board Options Exchange, Debt Management Office, London Stock Exchange, Merrill Lynch, Moody's investors Service, Thompson Datastream and Bank calculations.

(a) Simple, unweighted mean of the liquidity measures, normalised on the period 1999-2004. Data shown are an exponentially weighted moving average. The indicator is more reliable after 1997 as it is based on a greater number of underlying measures.

Risk dispersion and market liquidity

BANK OF ENGLAND

- New players boost liquidity most of the time
- Risk dispersal increasing capability to manage small/medium shocks
- But market untested under major stress
- Risk of common and correlated positions
- Low secondary market liquidity for some products and concentration of market-making capacity
- Risk of crowded trades
- System more interconnected, so major shocks more easily transmitted

Modelling complexity

BANK OF ENGLAND

- Structured products hard to model and value, hard to hedge
- Broker/dealers become ‘warehouses of basis risks’
- Basis risks may crystallise under stress (autos, sub-prime)
- Challenge for strengthening market discipline/improving counterparty risk management

Infrastructure and operational risks

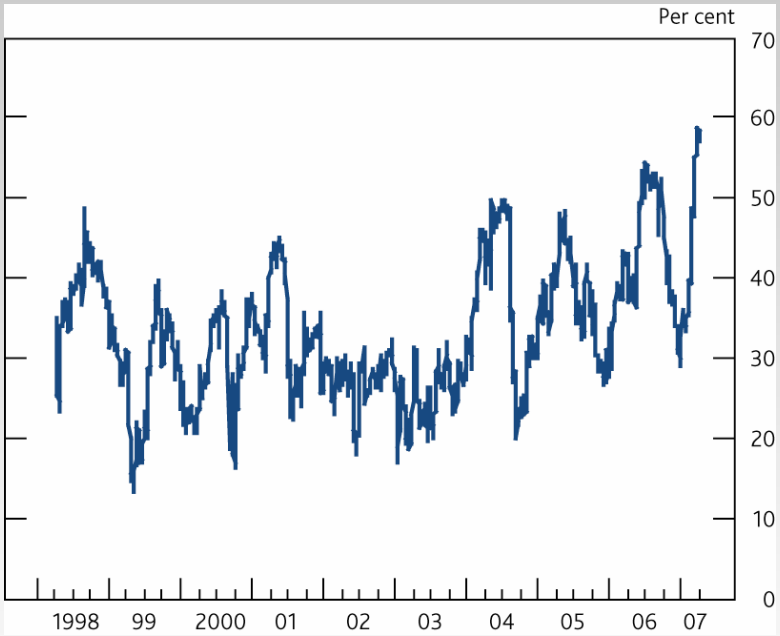
BANK OF ENGLAND

- Operational risks with new, rapidly growing market
- Market adapting to find solutions:
  - reference entity
  - Identifying credit events
  - Shortage of bonds for physical settlement
- Infrastructure may lag market development
- Some elements untested
- Collective action problems (assignments, backlogs, netting facilities)
- Strengthening legal/physical infrastructure important objective

Correlations change under stress

BANK OF ENGLAND

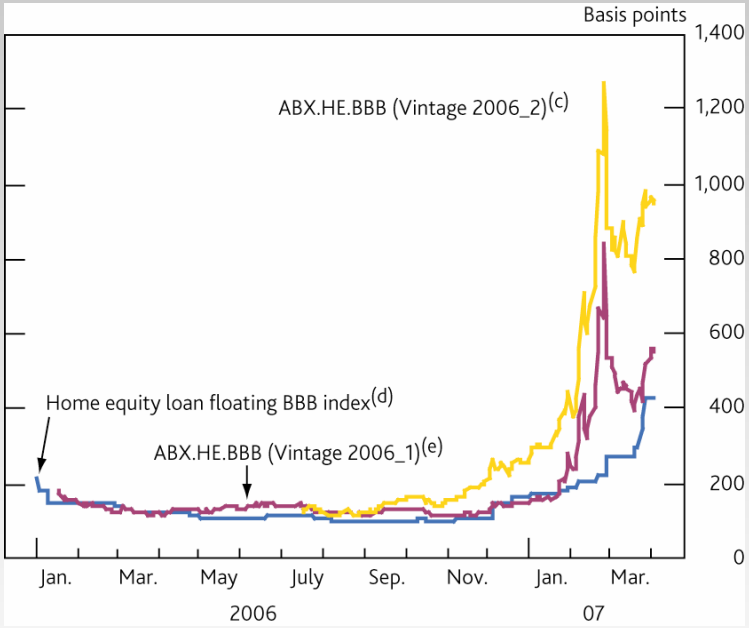
Common component in asset prices[a]



Sources: Goldman Sachs, Merrill Lynch, MSCI and Bank calculations.

(a) Proportion of variation in global equities, emerging market equities, high-yield spreads and commodities explained by a common component over a three-month rolling window.

ABX and home equity loan index spreads[a][b]



Source: JPMorgan Chase & Co.

(a) The ABX.HE index is a family of sub-indices, each of which consists of a basket of 20 credit default swaps referencing US sub-prime home equity securities.

(b) There are substantial differences in the assets underlying the ABX index and the home equity loan (HEL) index. For example, the HEL index includes a range of loan vintages, whereas ABX indices are referenced to specific vintages.

(c) Loans originated in 2006 H1.

(d) Five-year spread to one-month Libor.

(e) Loans originated in 2005 H2.