

your hub to euroland
CDS through crisis
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CDS THROUGH CRISIS

- DEFINITION AND PROPERTIES
- TRADING CDS
- LEHMAN DEFAULT
- CONSEQUENCES
- CONCLUSION

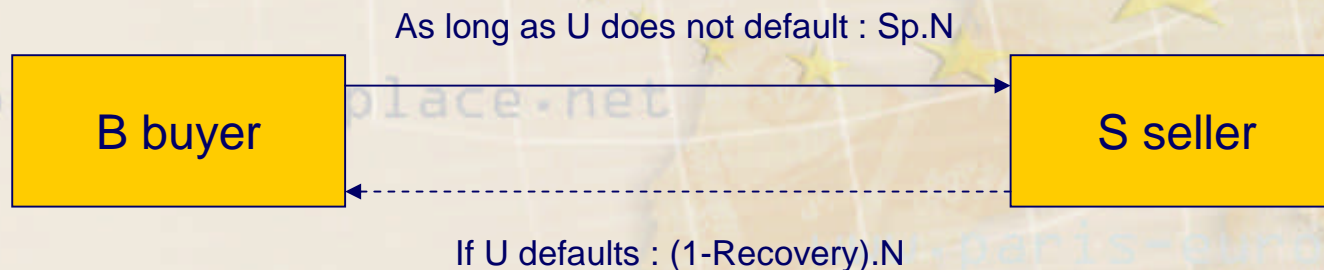
DEFINITION AND PROPERTIES

- CDS

Credit Default Swap = Insurance against default on a bond/loan of a specific firm

- PROPERTIES

- 2 counterparties : 1 buyer (B) / 1 seller (S) of protection
- Underlying (U)
- Notional (N)
- Maturity
- Spread (Sp)
- Frequency of payment



TRADING CDS

- Who and Why

- In 2002 : Amount of notional < \$ 2,000 bn

- Bondholders
- Frequent c/p

To Hedge default risk on **existing** positions

- In 2007 : Amount of notional > \$ 60,000bn (x30!)

- Bondholders + Frequent c/p
- Investors (insurance, Corporate)
- Hedge Funds

To Invest/speculate on the spread itself, creating **new** positions

- How

Trading via an OTC market, up to 2000 names on 4 maturities => no regulation

In 2007, the structured credit Market is huge,
increasing quickly, trading through an OTC market

LEHMAN DEFAULT (09/15/2008)

- Lehman Default as an underlying
 - Amount of CDS on Lehman : Between \$100bn and \$500bn
 - Lack of clarity
 - Final recovery : 8.625%. Far from expected 1 month before ($\approx 80\%$)
 - Recovery is now a real market data, not just an input
- Lehman Default as a counterparty : **NEW SITUATION**
 - Difficulty to net position
 - All trades are specific (OTC market)
 - Discrepancy on the fair value

➔ New open positions

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Necessity of a clearing house

CONSEQUENCES

- On the Market

- Counterparty risk
 - Funding issues
- Lack of liquidity on credit market
 - Very difficult to find hedge on specific name / maturity → mishedge
- Bid/Offer increased a lot
 - Hedge cost increased → Losses increased
- Too “big to fail” slogan disappeared
 - Confidence decreased
- Only \$ 6bn needed to offset contracts

- On Authorities

- Rescue of AIG
- Need to regulate this market
 - Development of DTCC (*Depository Trust and Clearing Corporation*) : 95% of CDS
 - CDS Standardisation : easy to unwind
 - 9th march 2009 : *ICE trust* chosen as a clearing house.

CONCLUSION

- Need to regulate

- Standardisation
- ICE trust
- DTCC

But

- In CDS we trust

- Systemic risk was overevaluated
- CDS enable investors to trade debt : real financial interest
- Additional information on companies
 - Quotes every day, on different maturities