Box 8

GAUGING THE EXTENT OF CREDIT RISK TRANSFER THROUGH CREDIT DERIVATIVES

In September 2006, Fitch Ratings published its fourth annual global credit derivatives survey.[1] This survey captures the main market developments between end-2004 and end-2005. It covers 75 financial institutions (including banks and broker/dealers, insurance companies and reinsurers, and financial guarantors). The institutions covered in the survey are believed to represent the major players in the credit derivatives market. It contains attempts at quantifying the scale of the transfer of credit risk outside the traditional banking and insurance arena. This Box discusses some of the most relevant findings of the survey from a financial stability perspective.

The September 2006 survey found that the notional amount of outstanding credit derivatives contracts had risen, increasing from USD 5.3 trillion at the end of 2004 to almost USD 12 trillion at the end of 2005, an increase of 122%. This confirms the trends recorded in surveys conducted by other institutions and industry associations (e.g. ISDA, the BBA and the BIS). The survey stresses the growing importance of indices and index-related products, which grew tenfold during 2005 and, at USD 3.7 trillion, comprise almost one-third of gross positions. Single-name CDSs still comprise about half of the whole market, although their growth has

1 See Fitch Ratings (2006), "Global Credit Derivatives Survey: Indices Dominate Growth as Banks' Risk Position Shifts", September.

slowed down somewhat. While the banking sector's overall position still remains that of long protection (with the net exposure falling significantly from USD 427 billion in protection bought at the end of 2004 to USD 268 billion at the end of 2005), the report points out that, especially in Europe, there were banks whose net position turned to neutral or even became net protection sellers. The insurance/reinsurance and financial guarantors sector acted as a net protection seller with USD 645 billion net outstanding. The difference between these two numbers (USD 377 billion, up significantly from USD 128 billion at the end of 2004) represents positions accumulated by institutions not covered by the survey (e.g. institutional investors, hedge funds, some banks, etc.). It may provide a reasonable approximation of the amount of credit risk transferred through the CRT markets outside the traditional financial sector, a phenomenon which has been a matter of concern to regulatory authorities ever since the emergence of credit derivatives markets.

Other interesting highlights of the survey include further confirmation of increasing market concentration, with the top 15 banks and dealers responsible for 83% of sold positions (compared with 75% at the end of 2004); market-making, which has become the prime motivation for banks' involvement in the market (as opposed to risk mitigation, which was the main driving factor in previous surveys); gross protection sold on speculative grade and unrated entities, which grew to 31% of the total (up from 24% at the end of 2004), reflecting the continuing search for yield; and the success of ABS CDS indices, where volumes more than doubled, reflecting the volume of CDS on structured assets.

The Fitch Ratings surveys' attempts to analyse the structure of credit derivatives markets as well as the amounts of risk transferred through CRT instruments is welcome, as they contribute to better understanding of the financial stability implications of this rapidly growing market. In this regard, more and improved data on net credit risk exposures and on the concentration of positions could be of considerable benefit to both market participants and the competent authorities. Further work and market intelligence are however needed to understand and monitor investors' behaviour should market conditions deteriorate. As suggested in Box 5, it remains crucial that the industry should play a prominent role in any future initiatives to improve transparency, owing to the global dimension of credit markets, their complexity as well as the rapid pace of innovation.