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RAPIDLY EXPANDING CREDIT DERIVATIVE MARKET POSES RISKS TO U.S. FINANCIAL SYSTEM, NEW LEVY STUDY SAYS

ANNANDALE-ON-HUDSON, N.Y.—While Fed Chairman Alan Greenspan has long contended that the flexibility of the U.S. economy has bolstered its resilience and lessened the need for government oversight, a new study from The Levy Economics Institute of Bard College asserts that today's large and growing credit derivatives market poses serious risks. In a new Policy Note, *Credit Derivatives and Financial Fragility*, Research Scholar Edward Chilcote recounts the crisis created by the collapse of the hedge fund Long-Term Capital Management in 1998, and argues that the threat of similar problems are mounting in the highly unregulated and often secretive world of credit derivatives.

Chilcote contends that many credit derivatives threaten the financial system because they introduce counterparty risk (the risk that the other party to a contract will not be able to meet its contractual obligations) and because they do not require credit-loss reserving, so that credit derivatives pay for credit losses as they come due rather than reserving for them in advance. One of the main dangers, he states, is the lack of risk awareness, due to the failure of many derivative instruments to disclose their risk to counterparties and the huge backlog of paperwork in the credit derivatives market, with evidence showing that some transactions have remained unconfirmed for month or years. Against this backdrop, Chilcote uses statistics on loan-loss provisioning from the Federal Deposit Insurance Corporation to suggest that banking regulation today is more lax than at any time since the early 1970s. And, just as oversight may be slipping, he shows that the credit derivative market is expanding rapidly, to the extent that the annualized growth rate for the first six months of 2005 was 128 percent.

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To illuminate these risks, Chilcote points to recent developments in the American automotive industry. “The downgrading of the corporate bonds of Ford and General Motors by rating agencies stunned the credit derivatives markets,” Chilcote writes, stressing that the cost of insuring some of General Motors’ debt through credit derivatives rose fourfold in five months. “Hedge funds lost hundreds of millions of dollars, owing to their exposure to derivative contracts and the downgrading of General Motors’ and Ford’s debt in May (2005),” he writes.

The credit derivatives market has not been tested during a serious downturn, Chilcote maintains. He presents scenarios in which a cascade of losses could result if several hedge funds were to fail simultaneously or a major corporation were to declare bankruptcy. In contrast to Chairman Greenspan’s confidence in private markets, Chilcote recommends heading off a crisis by creating policy that would standardize trading documentation, impose time limits for clearing transactions, mandate strict margin requirements, rewrite the bankruptcy code, require better public disclosure, and oversee capital adequacy and loss reserves for institutions engaged in the credit derivatives market. “Faith in ‘resilience’ may not get us through the next crisis,” he writes. “Decisive action to head off a future crisis in the credit derivatives market is need.”

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Policy Note 2006/1, *Credit Derivatives and Financial Fragility*

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