EVOLUTION OF CREDIT DERIVATIVES: AN OVERVIEW

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ABSTRACT

Every lock has a key just like every risk having a solution. This solution can be figured out with time as the changes that happen along with it will find a way to solve the issues based on the circumstances. Credit derivatives are all about risk management if it has to be described in a nutshell. It is a mechanism for dealing with the risks in the process of trade in the derivatives market where the transactions and agreements have to be managed appropriately. The parties involved in the process have to act according to the contract made for the trade and the transactions have to be done without fail. In this research, the researcher has focused on the concept of derivatives in general dealing with credit derivatives specifically. The changing legal aspects are discussed in the study along with the risks that can arise in such trade-related aspects. A detailed analysis is done on the reforms that have happened since the credit crisis in 2008 with a comparative study on the pre-crisis period. The need to have a properly functioning economy can be seen based on the activities done in the finance world.

Keywords: Credit Derivative, Management, Pre-crisis period, Economy, Finance.

Introduction

In this 21st century, as the elements of change continue to arise, the risk factor is also bound to come up especially in the financial sector. Risk and security from such risks is an essential aspect in those sectors involving assets, currencies, stocks etc. Derivatives are one among those mechanisms for protection against the risks which come along with the variations in the price of the underlying assets and their value which can determine the price of the security. This is utilized as an instrument for better financing and to maintain stability in the functioning of the same. In general terms, a derivative can be defined as a financial contract where its price is determined based on the price of the assets or the securities involved in the trade. The traders involved in the process often take risks for a greater gain and derivatives act as a tool for the management including the main purpose, which is reducing the risk for the people who are a part of the entire functioning.[1] In the case of a derivative contract, it is sure that one of the parties looks forward to freeing him from the risk which can arise from the commercial activities related to currency, interest rates etc and it can be fulfilled by ensuring the proper functioning of the process.

Credit derivatives (CD) can be considered as a method adopted to separate and transfer the risk from one person to another without bringing the underlying into the picture. The credit risk involved in the process is managed by the parties through contracts made between them where the one who takes the risk is paid by the buyer. A credit derivative is one of the important types of over the counter (OTC) derivative where the trade is done between the parties with the help of a bilateral contract without any kind of exchange.[2] It can be concluded as a trading platform utilized by the traders for business purposes based on the need of the circumstances. Risk transfer is the main purpose behind such derivatives where the parties are provided with a trading atmosphere having less financial burden. It will further enhance financial stability which is an inevitable initiative for the development of the economy of the world. Regulation and risk management go hand in hand where the application of the law is required to regulate the functions and to manage the activities based on the nature and scope of the situations arising in the process. As credit derivatives form an integral part of the trading world, it is important to analyse its legal aspect and

[1] David Gaines & Kevin Kane, "An Introduction to Credit Derivatives", 14 COM. LENDING REV. 10 (1998)
[2] John H. Hunt, Michael F. Szymanski & Michael J. Baek, "Regulatory Treatment of Credit Derivatives", 14 COM. LENDING REV. 17 (1998)

the changes that have happened all through the years. The market efficiency can be enhanced with the help of investors and parties involved in it by managing the risks and liquidity. Such derivatives contribute towards the flexibility of companies and ensure stability in the prices based on the specific needs of the consumers and hence improving the financial growth of the sector.

Credit derivatives - An overview

The root of modern derivatives can be found in the 1980s with the introduction of swap agreements where a contract is made between the parties to exchange cash flows in the mentioned period.[3] Such contracts had a different method in comparison to the contracts made about trade, as it is specific about the parties where the bilateral contracts are made for trade. Credit derivative can be described as a contract between two parties that is negotiated privately for the sole purpose of transferring credit risk from one party to the other.[4] It involves the payment of a certain amount of money by the seller to the buyer for the completion of the process. While dealing with the concept of credit derivatives, it can be seen that the contract made between the parties has a significant role in both funded and unfunded derivatives. One of the most important credit derivatives includes credit default swap (CDS) which is an unfunded credit derivative where the seller does not make any payment to the buyer before the settlement is done. As the term suggests, an investor can swap his/ her credit risk with another investor with the help of a contract. In this particular swap, the contract is made including the risk that can happen if there is a default in the process. This process is carried out by the buyer and seller involved in each case where the seller can utilize this tool to swap the risk which arises due to the buyer defaulting on any of the factors. Here the seller negotiates the fees so that the buyer can be compensated in case any kind of specified event happens concerning the payment. Such events can be due to default in payment, bankruptcy, failure to pay etc where the parties have to act accordingly to ensure the proper functioning of the transaction.

The Reserve Bank of India (RBI) has initiated certain schemes about the swap where a draft was made for the development of the process. "Reserve Bank of India (Credit Derivatives) Directions-

[3] Desmond Eppel, "Risky Business: Responding to OTC Derivative Crises", 40 COLUM. J. TRANSNAT'L. 677, 680-81 (2002)
[4] Satyajit Das, "Credit Derivatives: CDOs & Structured Credit Products" 6 (3d ed.) 2005

2021 Draft" was introduced with the motive to develop the CDS market as it is an essential factor for the growth of the liquid markets and the economy.[5] The method of redistribution of risk is utilized in this process to transfer and manage credit risk in an effective manner. Apart from CDS, other instruments of credit derivatives include Credit Linked Note (CLN) and Collateralized Debt Obligation (CDO) which are part of funded credit derivatives where the party that is assuming the credit risk makes an initial payment that is used to settle any credit events that can happen in the future.[6] Hence, the buyer is safe from any credit risk that can arise in the process from the seller. Such transactions are structured as security which allows transferring the risk of specific default to the investors.

An insight into the risks in credit derivatives

As the risk factor has a significant role in credit derivatives, it can be seen that the risks involved in continuing the process of credit derivatives have to be analysed to improve the growth of the financial sector.[7] The risks present in credit derivatives is acting as a hurdle for the investors who are interested in being a part of such transactions and this hindrance is having an impact on the growth and development of the same. Hurdles help in jumping higher and achieving better results while doing it is what leads to greater success. In the same way, as risks increase the outcome of the process also increases due to the methods adopted to solve such problems. Just like the fact that every problem comes with a solution, it is important to understand that most of the functions in the trade or financial sector come with risks that have to be managed by the proper regulation of the same.

A derivative is an investment instrument, consisting of a contract between two parties, risks are bound to happen at various levels of its development. At a glance, it can be said that the primary risks related to derivatives include market risk, counterparty risk, liquidity risk and interconnection risk. While dealing with the risks in CDs, it can be seen that the most severe risk involved in it is regarding the financial stability and functioning of the sector. Such risks arise in the normal

[5] Etay Katz, "Credit Derivatives and Market Conduct: An Update", 2 LAW & FIN.MKT.REV.341 (2008)
[6] John S. Rainey & Patrick J. Beaton, "Managing Credit Risk in Interesting Times through the Use of Credit Derivatives", 120 BANKING L.J. 894 (2003)
[7] David S. Miller, "Credit Derivatives: Financial Instrument or Insurance- And Why It Matters", 3 J. TAX'n FIN. Products 31 (2002)

functioning of the process which can be considered as general risks related to investments. Market risk is one among those risks which happen in the investment process where the probability of investment is a gain or loss is determined based on the investment made.[8] Investors take decisions on their own based on the assumptions made from the nature of the investment which can result in both positive and negative manner. While dealing with the counterparty risk, the fault of any of the parties involved in the process concerning the contract is to be considered as any such default in the contract will affect the whole functioning. Such risks have a greater impact on less regulated platforms as the actions of the seller or buyer fail to be monitored.

The continuous evolution of credit derivatives (Post-crisis reforms)

The regulatory reforms of credit derivatives have been a significant point of discussion since the credit crisis (2007-2009) and the transactions have also been the centre of attraction in the finance world. The credit derivatives platform has been on a continuous development road since its initiation (1990) where there was an accelerated growth that paved way for certain risks and issues.[9] The risks related to operation, counterparty, settlement etc continued to come up, which later became an important discussion topic. The issues about the documentation of the transactions have been cleared with time due to the effective regulatory reforms imposed by the authoritative bodies. The legal framework for transparency in the market was also introduced where the market data was no more a secret resulting in better functions and more growth.

While analysing the changing legal landscape for credit derivatives, it can be seen that before the credit crises happened, the functioning of the derivatives market was very poor and unregulated. The transaction and the agreement made between the parties were done in the least effective manner where none of the factors was considered properly in the derivatives market. This situation has changed creating a great impact on the market where it is subjected to rules and regulations throughout the world.[10] The derivatives market can indeed be blamed for the crisis that happened but the marvellous effect of the regulatory changes on the sector deserves an appreciation for its

[8] Carol M. Beaumier & Carl L. Hyndman, "Credit Derivatives: A New Way to Reduce Risk or Just Another Risk", 12 COM. LENDING REV. 53 (1997)
[9] Kenneth A. Kopelman, Stephen C. Tirrell & Christine L. Ayotte-Brennan, "The Continuing Evolution of Credit Derivatives: ISDA Publishes 2009 Supplement and Protocol", 5 PRATT's J. BANKR. L. 319 (2009)
[10] Hester Peirce, "Derivatives Clearinghouses: Clearing the Way to Failure", 64 CLEV. St.L. REV 589 (2016)

impact which cannot be compared with the other sectors. There have been many alterations in the regulatory process during the post-crisis period beginning with price transparency which has a significant role in the derivatives market. The process of trading derivatives has also opened its doors for reforms where many countries including the United States and European Union came forward for developing platforms for the same.[11] The introduction of electronic platforms for the fulfilment of trading requirements electronically and multilaterally was an effective step in the derivative market.

Another important reform introduced in the derivative was clearing the derivatives where the parties enter into an agreement defining what has to be done (bilateral clearing) in case of bankruptcy, default in payment etc. It is also carried out with the help of a central counterparty who acts as a mediator to manage default risk (Central clearing). This kind of clearance help to understand the creditworthiness of the parties involved in the transaction which is essential to improve the quality of the trade.[12] As time continues to run without any breaks, it is important to evolve at the same pace for the better functioning and development of the sector. The need for a transparent procedure was also considered in the reforms which introduced the regulation regarding reporting about the transactions to the central authority to have a crystal clear transparency in the whole system. One of the main factors in trade, trust, can be established with transparency and it is an essential ingredient for the success of such transactions.

The post-crisis regulations have changed the derivative market in many ways including the liquidity part where the banks were asked to set aside liquidity assets for any future emergency needs. The new regulation has pushed the participants of the derivative market to post more collateral with the requirement of having the collateral in the form of cash or government securities. Hence, liquidity has become an important factor that has to be considered in future transactions in the market. In addition, reduction of systemic risk will be one of the key objectives of the regulations as it determines the functioning of the financial system. Default- free system with a proper valuation of the transaction can be considered as the outcome of the regulations in

[11] Peter H. Huang, "A Normative Analysis of New Financially Engineered Derivatives", 73 S. CAL. L. REV. 471 (2000)
[12] Alireza M. Gharagozlou, "Unregulable: Why Derivatives May Never Be Regulated", 4 BROOK. J. CORP. FIN. & COM. L 269 (2010)

total as the changes brought about through the legal restructuring has had an impact on the trade procedures including the financial aspect. The change in the legal framework of the derivatives has resulted in creating a new face for the whole sector and has left scope for further development in the future. The pre and post-crisis phases have shown that change is not an impossible task and point to the fact that it is an inevitable factor for the development of any sector especially the financial sector.

The development of the credit derivative market has created a new tool for commercial banks to actively manage credit risk.[13] Credit derivatives provide an efficient means of isolating and transferring credit risk to the institutions most suited to hold it. The derivatives allow banks to optimize the risk through active portfolio management, where the distribution of credit risk can be done and further help in the process of generating income which cannot be done elsewhere. Hence commercial banks should consider developing and growing their credit derivative capabilities for the betterment of functions.

A peep into the present derivatives market

In the current scenario, concerning credit derivatives, it can be seen that the Reserve Bank of India (RBI) has come up with an initiative where the retail users can carry out transactions in the permitted credit derivatives for hedging (reducing the potential loss) their own underlying credit risk. They are allowed to undertake transactions for hedging and also for other related aspects based on the guidelines mentioned in the 2021 draft. The surprising factor is that it is allowed even for non- retailers. This initiative was introduced to develop the credit derivative swap (CDS) market as it is an integral part of the whole derivative system. The process of redistribution of risk which is carried out in the CDS market is an effective way of dealing with the risks in the present situation. As risks continue to increase due to the involvement of more investors and sectors, it is better to have a regulatory body with the rules and regulations including the restrictions mentioned in the draft. The functions carried out in the derivative market are completely focused on the credit derivative swap where the scope is widened for the increase in the number of participants in the current market system. A market is a place that continues to change and evolve with time and

[13] Christian A. Johnson, “At the Intersection of Bank Finance and Derivatives: Who Has the Right of Way”, 66 TENN. L. REV. 1 (1998).

hence it is right to say that the actions of the present will decide the future of the derivatives market. It can be concluded that the risks which arise in varied ways can be regulated only with the help of a properly functioning system to protect the interest of the investors to have a secure and effective derivatives market which will further enhance the economy.

Conclusion

Development is more or less the goal of every reform where the functioning and process are altered for better results. Regarding the world of finance, change is mandatory as it deals with risk-filled issues which can be solved through certain regulations which can be formed with time. Time can teach a lot of things and it is important to evolve and develop along with the changing ideologies and functions. Credit derivatives or derivatives, in general, is such an aspect that has to be monitored and regulated as it involves investors who look forward to some kind of profit or gain in the whole process. Investors being a significant part of the derivatives have a great role in determining the future of such aspects concerning the economy. The risk factor is tempting and deviating at the same time due to its complex nature which can be solved through strong regulations and laws. The legal framework has great importance where the structuring has to be done in the required manner. Risks involved in any process can be dealt with, with the help of a legal framework. Any function has to be done based on some rule or regulation and it has to be followed all through the process to avoid unnecessary complications and problems.

While dealing with credit derivatives, it can be seen that the reforms that were made after the credit crisis has helped the whole process to develop and evolve with those new regulations made based on the issues and problems that came up during the time. Such issues act as triggering devices that can have a great impact on the whole sector. The consequences of changes can be determined over time as they are tested in the changing market. These changes have to be closely monitored to understand their functioning and impact on the market so that the process can be carried out based on the same. On the other side, there is no certainty that the derivatives will continue to follow this trend with the changing times. In the pre-crisis phase also it has to be noted that there was profit for large banks and others and it can be restored in the future. Such kind of change is also a possibility in this particular sector. As change can happen, it can happen in such a way that it can create a new market as a whole with different functions and regulations that may be similar to the situation which was present before the crisis. Hence, nothing can be predicted as it continues to change with time and evolve accordingly. In such a situation, the main focus should be given to the process and its impact on the market participants and the market at large so that reforms continue to happen without altering the main purpose of the derivatives. It has to be regulated in such a way that it will have an impact on society and will help in the growth of the economy. Transactions and trade are functions that require a lot of monitoring due to their complex nature and hence it is better to have a proper system for the betterment of the economy of the country which will further contribute towards the development of the world.