Unregulated Financial Products: Potential, Risk and Regulatory Reform

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OECD-ADBI 10th Roundtable on Capital Market Reform in Asia
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• CDS, CDO, CLO, etc.

> Uncertain size: notional, gross, net, market value, etc.
> Uncertain distribution: who is exposed to whom on what, and by how much?
> Uncertain market impact:
  * Mark-to-market losses: banks, insurance companies, etc.
  * Netting, settlement and replacement when a major counterparty fails
  * Restructuring proceedings

> Reforms: Don’t throw baby out with bathwater
  * Trade compression/upgrade standard contracts
  * Centralized clearing counterparty
  * Revive securitization markets
  * Others (e.g., “skin in the game”)
• **Hedge funds**
  > Performance
  > Change in assets under management
  > Leverage and market impact: liquidity providers or takers?
  > Reforms: focus on hedge funds or prime brokers?

• **Private equity**
  > Leverage of the target companies
  > CLOs

• **Back to the banks**
  > Exposure to risk
  > Funding risk
Credit Default Swaps Outstanding — Gross Notional*

US$ trillions


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Source: BIS (December 2007 and June 2008); DTCC (all other dates); IIF calculations.
* Estimate of gross notional value of CDS outstanding; assumes DTCC database covers 90 percent of CDS market.
Credit Default Swaps Outstanding – Net Notional*

Source: DTCC; IIF calculations.

* Estimate of net notional value of CDS outstanding; assumes DTCC database covers 90 percent of CDS market.
Credit Default Swaps Outstanding by Type of Counterparty

US$ trillions, gross market value

- Nonfinancial firms
- Other financial institutions*
- Reporting dealers

Source: BIS; IIF calculations.
* Includes banks and security firms, insurance and financial guaranty firms, and other financial institutions.
Securitized Assets Outstanding by Region*

U.S. Originated Assets

US$ billions

- ABS
- Nonagency RMBS
- Agency MBS
- CMBS

Total: $9,607 bn

- 5,048
- 2,658
- 626
- 1,275

European Originated Assets

US$ billions

- ABS
- CDO
- CMBS
- RMBS
- WBS**

Total: $2,415 bn

- 1,487
- 267
- 55
- 192
- 19.6

Source: European Securitization Forum.
* Outstanding volumes at end-2008. ** Whole business securitization.
Losses Reported by Financial Institutions*

**Banks**

- **Americas**: 500.3
- **Europe**: 292.7
- **Asia**: 29.7

**Total: $823 bn**

**Insurance Companies & GSEs**

- **Americas**: 257.7
- **Europe**: 19.6
- **Asia**: 1.5

**Total: $279 bn**

Source: Bloomberg.

*Since beginning of 2007; includes writedowns and credit losses.*
Lehman-referencing Credit Default Swaps

Source: BIS.
• Reforms: Don’t throw baby out with bathwater
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Hedge Fund Annual Returns

Source: Bloomberg; IIF calculations.
Hedge Fund Assets Under Management

Hedge Fund Leverage

Source: FSA.
Leveraged Loans Outstanding

US$ billions

Source: S&P/LCD.
Underwriting Standards for Leveraged Loans

percent of outstanding loans

- Covenant-lite
- Second-lien

Source: JPMorgan.
Leverage Multipliers of Outstanding Leveraged Loans

weighted average current debt/EBITA ratio

Source: S&P LCD.
Collateralized Loan Obligation (CLO) Issuance*

Source: SIFMA.

* Global issuance of CDOs backed by investment grade or high yield loans.
Loans/Credits
- Mortgages
  - Subprime
  - Home equity loans
- Consumer finance
  - Auto loans
  - Credit cards
- Corporate credit
  - High yield
  - LBO leveraged loans

Innovative Products
- CDS
- MBS/ABS
- CDO
- CLO

Investors
- Insurance companies
- HF/AM/Pension funds
- SIV/Conduits
- ABCP investors (money market MFs, municipalities, etc.)

Banks
- Origination and servicing
- Buy loans to securitize
- LBO bridge loans
- Credit to originators

Package and distribute, retaining a portion/warehousing financing

Providing insurance/hedging to banks

Prime brokerage and repo markets

ABCP backup liquidity lines
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