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Credit Derivatives: Did They Exacerbate the 2007 Global Financial Crisis? AIG: Case Study

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Abstract

Banks and other financial institutions have increasingly realized the necessity to measure and manage the credit risk of their loans. Credit derivatives CDs, therefore, have arisen in response to the surging demand of financial institutions to design vehicle tools for hedging and transferring credit risks. Credit Default Swaps CDS are valuable financial tools that have created system-wide benefits. However, at the same time these innovation contracts have likewise created the prospect for market participants to destabilize the whole economic system. Over the last years, international financial markets have suffered disastrous disruptions caused by various factors. The most important of these factors, in particular, is the detrimental impact of CDs as hedge funds on different markets of different sizes and structures. They have been blamed for part of the difficulties associated with the subprime credit crisis. As though, these credit risk transfer products require a basis for sound applications and uses. This study aims to elucidate on the problems associated with market participants in particular the large financial institutions that were eminently involved the recent financial crisis. Furthermore this paper presents a discussion of the blaming of hedge funds for financial crisis by focusing on the American International Group which blundering in the CDS market and causing system-wide instability, and argue the company's high efficient risk management and profuse diversity financial tools, which insure financial institutions, could prevent sorts of financial risks. As a result of AIG's exposure analysis in CDS positions, we find CDS were key contributor on igniting and exacerbation of current financial crisis.

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Key words: CDs, Subprime Credit Crisis, CDS, AIG;

1. Introduction

In general, CDs are remarkably versatile and adjustable instruments, allowing counterparties to efficiently manage their credit risk exposure and their value is derived from underlying credit instruments. CDs are essentially designed to reduce or eliminate credit risk by offering insurance contracts against losses experienced due to the credit events as well as to acquire specified level of credit exposure to enhance the profits of market's participants.

Among various CDs tools, a credit default swap is the most important type of CDs, bilateral over-the-counter OTC contract whose purpose is to shift credit exposure to a credit protection seller. A protection buyer pays periodic cash flows as a premium to the protection seller in exchange for payment if a credit event occurs.

While CDs play an effective role by reallocating risk and allow superior alignment between maturities of diversified credit exposures, they can also create problems in the financial system by minimizing incentives to monitor the

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borrowers, create moral hazard problem and asymmetric information risks that have been pictured as one of the main culprits of the recent financial crisis.

These credit transfer vehicles have had a considerable effect on financial markets, both in easing the trading of credit risk and increasing the complexity of financial transactions. This paper proceeds as follows, firstly, we provide an overview of CDs, problem statement and research objectives. Secondly, we highlight market challenges of CDs and their role in the 2007 financial crisis. Thirdly, we shed light on some aspects of the American International Group AIG including its Background, AIG Bankruptcy, Share Price and an aggressively writing on CDS. Finally, we present concluding remarks.

1. Overview of Credit Derivatives Market

Credit derivatives are the fastest growing area of the OTC derivatives during the first decade of the twenty-first century. According to British Bankers Association (Figure 1), the global outstanding of CDs grew from $180 billion notional value in 1996 to $20 trillion in 2006, about 112 times the market size of 1996. By June 2008, notional amounts of CDs were estimated to rise over $33 trillion. CDs become a key instrument in the financial capital as a tool to manage credit exposure. These instruments are designed initially to isolate the credit risk of the underlying asset, by providing insurance against a specific exposure of credit events (Eales and Choudhry, 2003), but have actually become a serious tool of trading.

The rapid growth in CDs was mostly driven by increased request from banks and other financial institutions to manage their credit exposure. The growth of these tools came into existence when the uncertainly business world was rising (Gupta, 2005). With the use of CDs, banks can actively unbundle and manage credit risk in unprecedented ways, and can convert their credit risk profiles rapidly (Schinasi et al., 2000).

There are fundamentally two reasons why the participations on credit derivatives market have found them attractive, the first one is, Credit Derivatives can allow businesses to manage effectively exposures to a credit related event and customize the credit exposure intended, without having proximate relationship with other parties (Lore and Borodovsky, 2000) The flexibility of CDs and as they are over the counter OTC financial tools, they can be designed to meet specific requirements of dealers so these instruments of risk dispersion satisfied the needs of investors who wanted to reduce asset risk in volatile markets (Eales and Choudhry, 2003). The other is, the usage of CDs allows the main dealers to trade more efficiently and employs less capital and can be designed to meet specific counterparty's requirements.

1-1 Problem Statement

Undoubtedly, CDs have been the most important financial innovations in the last few decades; however, there have been many studies suggest that the risks that they trigger are wide harder than feasibilities generated.

Warren Buffet claims that CDs are "weapons of mass destruction". These words had been written five years before the credit crisis broke out. In contrast speeches as chairman of the Federal Reserve System, Alan Greenspan states "that credit derivatives and other complex financial instruments have contributed to the development of a far more flexible, efficient, and then resilient financial system". Alan Greenspan's impression is that credit derivatives are sensational tools to efficiently allocate risk, expediting the access of many businesses into credit. Greenspan further indicates that the risk dispersion tools CDs have capacitated the largest and most professional banks in their credit-afford role to shun much credit exposure by transferring it to institutions with far less leverage. This paper argues that the unprecedented growth of CDs of all kinds, mainly Credit Default Swaps CDS, and there hidden dangers have considerably contributed to the exacerbation and transmission of the financial crisis. While CDs can generate benefits, these instruments have a significant effect on financial markets, both in mitigating the trading of credit risk and increasing financial transactions complexity. However, the affirmative thought of the role of credit risk transfer has been criticized and CDs are blameful for portion of the difficulties associated with the subprime credit crisis.

Research Objectives

The purpose of this paper is to identify the nature, uses and the main issues of CDs in financial markets. Further, we aim to investigate whether CDS are a key contributory factor to the 2007 global financial crisis. The analytical focus