Credit Valuation Adjustments Will Change The World

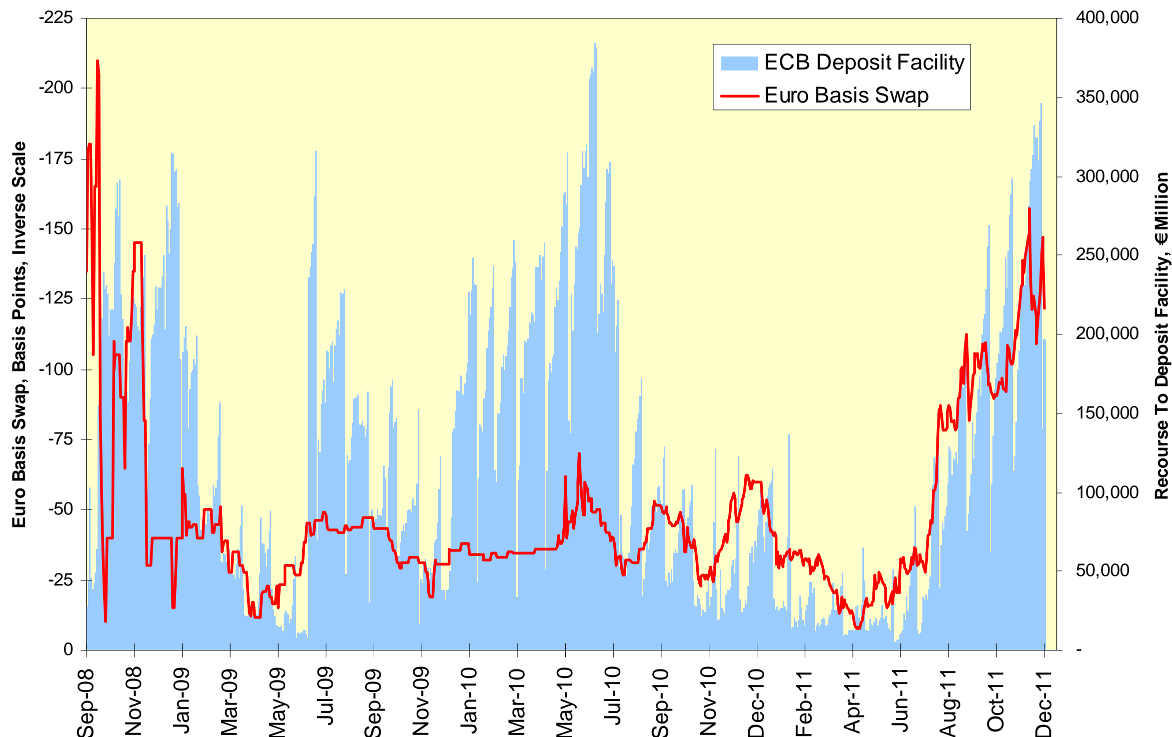
Accounting For Counterparty Risk Means Banks Will Have To Assume Less Of It

Archimedes understood the principle of leverage: "Give me a place to stand, and I will move the earth." He also was alleged to have set fire to Roman ships besieging Syracuse with a set of solar mirrors; not only would this have been a rare case of unsubsidized solar power achieving something, it would have created one of history's great YouTube moments (I think the parting of the Sea of Reeds during the Exodus would be the chart-topper in this category).

Regulators, risk managers and compliance officers understand the principle of leverage as applies to things such as the Basel III capital standards. These require counterparties to account for credit valuation adjustments (CVA) on swaps. A CVA is the difference between the fairytale risk-free portfolio and a real-world portfolio where the probabilities of counterparty default are calculated. The principle is simple: He who lies down with dogs will not only arise with fleas but will have to fork over additional capital to sustain the position. You might think something like this would have existed before June 2011, but it did not.

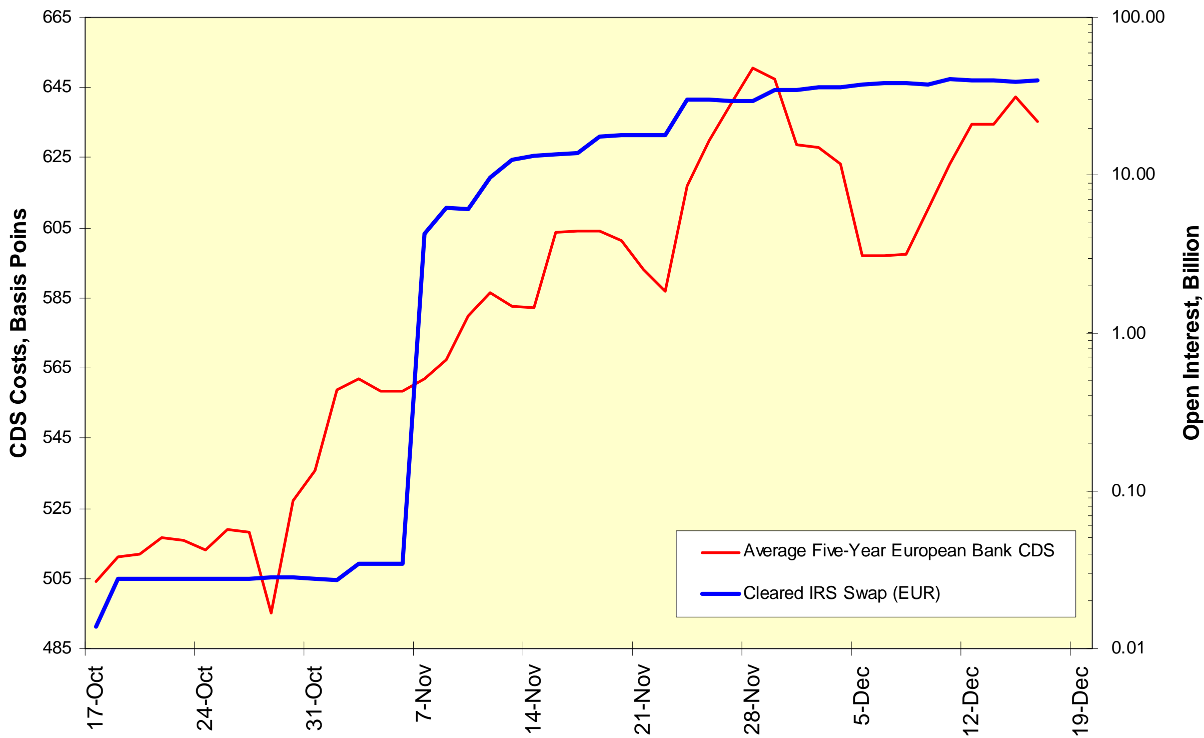
Banks Fleeing Each Other
The 2008 financial crisis really culminated with a collapse in interbank liquidity between late September and mid-October. European banks found themselves dollar-short and were willing to accept a lower interest rate on euros than they were paying for dollars. This negative basis swap corresponded with an increased use of the European Central Bank's deposit recourse facility: Banks did not trust each other and therefore put their funds on deposit with the ECB. If the current situation, depicted below, looks like 2008 or like the Greek bailout in May 2010, it is.

Liquidity Stress Pushes Interbank Lending To ECB Deposits



Where To Now?
One way interest rate swap players could sidestep CVA charges is to collateralize the position; a second way would be to buy credit default swap protection on their counterparty to offset credit risk. Both of these tactics are very, very expensive and in the CDS case, their reliability has to be questioned after this past summer's trouncing of "the meaning of bankruptcy" in the Greek case.

The answer of how banks will handle the real costs of doing business likely will be a migration of interest rate swap positions to a centralized clearinghouse. A good illustration of this can be found in the exponential growth in cleared euro interest rate swaps on the Chicago Mercantile Exchange in response to the rise in the average cost of a five-year CDS on European banks.



This centralized clearing of swaps really cannot come fast enough for my taste. The old concept of a bank's risk being its net position really collapses in a time of financial stress; the failure of one or more key players will lead to banks facing their gross exposure with each other and with their corporate clients. Restated, if you loved the Lehman Brothers bankruptcy, you would really love the failure of a major European bank holding a pile of dodgy sovereign debt.

The simple move of forcing everyone to face reality and to get away from mark-to-myth and extend-and-pretend accounting will go a long way toward defusing some of the ticking time-bombs out there. The centralized clearing of smaller derivative books has to be preferable to another round of the exhausting rollercoaster ride of 2011.