ROLE OF CREDIT DEFAULT SWAPS (CDS) IN 2008 FINANCIAL CRISIS AND SUBSEQUENT LEGAL REFORMS

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1. Introduction

Credit Default Swaps (CDS) emerged as a vital aspect of the crisis because financial practitioners initially designed these derivatives to manage credit risk but eventually used them to bet against the market. CDS took an intricate role throughout the financial collapse yet failed to produce the crisis by itself and demonstrated both positive and negative influences. CDS transactions exposed financial systems to additional systemic threats because institutions including American International Group (AIG) collapsed in covering their obligations thus requiring major government intervention.[1] The insurance function of CDS contracts could not be properly utilized because these agreements were commonly used without holding the underlying assets thus creating market irregularities and higher counterparty risks. The collapse of Lehman Brothers during September 2008 showed the extensive risks associated with unmanaged CDS contracts because financial institutions incurred substantial financial losses from CDS deals. The financial crisis pressured regulators across the world to redesign legal protocols which control CDS and other OTC derivatives. National legislators passed Dodd-Frank and EMIR legislation to combat market opacity while making central clearing mandatory and controlling excessive speculation after the financial crisis.[2] This research looks at how CDS functions during the 2008 financial crisis before analyzing the establishment of post-crisis regulations that aim to stop another financial market collapse.

2. Understanding Credit Default Swaps (CDS)

Definition and Structure

The financial market tool Credit Default Swaps (CDS) helps transfer credit risk between different entities who enter this derivative contract. The instrument works as insurance by

[1] Lynn A. Stout, Derivatives and the Legal Origin of the 2008 Credit Crisis, Vol. 1(1), HARV. BUS. L. REV., 1 (2011).
[2] International Swaps and Derivatives Association (ISDA), The Role of Derivatives in the Financial Crisis, 12 (January 2009), available at https://www.isda.org/a/IIEJDE/role-of-derivatives.pdf.

allowing premium payments from the CDS buyer to the seller regarding protection against reference obligation default. An entity that owes the debt maintains the role of reference entity.[3] The protection buyer in CDS deals looks for credit risk protection through premium payments that the protection seller accepts as a risk obligation. When a pre-defined credit event happens like bankruptcy or debt failure to pay or debt restructuring the seller must compensate the buyer through the choice of physical settlement which requires asset purchase at face value or cash settlement which involves paying the difference between asset notional value and market price.[4] The CDS market developed new complex instruments alongside Synthetic Collateralized Debt Obligations (Synthetic CDOs) and Index CDSs that combine various reference entities under one contract for improving trader liquidity.Economic Functions.[5]

Economic Functions CDS contracts perform the following economic goals:

1. Through CDS contracts both financial institutions together with investors function to reduce their exposure to credit risks. Financial institutions that grant substantial loans by buy CDS contracts as a means to protect against default losses to their borrowers.

2. The trading activity in the CDS market helps bond market participants find fair prices while increasing marketplace liquidity so investors can manage their risks effectively.

3. Through CDS contracts investors conduct speculative trades on the credit value of a company without directly owning its assets. Individuals who specuate in CDS contracts secure cover from distressed entities to obtain profits if credit defaults happen or sell CDS protection at elevated prices when market perceptions change.Advantages and Risks

Advantages:

Financial institutions use CDS contracts to shift their credit risk efficiently to numerous market participants thus preventing concentrated exposures.

The credit swap market enables investors to access credit market opportunities through

[3] Dan Awrey, Complexity, Innovation, and the Regulation of Modern Financial Markets, Vol. 2(2), HARV. BUS. L. REV., 235 (2012).
[4] U.S. Securities and Exchange Commission (SEC), Study on the Role of Credit Rating Agencies in Structured Finance Markets, 45 (July 2008), available at https://www.sec.gov/files/cred-rating-study-2008.pdf.
[5] *Ibid.*

indirect bond purchases which establishes multiple investment options across credit areas.[6]

Market transparency occurs because CDS prices display the current market perception of credit risks for entities.

Risks:

Counterparty risk remains high in over-the-counter (OTC) CDS transactions because default by any counterparty may trigger financial instability throughout the entire system just as it did in 2008.

The use of naked CDSs allows investors to acquire protection contracts without owning assets under scrutiny because it intensifies financial distress and encourages attacks on sovereign debt.

The opaque structure of CDS markets faces regulatory challenges across two mainstream regulatory reforms: Dodd-Frank stays active in the United States independently from European Market Infrastructure Regulation (EMIR) as a European intervention.

3. The Role of CDS in the 2008 Financial Crisis

CDS and the Housing Market Bubble

The 2008 financial crisis emerged because U.S. financial institutions gave too many subprime mortgage loans to homebuyers without proper loan qualifications. Mortgage-backed securities (MBSs) and collateralized debt obligations (CDOs) were formed from these dangerous loans before being distributed to investors extensively.

Credit Default Swaps (CDSs) functioned as fundamental instruments for promoting and enlarging the securitization process.[7] Financial institutions that bought MBSs and CDOs protected themselves from default risk through the acquisition of CDS contracts[8]. The practice

[6] European Central Bank (ECB), OTC Derivatives and Systemic Risk: Lessons from the Crisis, ECB Occasional Paper Series No. 133, ¶22 (2012), available at https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp133.pdf.
[7] Gillian Tett, The Role of Credit Derivatives in the 2008 Crisis, Vol. 44(3), J. Fin. Econ., 487 (2009).
[8] International Swaps and Derivatives Association (ISDA), The Role of Derivatives in the Financial Crisis, 12 (January 2009), available at https://www.isda.org/a/IIEJDE/role-of-derivatives.pdf

created a situation in which banks retained fewer incentives for maintaining high-quality loans because CDS sellers began taking on default risks shared from the banks.

The market speculation for CDS contracts caused an expansion of the financial bubble. Hedge fund investment firms built poorly made CDOs with the goal of profiting from CDS contracts that they bought to short against those dangerous securities.[9] Market participants used the trading method called "naked CDS trading" to generate profits from defaulted contracts while elevating risks that affected entire systems.

CDS and the Collapse of Financial Institutions

Major financial institutions experienced collapse in 2008 because they held excessive amounts of CDS contracts.[10] In March 2008 Bear Stearns sustained a liquidity crisis because of its losses from CDS contracts so the company received emergency help from JPMorgan Chase as well as support from the Federal Reserve.

The worst failure in the financial crisis happened when Lehman Brothers declared bankruptcy during September 2008. Lehman Brothers remained weak because it used short-term funding while heavily investing in subprime mortgage assets. The numerous CDS contracts connected to Lehman Brothers' securities aggravated market uncertainty because counterparties encountered difficulties in determining possible financial losses.

AIG encountered massive financial difficulties when the company faced bankruptcy due to its absence of hedging protection on mortgage-related derivative contracts. The downgrade by rating agencies forced AIG to fail its collateral requirements as the company lacked sufficient funds to meet them.[11] The U.S. government provided $180 billion in funds to save the system from imminent failure.

Counterparty Risk and Systemic Failures

The 2008 market collapse revealed hidden counterparty risks that exist in both traded and non-standardized (OTC) CDS agreements. CDS sellers such as AIG did not establish enough

[9] *Ibid.*
[10] Arthur E. Wilmarth Jr., The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem, Vol. 89(3), OR. L. REV., 951 (2011).
[11] *Ibid.*

default coverage reserves despite depending on their strong credit standing for avoiding collateral demands.[12] Numerous institutions faced financial collapse after defaults reached high levels because counterparties requested immediate collateral delivery.

The interconnected structure of the CDS market served to increase the risk which affected the entire financial system. The inability of AIG to fulfill its payment obligations would trigger an immediate catastrophic domino effect on the worldwide financial network because numerous banks and investment institutions received direct CDS protection from AIG.[13] The interconnected nature of the financial industry prompted the U.S. government to step in because confidence ceased to exist in the markets.

4. Legal and Regulatory Gaps Prior to the 2008 Crisi

Lack of Transparency and Over-the-Counter Trading

Before the 2008 financial crisis the main legal gap involved insufficient transparency surrounding the over-the-counter (OTC) Credit Default Swap (CDS) market.[14] The private nature of CDS negotiations caused monitoring challenges because regulators lacked sufficient visibility into this market's unique risks and systemwide vulnerabilities of the industry.

Financial institutions benefited from customized CDS contracts through OTC trading however the system created extensive market imbalances through lack of clear data about CDS volumes and pricing as well as counterparties secrecy.[15] During the 2008 financial crisis the inability to view CDS trading activities prevented institutions from understanding their counterparty risk which disrupted financial markets through widespread panic.

After the crisis regulatory authorities determined that higher transparency principles became critical.[16] At the 2009 G-20 Pittsburgh Summit world leaders stated that the reporting of all OTC derivatives to trade repositories would allow regulators to access market data including

[12] Frank Partnoy & David A. Skeel Jr., The Promise and Perils of Credit Derivatives, Vol. 75(4), U. CIN. L. REV., 1019 (2007).
[13] Lynn A. Stout, Derivatives and the Legal Origin of the 2008 Credit Crisis, Vol. 1(1), HARV. BUS. L. REV., 1 (2011).
[14] David Mengle, Credit Derivatives: An Overview, Vol. 4(3), Fed. Res. Bank Atlanta, 1 (2007), available at https://www.frbatlanta.org/-/media/documents/research/publications/economic-review/2007/vol4no3_mengle.pdf.
[15] *Ibid.*
[16] International Swaps and Derivatives Association (ISDA), The Role of Derivatives in the Financial Crisis, 12 (January 2009), available at https://www.isda.org/a/IIEJDE/role-of-derivatives.pdf.

CDSs. The Dodd-Frank Act (2010) of the U.S. united with the European Market Infrastructure Regulation (EMIR) of the EU to enforce both reporting requirements and mandatory central clearing procedures for CDS deals.

Regulatory Arbitrage and Speculative Practices

Prior to the financial crisis financial institutions found ways to bypass regulatory rules in order to maintain low capital reserves while gaining increased financial leverage.[17] The practice of regulatory arbitrage included banks creating mortgage-backed securities and collateralized debt obligations from risky assets before they used CDS contracts as risk hedges. Through this method the institutions attained regulatory freedom from banking requirements for capital reserves.

CDSs enabled investors to speculate through naked CDS trading which involved buying credit protection on bonds even if they did not actually own them. The market developed major distortions because speculative CDS trading created more financial instability in sovereign debt markets.

United States legislators made the problem worse through the Commodity Futures Modernization Act (2000) which created an unregulated zone for CDSs leading to excessive uncontrolled speculative trades.[18] Because the market went without proper oversight systemic risks increased to critical levels which led to the downfall of Lehman Brothers together with AIG in 2008.

The Role of Rating Agencies

Credit rating agencies Moody's Standard & Poor's and Fitch were essential elements in causing the 2008 crisis. The rating firms gave out AAA ratings to high-risk mortgage-backed securities and CDOs which allowed financial institutions to replace accurate risk evaluations with CDSs.

Rating agencies faced significant conflict of interest because issuers paid for their services

[17] Dan Awrey, Complexity, Innovation, and the Regulation of Modern Financial Markets, Vol. 2(2), HARV. BUS. L. REV., 235 (2012).
[18] *Ibid.*

instead of using investor funds.[19] The payment system that rating agencies followed produced misleading scores that deceived market players into trusting these ratings.[20] The increased number of mortgage defaults caused rating systems to fail which initiated a sequence of CDS payout events that worsened economic instability.

The financial crisis motivated reforms with the goal of improving credit rating accountability. Since its enactment the Dodd-Frank Act established tougher requirements for rating approach disclosure standards simultaneously the EU Regulation on Credit Rating Agencies (CRA Regulation) implemented measures which minimized rating agency conflicts of interest along with expanded regulatory authority.

5. Post-Crisis Legal Reforms and Regulatory Measures

The Dodd-Frank Act and CDS Market Oversight

The 2008 financial crisis in America received its most immediate legislative response through the creation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010).[21] This Act created a system to track systemic risks linked with over-the-counter derivatives including Credit Default Swaps (CDS). Title VII from the Act which people call Wall Street Transparency and Accountability Act required improved visibility together with regulatory control and risk management solutions for derivative marketplaces.

All CDS transactions needed to report trade data for regulatory observation purposes under the new requirements of the Act.[22] The Act bestowed regulatory authority upon both the Commodity Futures Trading Commission and the Securities and Exchange Commission to maintain CDS market compliance with its trading and clearing principles.

European Union's Regulatory Framework

The European Union implemented a thorough regulatory system to manage derivatives trading

[19] European Central Bank (ECB), OTC Derivatives and Systemic Risk: Lessons from the Crisis, ECB Occasional Paper Series No. 133, ¶22 (2012), available at https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp133.pdf.
[20] *Ibid.*
[21] U.S. Securities and Exchange Commission (SEC), *Study on the Role of Credit Rating Agencies in Structured Finance Markets*, 45 (July 2008), available at https://www.sec.gov/files/cred-rating-study-2008.pdf
[22] David Mengle, Credit Derivatives: An Overview, Vol. 4(3), Fed. Res. Bank Atlanta, 1 (2007), available at https://www.frbatlanta.org/-/media/documents/research/publications/economic-review/2007/vol4no3_mengle.pdf.

after the financial collapse occurred. EMIR became operational as a European Market Infrastructure Regulation during 2012 to improve market continuity by promoting central clearing and trade reporting and risk controls.

Through its creation of the European System of Financial Supervision (ESFS) the EU formed both the European Systemic Risk Board (ESRB) and the three sectoral supervisory authorities.

- European Banking Authority (EBA)
- European Securities and Markets Authority (ESMA)
- European Insurance and Occupational Pensions Authority (EIOPA).

These entities received their assignment from regulatory mandates to track systemic dangers and enforce financial organizations to comply with the new regulatory framework.[23] The implementation of EMIR established CCP clearing requirements for derivatives agreements and non-Clearing derivative transactions needed to fulfill capital threshold criteria for risk reduction purposes.

Introduction of Central Clearing and Reporting Requirements

After 2008 came the essential regulatory change that demanded financial institutions to use CCPs for clearing their CDS and other derivative contracts alongside mandatory reporting standards. The objective behind this regulation was to make financial systems more transparent by requiring institutions to conduct their trades through CCPs for lowering counterparty risk.

Restrictions on Speculative CDS Trading

Before the crisis subsidiary CDS trading through naked contracts became the most disputable market practice because investors bought these contracts without owning underlying bonds.[24] Many analysts condemned this practice because it deepened market volatility resulting in financial markets becoming unstable.

[23] Gillian Tett, The Role of Credit Derivatives in the 2008 Crisis, Vol. 44(3), J. Fin. Econ., 487 (2009).
[24] Ben S. Bernanke, THE COURAGE TO ACT: A MEMOIR OF A CRISIS AND ITS AFTERMATH, 304–325 (W.W. Norton & Company, 2015).

The occurrence of speculative CDS trading prompted regulators to implement several regulatory frameworks for its control:

- Under the EU Short Selling Regulation (SSR) naked CDS trades that targeted government debt became banned since traders must physically own the underlying bonds first.

- The Federal Financial Supervisory Authority (BaFin) from Germany issued a temporary restriction on Eurozone government bond naked short selling and naked CDS trading during 2010.[25]

- Under Dodd-Frank regulators gained more power to manage speculative trading activities while restrictions were implemented for high-risk CDS transactions.

6. The Impact of Reforms and Current Challenges

Increased Market Transparency and Stability

Post-crisis reforms achieved major success through their creation of better transparency and market stability within the CDS marketplace. Previously CDS transactions operated as over-the-counter (OTC) products thus regulators alongside market participants remained unaware about system-wide risk factors before 2008.[26] The Dodd-Frank Act (2010) in the U.S. along with the European Market Infrastructure Regulation (EMIR) in the EU created both jurisdictions' requirement to send their trade transactions to central trade repositories for regulator access to real-time market data.

The implementation of central clearing counterparties (CCPs) reduces counterparty risk which played a significant role in the financial spread of 2008.[27] The implementation of clearinghouses between CDS buyers and sellers enables the system to withstand single institution failures that would previously set off multi-level financial system crises. The put in place restrictions supplied protection against pre-crisis levels of speculative behavior in CDS trading while reinforcing participant oversight of markets.

[25] *Ibid.*
[26] Andrew Ross Sorkin, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM—AND THEMSELVES, 447–463.
[27] *Ibid.*

Challenges in Implementation and Compliance

- Although some improvements have been made, there remain soft spots in the supervision and execution of CDS's management.

- Shift of Regulation: Mostly financial bodies look for some loophole to breach the rigid supervision. Some companies have relocated some of their trading of derivatives to other countries where enactments are not strict, which weakens the safety of the international finance system.

- Expenditure of Adherence: Some operational prerequisites like reporting and calling have been heightened, which lead to high expenses operationally for the financial institutions.[28] Some banks and investment companies claim that these expenditures hamper rather than enhance the market's liquidity and thwarts proper hedging.

- Systemic dangers of Consolidated Counterparty Procedures: Concentrated counter party control encourages the mitigation of individual participants risk, but introduces a new danger termed as concentration risk. Should one large clearinghouse fail, the whole banking system could collapse in a way that is similar to 2008.

The Future of CDS Regulation

As time goes by, regulatory bodies attempt to modify rules governing credit default swaps to take into account potential risks that are imminent.

- Greater Integration of Varied Jurisdictions: The regulators working in this area are attempting to integrate different governing sets to deal with regulatory avoidance for the obvious reasons regarding the international character of the CDS realm.

- Augmented Stress Test for Centralised Cleared Counter Party: More conservative tests for capital and margin placed on clearing houses are being looked as a means to avert the failure of centralised clear counter party.

[28] David Mengle, Credit Derivatives: An Overview, Vol. 4(3), Fed. Res. Bank Atlanta, 1 (2007), available at https://www.frbatlanta.org/-/media/documents/research/publications/economic-review/2007/vol4no3_mengle.pdf.

7. Conclusion

The crisis underlined the risk of the lack of supervision within the financial market. Lehman Brothers' failure, the AIG's close collapse, and the ensuing panic in the market highlighted the transparency and counterparty risks in the CDS contract.[29] Regulators responded with far-reaching regulatory changes to increase transparency, contain systemic risk, and avert excessive speculation. Post-crisis regulations, such as the Dodd-Frank Act in the United States and EMIR in the European Union, implemented compulsory central clearing, reporting of trades, and prohibitions on speculative trading.[30] These were designed to lower counterparty risks, enhance market surveillance, and promote financial stability. Although these reforms enhance market resiliency, there are challenges facing their implementation in the form of regulatory arbitrage, costs associated with compliance and possible CCPs-related risks.

Forward looking, CDS regulation continues to be a changing problem. With increasingly pressing requirements for worldwide coordination to keep potentially damaging financial innovations on the straight and narrow, regulatory and economic interests have long converged.[31] Lastly, policymakers are obligated to provide incentives that harmonize market discipline and efficient operation in an attractive competitive framework so as to sustain growth, thereby stabilizing financial systems.

Hence, even though reforms in CDS have eliminated some of the weaknesses leading to the 2008 crisis, there is still room for challenges in sustaining an efficient regulatory structure. Whether these reforms will be effective will hinge on sustained observation, flexibility to respond to new financial threats, and collaboration between countries. The experience from the crisis is an eye-opener to the fact that legal and financial governance have a fundamental role to play in averting future financial crises.

[29] *Ibid.*
[30] European Central Bank (ECB), OTC Derivatives and Systemic Risk: Lessons from the Crisis, ECB Occasional Paper Series No. 133, ¶22 (2012), available at https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp133.pdf.
[31] Emilios Avgouleas, GOVERNANCE OF GLOBAL FINANCIAL MARKETS: THE LAW, THE ECONOMICS, THE POLITICS, 212 (Cambridge University Press, 1st edn., 2012).