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Recent Developments in Financial Markets: Some Implications for Financial Stability

In a speech to be delivered at the Banca D'Italia on 9 March, David Clementi, Deputy Governor Financial Stability, discusses some recent developments in financial markets and their possible impact on financial stability.

Mr Clementi highlights the rapid change in the instruments and markets used for the transfer of credit risk and in particular credit derivatives. A survey by the British Bankers' Association in July 2000 found that outstanding notional principal of all credit derivatives had increased more than three times since 1997 to around \$600 billion. However, this is small relative to the overall size of the OTC interest rate derivatives market (according to BIS data, around \$64 trillion).

Mr Clementi notes that the development of markets for the transfer of credit risk should be highly desirable. If they work well, they have the potential to enhance financial stability and efficiency by ensuring that exposures to shocks are diffused throughout the system with no single player excessively exposed.

However he draws attention to possible questions about transparency and about documentation.

Transparency to the extent that these markets mean that a bank need no longer remain exposed to its main customers but can rapidly take on large exposures to other credits without any new borrowing by the underlying entities. This could make it more difficult for creditors, shareholders and regulators to assess risk.

Documentation to the extent that participants may have different understandings of the transactions into which they have entered and to the extent that there may be uncertainties about how the courts in some countries would treat these agreements, which have yet to be tested in a downturn. The recent debate about whether and how restructuring should be included within the definition of a credit event is an example although ISDA, the International Swaps and Derivatives Association, is addressing the question.

He concludes that market participants will therefore have to pay even greater attention to documentation, in particular to any unsigned master agreements or backlogs of confirmations. "It is not a happy position if back and middle offices are struggling to keep up with the traders."

The Bank of England, will continue to monitor developments in this area as part of its responsibility for financial stability and its more general role in relation to financial markets.