May 2023

Single-name CDS Market Update

Credit default swaps (CDS) are an important hedging tool for lenders and investors. ISDA's latest review of the single-name CDS market reveals some interesting dynamics about trading activity over the past five years.

While single-name CDS market liquidity overall continues to decline, and all but a handful of reference entities are illiquid, market activity over the past five years has increased during certain periods as credit conditions tightened and the risk of defaults rose. At the same time, transparency has further improved and clearing of single names has increased.

EXECUTIVE SUMMARY

- Single-name CDS market activity rose at the onset of COVID in 2020, throughout 2022 and particularly in the first quarter of 2023, when trading reached a five-year peak of $1.1 trillion (Chart 1). CDS index volumes have also risen (Chart 2).

- During these periods, the number of non-sovereign names averaging 10 or more trades per day increased (Chart 3). This activity underscores the episodic nature of CDS liquidity in response to heightened credit concerns. At these times, CDS liquidity increases and can play a valuable role in hedging and managing risk in individual names (Charts 5, 6 and 7).

- However, the vast majority of non-sovereign names are illiquid, with only a handful averaging 10 or more trades per day. These names represent 3% or less of the total universe of entities that traded each quarter during the past five years, with the exception of the first quarter of 2023. In addition, the number of names that trade in a quarter continues to decline, from 854 in the first quarter of 2018 to 719 in the first quarter of 2023 (Chart 3).

- Looking at liquidity in another way, 1,169 reference entities traded at least once over the past five years and 600 names traded on average less than once per quarter (with total notional activity in them generally less than 15%). The remaining 496 names traded every quarter, totaling more than 80% of all market activity (Chart 4). Of these 496, 30 were in the top 100 of notional traded every quarter. These names account for one third or more of trading volume per month (Chart 4). Sixteen of the 30 names were sovereigns.

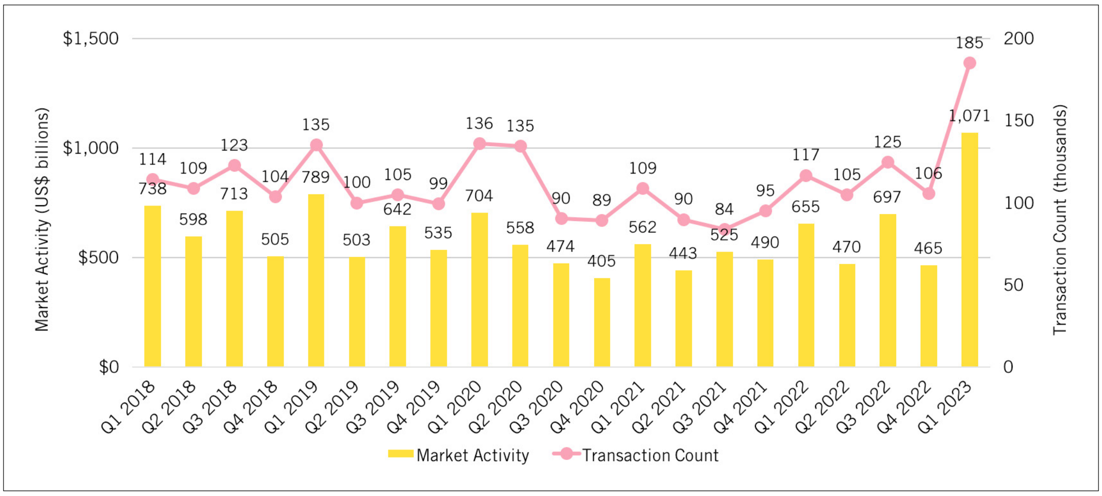
- The illiquidity of single-name CDS has important implications for how market participants view CDS prices/spreads. (The price of a CDS, which can be used to derive the reference entity's creditworthiness or probability of default, is also known as the spread and is usually expressed as a proportion of the trade's notional value in basis points.) Changes in spreads from transaction to transaction can be significantly affected by the illiquidity of a reference entity (as well as other factors) and are understood in this way by market participants.

- Public and regulatory transparency in the CDS market continues to increase. Real-time public reporting of single-name CDS transactions is available in the US since February 2022. Pricing information is available on a global basis from several vendors, as well as central counterparties (CCPs). Real-time public reporting of CDS index trades has been available in the US for some time. Key details of all trades are required to be reported to regulators via trade repositories in all major trading centers. The Depository Trust and Clearing Corporation Trade Information Warehouse (DTCC TIW), a centralized electronic database, holds the most current information for virtually all cleared and bilateral CDS contracts globally.

- Central clearing is now well established for US and euro-denominated index and single-name CDS, as counterparties seek the risk management and capital efficiencies that clearing offers. The Bank for International Settlements estimates that half of the overall market is cleared globally. At year-end 2022, CDS open interest at four major CCPs was about $2.9 trillion and initial margin was $70.1 billion. 87.4% of index CDS traded notional required to be reported under US Commodity Futures Trading Commission reporting rules was cleared in the first quarter of 2023. Market participants cleared 51.2% of single-name CDS traded notional required to be reported under US Securities and Exchange Commission reporting rules over the same period.

SINGLE-NAME CDS MARKET

Chart 1: Single-name CDS Market Activity and Transaction Count

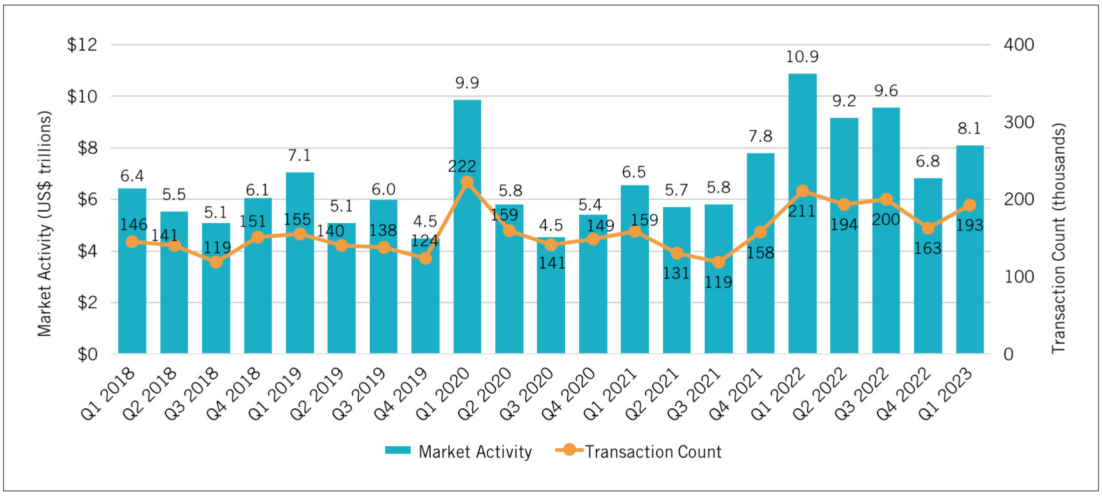


Source: DTCC TIW

Chart 1 illustrates single-name CDS market activity, measured in notional and trade count. Over the past five years, the volume of trading in single-name CDS ranged between $405 billion and $1.1 trillion per quarter, hitting a trough in the fourth quarter of 2020 and then rising over 2022 and into 2023, when it hit its peak during the period.

The sharp increase in activity in the first quarter of 2023 reflects hedging of credit exposures in light of several bank failures. One factor driving CDS activity in early 2020 (during the onset of COVID) was financial intermediaries hedging their exposures to particular counterparties so they could increase the provision of credit to them during a period when financing activity was difficult (see Chart 6 for an example of this activity).

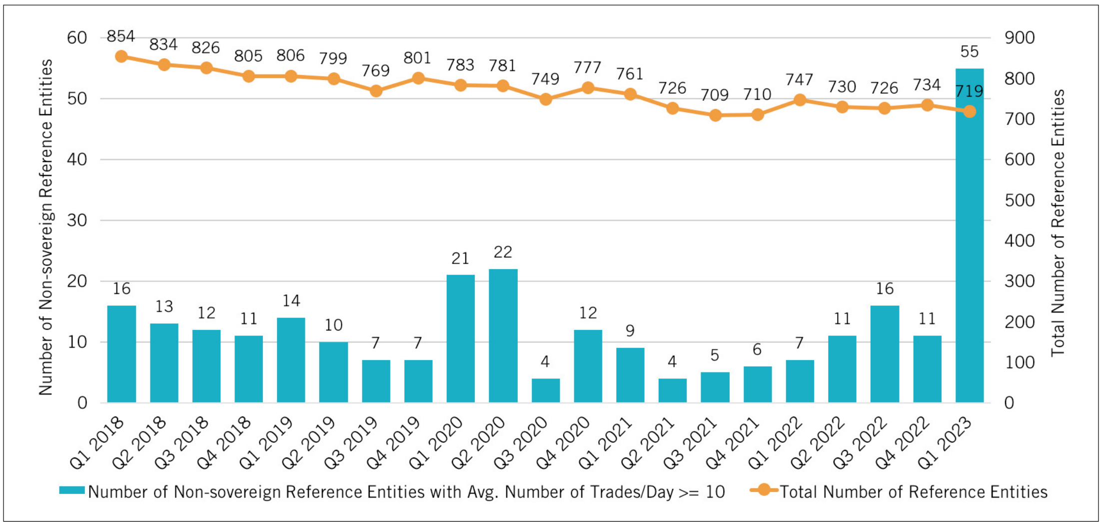
Chart 2: Index CDS Market Activity and Transaction Count



Source: DTCC TIW

While this report focuses mainly on single-name CDS, Chart 2 illustrates the growth in CDS index market activity over the past five years and, in particular, the increase of activity in 2022 and 2023. The liquidity of these instruments makes them useful as a reference on market sentiment and as tools for expressing macro views on credit in general, a specific region or a sector. For example, individual CDS indices exist for investment-grade names, high-yield names, the financial sector and emerging markets.

Chart 3: Number of Single-name CDS Non-sovereign Reference Entities with 10 or More Trades Per Day

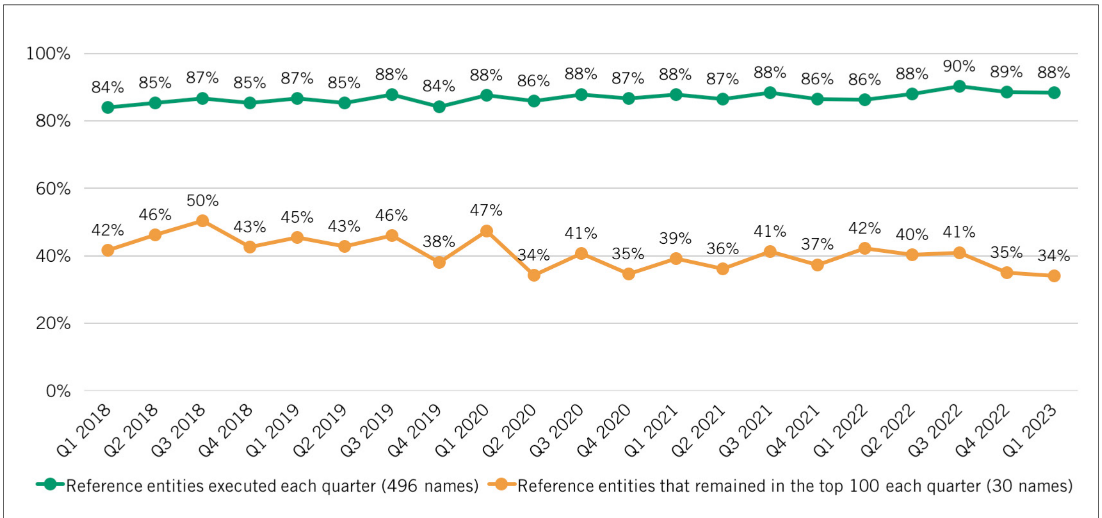


Source: DTCC TIW

Chart 3 shows the relatively small number of non-sovereign names with daily average trading of 10 more contracts per day. This shows that, even amid an increase in single-name CDS trading, the vast majority of non-sovereign names are illiquid.

The chart also demonstrates that during periods of stress, CDS liquidity can increase. In two periods – the onset of the COVID pandemic in early 2020 and several bank failures in the first quarter of 2023 – the number of non-sovereign names averaging 10 or more trades per day rose.

Chart 4: Market Activity of Single-name CDS Reference Entities Executed Each Quarter

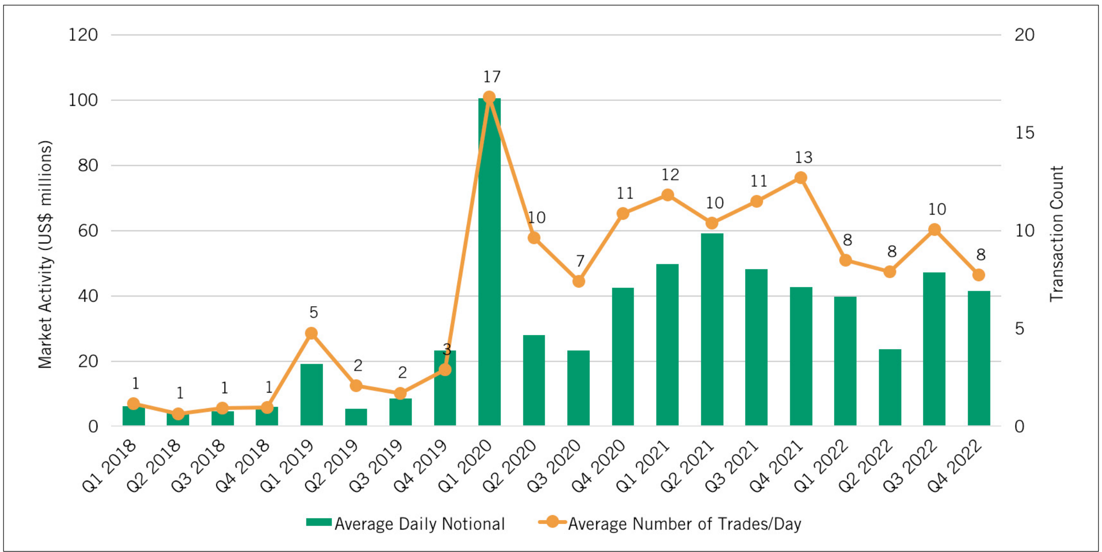


Source: DTCC TIW

Over the past five years, 1,169 reference entities traded at least once and 600 names traded on average less than once per quarter (total activity in them is generally less than 15%). The remaining 496 names traded every quarter, totaling more than 80% of all market activity, as indicated by the green line in Chart 4.

Of these 496, 30 were in the top 100 of notional traded every quarter. These names account for one third or more of trading volume per month, as per the orange line in Chart 4. Sixteen of the 30 names were sovereigns.

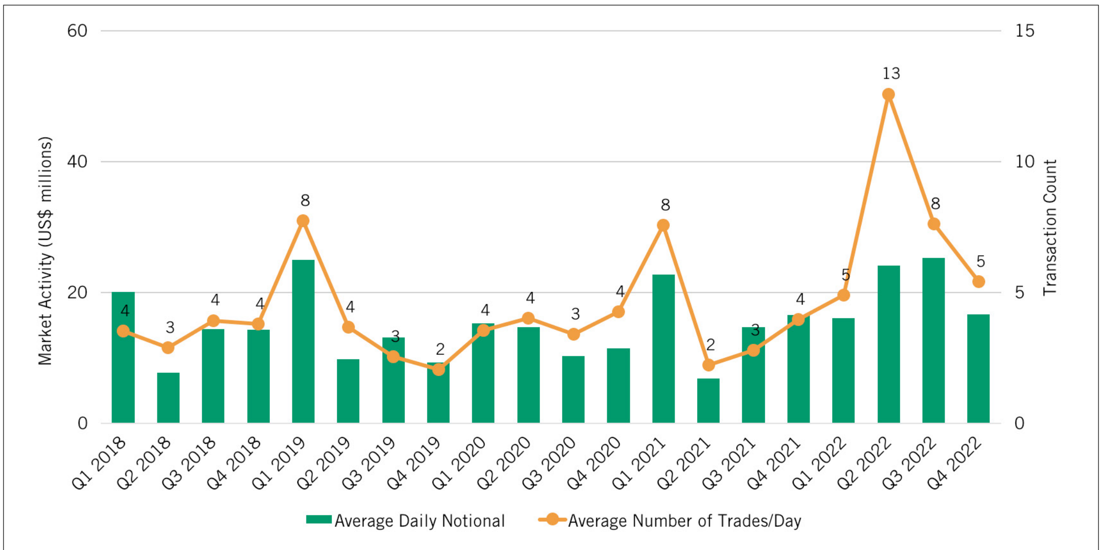
Chart 5: CDS Trading in a US Industrial Company



Source: DTCC TIW

Chart 5 shows CDS trading in a US industrial company over the past five years and illustrates the episodic nature of some CDS market activity. At the onset of the COVID pandemic, CDS trading in the name increased significantly. The increase was likely due to activity by capital providers to manage their exposure to the name, free up balance sheet capacity and enable them to continue to provide funding to the company.

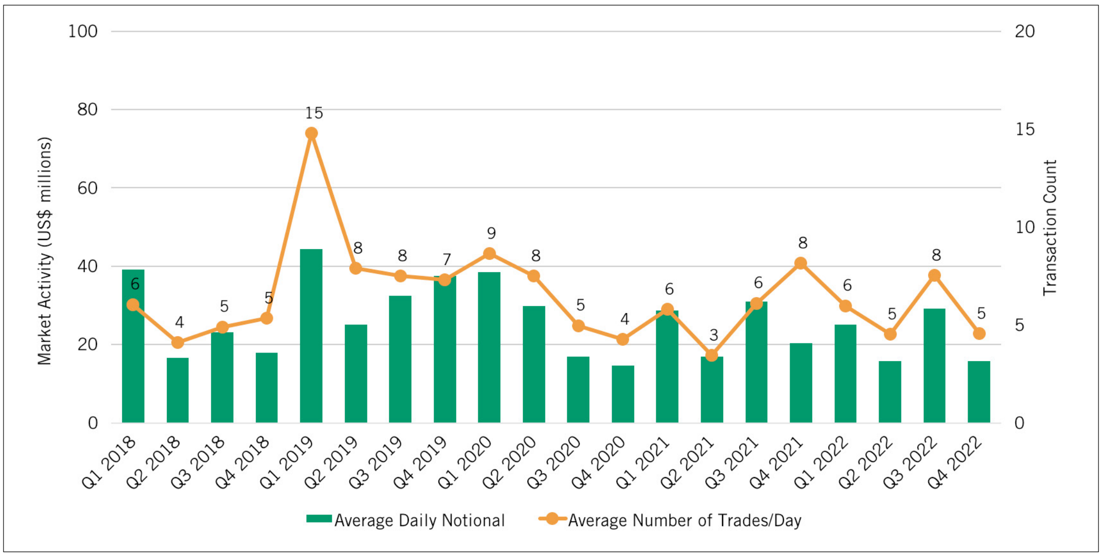
Chart 6: CDS Trading in a European Industrial Company



Source: DTCC TIW

Chart 6 illustrates CDS trading in an EU non-financial company with exposure to increased prices in raw materials and energy. It also shows episodic liquidity in the CDS market. CDS trading in the name is normally low. During early 2022, the company experienced financial headwinds and saw a spike in CDS activity, which is consistent with the behavior of investors hedging their exposure. However, overall trading volumes remained relatively modest and trading declined in subsequent quarters.

Chart 7: CDS Trading in a European Industrial Company



Source: DTCC TIW

Chart 7 shows CDS trading in a European industrial company. CDS market activity rose in early 2019 as the firm's credit ratings were reviewed and then downgraded, likely resulting in hedging and risk management by market participants with exposure to it. Trading declined from this peak over the next several years.

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  www.isda.org/a/aeLgE/ISDA-Clarus-RFR-Adoption-Indicator-March-2023.pdf
- ***SwapsInfo First Quarter of 2023 Review: Summary***
  www.isda.org/a/erLgE/SwapsInfo-First-Quarter-of-2023-Review-Summary.pdf
- ***Interest Rate Derivatives Trading Activity Reported in EU, UK and US Markets: Full Year 2022 and the Fourth Quarter of 2022***
  www.isda.org/a/GkJgE/ISDA-Latest-News-Alert-IRD-Trading-Activity-Reported-in-EU-UK-and-US-Markets-Full-Year-of-2022-and-Fourth-Quarter-of-2022.pdf

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