

1. Record Nr.	UNINA9910788338303321
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Titolo	The Use (and Abuse) of CDS Spreads During Distress / / Carolyne Spackman, Manmohan Singh
Pubbl/distr/stampa	Washington, D.C. : , : International Monetary Fund, , 2009
ISBN	1-4623-8806-X 1-4527-7832-9 1-4518-7209-7 9786612842832 1-282-84283-8
Descrizione fisica	1 online resource (13 p.)
Collana	IMF Working Papers
Altri autori (Persone)	SinghManmohan
Disciplina	338.267
Soggetti	Credit derivatives Derivative securities Investments: Bonds Macroeconomics Money and Monetary Policy International Lending and Debt Problems Banks Depository Institutions Micro Finance Institutions Mortgages Bankruptcy Liquidation Information and Market Efficiency Event Studies Financial Institutions and Services: Government Policy and Regulation Monetary Policy, Central Banking, and the Supply of Money and Credit: General General Financial Markets: General (includes Measurement and Data) Price Level Inflation Deflation Monetary Systems Standards Regimes Government and the Monetary System Payment Systems

Monetary economics	
Investment & securities	
Credit default swap	
Bonds	
Asset prices	
Currencies	
Credit	
Money	
Financial institutions	
Prices	
Ecuador	
Lingua di pubblicazione	Inglese
Formato	Materiale a stampa
Livello bibliografico	Monografia
Note generali	Description based upon print version of record.
Nota di bibliografia	Includes bibliographical references.
Nota di contenuto	Contents; I. Introduction; II. Recent Distress in Financial Institutions; Figures; 1. Landsbanki; 2. Washington Mutual; 3. Lehman Brothers; III. Policy Implications of Using Stochastic Recovery; Table 1. CDS Settlements Determined Under the ISDA Cash Opt-in Protocol; Box 1. Ecuador ISDA Auction; Appendix I. Recovery Swaps, or Where the Ctd Bonds End Up; References
Sommario/riassunto	Credit Default Swap spreads have been used as a leading indicator of distress. Default probabilities can be extracted from CDS spreads, but during distress it is important to take account of the stochastic nature of recovery value. The recent episodes of Landbanski, WAMU and Lehman illustrate that using the industry-standard fixed recovery rate assumption gives default probabilities that are low relative to those extracted from stochastic recovery value as proxied by the cheapest-to-deliver bonds. Financial institutions using fixed rate recovery assumptions could have a false sense of security, and could be faced with outsized losses with potential knock-on effects for other institutions. To ensure effective oversight of financial institutions, and to monitor the stability of the global financial system especially during distress, the stochastic nature of recovery rates needs to be incorporated.