

## **Ban Naked CDS**

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In a credit default swap (CDS), the buyer contracts to pay the seller a regular premium in return for a commitment that the seller will pay out in the event of a default on a specified financial instrument, typically a bond. The market began in the late 1990s as a pure insurance market that permitted bondholders to hedge their credit exposure – an excellent innovation.

But then market participants realised that they could buy and sell ‘protection’ even if the buyer did not hold the underlying bond. This is a ‘naked’ CDS, which offers a way to speculate on the financial health of an issuing corporate or sovereign without risking capital, as short-selling would do. That was so attractive that soon the market was dominated by naked CDS, with a volume an order of magnitude greater than the stock of underlying bonds.

A good side effect of Greece’s troubles is that politicians, regulators and central bankers are finally paying serious attention to this market. For two years, I have been pointing out the destabilising effects of naked CDS in the financial crisis and the dangers in the use of these instruments as a speculative device. Only now is this taken seriously.

Much of the media reaction, however, simply puts the line of the big banks that profit greatly from this market. It deploys clichéd rhetoric and misinterprets data, with little regard to research or to the views of informed market participants and analysts who are not on the payroll.

Critics of naked CDS want to ‘shoot the messenger’ – why not, if he isn’t telling the truth but spreading false rumours? We are ‘blaming the referee’, ‘blaming a thermometer for the temperature’, we want to ignore the ‘canary in the coal mine’. ‘Banning naked CDS won’t stop bond prices from falling’ – indeed, but what do they

contribute to price discovery? As for the politicians, they are just scapegoating, trying to deflect attention from their own failings.

Let's look at naked CDS seriously, ignoring Greece. We start with the justifications.

Like almost all the financial innovations in recent years, naked CDS are said to be a beneficial move towards more complete markets. And speculation, we are told, is essential to the proper functioning of markets. This is simply market fundamentalism that ignores masses of research on destabilising speculation as well as a key lesson of the financial crisis, that some innovations have been dysfunctional and dangerous.

A much more serious argument is that the CDS market, of which naked CDS are a dominant component, improves pricing efficiency. The CDS market leads the cash bond market in price discovery and in predicting credit events. Smart traders in the market reveal information, and the market can provide information when the bond markets are illiquid. Indeed, most research does suggest that for corporates, CDS does lead in price discovery, partly because the market is more liquid than the underlying. But this is less likely for government bonds, where the markets are much bigger relative to CDS and more liquid. Still, 'leadership' may be the result not of better information, but of the *effect of CDS prices on the perceived creditworthiness of the issuer*. We return to this key issue below.

CDS prices have many defects as information. They are often demonstrably unrelated to default probabilities – as when the US sovereign CDS price rises; or when corporate prices are less than those for the country of residence, even though the corporate bond yield is much higher than that on the country's government bond. Many highly variable factors influence the CDS-bond spread: liquidity premia, compensation for volatility, accumulating counterparty risk in chains of CDS contracts. What do pricing efficiency and the informational content of prices mean in a highly opaque market, where much of the information is available only to a few dealers?

The BIS recently published data on gross and net CDS positions on sovereigns. We are told (not by the BIS) that because net CDS exposures are only a few percent of the

stock of outstanding government bonds, ‘the tail can’t wag the dog’, so the CDS market can’t be responsible for the rising spreads on the bonds. This of course contradicts the argument that the CDS market leads in price discovery because of its superior liquidity. More important, it is nonsense. Over a period of several days in September 1992, George Soros bet around \$10 billion against sterling, and most observers believe that significantly affected the market – and the outcome. But *daily* foreign exchange trading in sterling then before serious speculation began was somewhat over \$100 billion. The issue is how CDS prices affect market sentiment, whether they serve as a coordinating device for speculation. We return to this below.

Perhaps the weakest argument is that banning naked CDS ‘would also confine hedging to a world of barter, requiring one to find those with opposite hedging needs.’ If the insurer doesn’t want to take on the risk, it shouldn’t be selling insurance.

Some say that naked CDS are justified because they add liquidity to the market. But is the extra liquidity worth the costs? And we now turn to these.

The most obvious argument against naked CDS is the moral hazard arising when it is possible to insure without an ‘insurable interest’ – as in taking out life insurance on someone else’s life (unless she is a key executive in your firm, say).

The most important argument is related to this moral hazard. Naked CDS, as a speculative instrument, may be a key link in a vicious chain. Buy CDS low, push down the underlying (e.g., short it), and take a profit from both. Meanwhile, the rise in CDS prices will raise the cost of funding of the reference entity – it normally cannot issue at a rate that won’t cover the cost of insuring the exposure. That will harm its fiscal or cash flow position. Then there will be more bets on default, or at least on a further rise in the CDS price. If market participants believe that others will bet similarly, then we have the equivalent of a ‘run’. And the downward spiral is amplified by the credit rating agencies, which follow rather than lead. There is clearly an incentive for coordinated manipulation, and anyone familiar with the markets can cite examples which look very much like this. The probability of default is not independent of the cost of borrowing – hence there may be multiple equilibria, with self-fulfilling expectations, as Daniel Cohen and I have argued.\*

The mechanism of CDS is like that of reinsurance. The fees are received up front, the risks are long-term, with fat tails. There are chains of risk transfer – a CDS seller will then hedge its position by buying CDS. So the net is much less than the gross, but the chain is based on the view that each party can and will make good on its contract. If there is a failure, the rest of the chain is exposed, and fears of counterparty risk can cause a drying up of liquidity. The long chains may create large and obscure concentration risks as well as volatility, since uncertainty about any firm echoes through the system.

Naked CDS increase leverage to the default of the reference entity. They can thereby substantially increase the losses that come from defaults. And the leverage comes at low cost – nothing equivalent to capital requirements, no reserve requirement of the kind insurers must satisfy,

Banning naked CDS will require common action in the US and the EU, but the political environment is right. We should not lose this opportunity.

\*‘A lender of *first* resort’, IMF Working Paper WP/06/66, March 2006.

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