



Private interest dressed in public interest clothes

Finance Watch is starting a series of short position papers where it highlights situations where a private interest is disguised as a public interest argument.

Finance Watch believes that private interests are not only legitimate but also useful to society as long as they are not pursued to the detriment of public interest. It also believes that dressing a private interest in public interest clothes is unacceptable and should be denounced.

Hence the “Private interest dressed in public interest clothes” series we are starting today.

Finance Watch

July 11th 2011

Why sovereign credit default swaps do not lower the cost of funding of sovereign borrowers

Executive summary:

Simple logic as well as statistical evidence show that so-called naked use of sovereign credit default swaps cannot contribute to lowering the cost of borrowing of sovereign issuers.

Moreover, even though sovereign credit default swaps are not the cause of debt crises, they contribute to making already difficult credit situations degenerate as they create a mechanical “acceleration effect” on the way down.

Everything else being equal, sovereign credit default swaps amplify sovereign credit crisis situations and make finding a solution to those situations more difficult than it would be without them.

Ever since the Economic and Monetary Affairs (Econ) Committee of the European Parliament voted in favour of banning the naked use of sovereign credit default swaps (i.e. the use of sovereign credit default swaps for speculative purposes, as opposed to hedging purposes), an argument has been put forward by a number of market players that says that credit default swaps have the effect of lowering the cost of funding of sovereign issuers and that, therefore, banning their naked use would increase the cost of borrowing of those issuers.

This argument is wrong and is a perfect illustration of a private interest (conducting profitable business) disguised by the derivatives lobby as a public interest argument (lowering the cost of funding of sovereign borrowers).

This paper shows why this argument is wrong.

Why the naked use of sovereign credit default swaps cannot lower the cost of funding of sovereign issuers

In order for a financial instrument to have an impact on the cost of funding of an issuer, this instrument must, by definition, contribute to the acceptance of bond investors to buy a piece of debt with a lower yield when this debt is issued in the primary market or of lenders to lend money at a cheaper rate.

The case of bond holders:

Naked use of sovereign credit default swaps does not concern, as the name “naked” indicates, bond investors and thus cannot contribute to the acceptance of those investors to buy debt with a lower yield in the primary market.

In other words, naked use of sovereign credit default swaps does not bring anything to bond investors because it has, by definition, nothing to do with them (if it had to do with them it would not be called “naked”!), and there is therefore no logical reason why it would motivate them to buy bonds with a lower yield from a particular sovereign issuer.

Note: an argument is often put forward to explain why naked short selling of sovereign credit default swaps lowers the yield of sovereign debt and is therefore good for issuers. This so-called “liquidity argument” goes along the following line: naked short selling of sovereign credit default swaps would bring liquidity to the market which in turn would make it easier to hedge for genuine investors and therefore would enable them to buy debt at a lower yield. This argument is both unsubstantiated and technically flawed: all derivatives dealers know that the liquidity of a derivative contract is a direct function of and never greater than the liquidity of its underlying asset (and not the other way around) unless that derivative is sold massively by market participants who do not hedge their exposure, very much like AIG Financial Products did in the run up to the bankruptcy of its parent company in 2008. In other words, the “liquidity argument” is either technically wrong or will lead to financial disaster

and we therefore refuse to take it into account as an argument in favour of naked sovereign credit default swaps.

The case of lenders:

The question here is: does hedging through the purchase of naked sovereign credit default swaps enable financial institutions to lend money to sovereign borrowers at a cheaper rate? The answer is no for two reasons:

- First, statistical evidence shows that the net volume of sovereign credit default swaps is very small compared to the total amount of money lent to sovereign borrowers. For instance, in the case of Greece, this number stands currently near 1% (about \$ 5 billion - € 3.5 billion - net notional of credit default swaps compared to about \$ 482 billion - € 340 billion - of debt): if it is assumed that one third of credit default swaps are effectively used by lenders to hedge their exposure (which is an unproven and optimistic scenario), it becomes obvious that, in the example of Greece, the hedging of 0.33% (one third of 1%) of the total amount of money lent out is not significant enough to have an impact on the cost of funding of that borrower. The reasoning would be the same for other sovereign borrowers.
- Second, and as importantly, deciding to lend money comes down for the lender to evaluating the risk/reward profile of the loan made: “does the rate paid by the borrower balance out the risk?”. If a lender does not like the credit of a certain issuer, why would it lend money to that issuer in the first place and hedge its risk away as opposed to not lending at all (with the same net economic effect as the cost of the credit default swap purchased is by construction equal to the risk premium perceived on the loan)? Lending money to a borrower and hedging away immediately the credit risk by buying credit default swaps does not make economic sense and therefore that practice can only remain marginal if we consider that bankers understand the notion of risk/reward of a loan (and we do). And if hedging by the lender comes after the fundraising has been completed, it has, by construction, no impact on the cost of funding of the sovereign borrower.

Conclusion:

Naked use of sovereign credit default swaps does not concern, by definition, bond investors. It can therefore have no impact on lowering the cost of funding of sovereign issuers in the primary bond market.

Naked use of sovereign credit default swaps is totally negligible for lenders, which is logical as it makes no economic sense for them. It has therefore no impact on lowering the cost of loans for sovereign borrowers.

Simple logic as well as statistical evidence show that the naked use of sovereign credit default swaps cannot contribute to the lowering of the cost of funding of sovereign issuers.

Why the naked use of sovereign credit default swaps amplifies credit crisis situations

The reason why the naked use of sovereign credit default swaps amplifies credit crisis situations can be easily demonstrated:

When a speculator who wants to bet on the deterioration of a particular credit situation buys a credit default swap, a market maker sells that credit default swap to that speculator. From a technical stand point, the speculator has “gone short” a particular credit profile and the market maker has “gone long” the same credit profile.

As the market maker’s objective is not to make money by betting on a market price move but on a spread embedded in prices made to other market players, the market maker hedges its own exposure by “selling short” the debt underlying the sovereign credit default swap sold to the speculator. The net effect of the transaction is therefore that the actual physical debt underlying the credit default swap has been “sold short” in the market (by the market maker), something which, if anything, puts pressure on the price of that debt,

and increases its yield. In normal times and if this is done in reasonable amounts (i.e. if the bonds the market maker has to sell in order to hedge represent a small proportion of the volumes of bonds actually traded in the market), this effect can be considered as almost negligible.

The problem comes when a debt crisis arises and market participants are faced with a situation of simultaneous fall in bond prices and reduction of liquidity in the underlying bond market.

For technical reasons that can be easily demonstrated albeit in a longer paper, the more the price of the underlying debt goes down (the more its yield goes up), the higher the quantity of underlying bonds market makers have to “sell short” in the market (a situation called “negative gamma management” in derivatives lingo).

The consequence of this is that, in times of credit crisis, sovereign credit default swaps market makers have to sell more bonds at a lower price in markets suffering from a reduced liquidity. This, in turn, leads to negative spirals, to the acceleration of negative price movements and to artificial volatility as the market for the underlying sovereign bonds is not liquid enough to “absorb” credit default swaps hedging volumes.

Illustration:

Bank of Greece statistics show that volumes of Greek bonds actually traded fell from a daily volume of € 1.05 billion in January 2010 (five months before Greece’s bail-out) to € 69.7 million in May 2010 (date of bail-out), € 12.76 million in December 2010, only to bounce slightly to € 32 million in May 2011 before falling back to € 23 million during the first two weeks of June 2011. Liquidity of Greek sovereign bonds was reduced by almost 98% between January 2010 and June 2011.

A rule of thumb in derivatives market says that if the daily “gamma rebalancing” of derivatives transactions represents more than 30% of daily volume traded in the underlying asset, there exists a risk of creating negative price spirals. This means that with € 23 million per day of Greek bonds actually traded in June,

there was only $30\% \times \text{€ } 23 \text{ million} = \text{€ } 6.9 \text{ million}$ of traded bond volume “available” each day to “absorb the gamma rebalancing” due to credit default swaps positions without influencing the market. This € 6.9 million represents a paltry 0.2% of the net outstanding volume of Greek sovereign credit default swaps (€ 3.5 billion), a percentage clearly insufficient to enable daily “gamma rebalancing” linked to credit default swaps positions without creating negative price spirals or artificial volatility (it must be noted that this was not the case, for instance, in January 2010 when the daily volume of bonds traded in the market was sufficient to “absorb” credit default swap hedging activity but this was five months before the bail-out of Greece, i.e. before the height of the crisis).

The Greek situation shows that a distinction must be made between “normal” times and times of crisis when it comes to evaluating the impact of sovereign credit default swaps on their underlying bond markets.

In “normal” times the impact of sovereign credit default swaps on the secondary market of the underlying bonds can be considered as acceptable.

The problem arises when a credit situation becomes difficult for a particular issuer: in that case, credit default swap positions make the situation even worse by the sole virtue of the fact that the more the price of the underlying bonds goes down, the higher the quantity of bonds market makers have to sell at a time when the natural liquidity of the underlying bonds dries up. This, as already stated, creates downward pressure on the price of the bonds (increases their yield) and makes the decision process by policy makers more difficult. If other factors are taken into account such as the herd behaviour inherent to financial markets in times of crisis, the influence on the price of credit default swaps of the cost of borrowing the underlying bonds and technical issues around the settlement method in case of credit event, the problem becomes even worse.

In other words, if a credit situation is bad credit default swaps positions will contribute to making it worse. This is quite a paradox for a financial instrument that is supposed to offer protection in times of duress. One could say that

credit default swaps work well from a technical stand point when they are not economically useful (“normal” times) and do not work from a technical stand point (they make things worse) when they are supposed to serve an economic purpose (offer protection in “bad” times).

The one purpose they serve well is for market participants holding no credit exposure and wishing to bet on the default of an issuer: credit default swaps not only pay those speculators more and more as things get worse but they also contribute to creating negative price spirals which, in turn, generate more money for them.

Conclusion:

Sovereign credit default swaps are not the origin of debt crises but they contribute to making already difficult credit situations degenerate as they create mechanical “acceleration effects” on the way down when a crisis strikes.

Naked use of sovereign credit default swaps is like wind on a fire: wind does not start the fire but it makes it grow and, at some point, makes it increasingly difficult to control.

Note:

The “market maker argument” developed above (speculators buy credit default swaps from market makers who hedge their exposure) suffers exceptions when hedge funds sell credit default swaps to banks without hedging. The problem is, in that case, different but raises very serious questions about the stability of the financial system as this means that banks buy credit default swaps from largely unregulated, low capitalised, leveraged entities (the hedge funds) whose job is to speculate with money that they have borrowed...from the very same banks they are selling credit protection to, in a context where selling massive un-hedged amounts of risk is a well known recipe for disaster as demonstrated by the 2008 AIG bankruptcy.