

Are Naked Credit Default Swaps Too Revealing?

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There's nostalgia for the financial world of yore, a world where a financial security was a well-known object. When the risk of a security can be split from its cash host, and the risk itself traded separately, things have changed. But, what exactly has changed? This question has recently arisen with regard to credit derivatives.

The answer to what has changed is not obvious. But there are many charges and assertions. Greece's Prime Minister, George Papandreou, on his trip to the U.S. (March 9, 2010) famously blamed credit default swaps (CDS) for his country's financial crisis: "It is common sense, enforced by insurance regulators, that a person is not allowed to buy fire insurance on his neighbor's house -- and then burn it down to collect on that insurance. Yet that is exactly what is done in the market for credit default swaps." On the same day, Gary Gensler, chairman of the Commodities Future Trading Commission said pretty much the same thing:

At the height of the crisis in the fall of 2008, stock prices, particularly of financial companies, were in a free fall. Some observers believe that CDS figured into that decline. They contend that, as buyers of credit default swaps had an incentive to see a company fail, they may have engaged in market activity to help undermine an underlying company's prospects. This analysis has led some observers to suggest that credit default swap trading should be restricted or even prohibited when the protection buyer does not have an underlying interest.¹

Others have argued similarly, that somehow buying protection in the form of a credit default swap can cause the very event that would trigger a payout under the swap. Of course, as Papandreou was speaking, his house was burning down. And Gensler disingenuously cites "some observers" as his evidence. (And now the "some observers" cite him as evidence.) For some this is enough to agree with V.I. Lenin that: "For as long as we fail to treat speculators the way they deserve—with a bullet in the head—we will not get anywhere at all."² Let's go a bit more slowly.

What happens when the risk, the risk of loss due to default in this case, can be separately traded from the cash bond. As many have noted, it can be the case that the protection buyer may not actually own bonds of the company or country that is referenced in the swap. This means that the amount traded synthetically can be much greater than the outstanding amount of the bonds. For any particular reference entity this can certainly be true. This has been called "naked shorting" (though it is not at all like shorting a stock) and we have heard much about it.

This notion of naked shorting is problematic. As a hedging instrument a CDS is useful for a much broader range of risks than just the risk of loss due to default on the debt of the reference entity. The earliest instance of this was during the Asian crisis of 1997-1998. It was a widely-held view (by "some observers" like me) that the notional amount of CDS written on the Korea Development Bank (KDB) was

¹ See <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opagensler-32.pdf>.

² Vladimir Lenin, Complete Collected Works, vol. 35 (Moscow: 1964), page 311.

many times higher than the outstanding amount of KDB debt. That was because CDS on KDB debt could be used to hedge Korea risk more generally and even risks in other Asian countries. There are many examples like this, where the risks that are being hedged are correlated with the reference entity's default, but are not exactly the reference entity. So, it is basically impossible to determine what a "naked short" position is, or whether it is "pure speculation," whatever that is.

But, in any case, the fact is that some traders are trading CDS for purely information-based reasons. So, what does this naked shorting have to do with the insinuation that buying protection via CDS without owning the reference entity debt is destructive speculation ipso facto? Well, CDS may have changed one thing. Before CDS trading credit was much more difficult. Expressing a negative view was next to impossible because it is hard to find the bonds and short them for a longer period. Even expressing a positive view would usually require finding off-the-run bonds to buy, not easy in size. But, more importantly, it simply would not pay to investigate, or analyze, and find information that was so important that it would affect a reference entity's bond prices. Information always impacts the equity because that is the residual claim, but information has to be fairly important to affect bond prices. That's why, prior to the introduction of CDS, changes in the spreads on investment grade corporate debt were functions of U.S. Treasury rates, but not of firm-specific information. Such debt is *information-insensitive*. Information-insensitive debt plays an important role in the economy because it can be sold fairly easily without fear of losing to better informed traders (because it is not profitable for them to become informed). So, it is held, for example, by insurance companies which have to sell to payoff claims at random times. It can be used as collateral for repo, clearing and settlement. The reason that Treasuries were scarce before the crisis is because they are information-insensitive.

CDS may well have changed some previously information-insensitive debt into information-sensitive debt. How could that happen? Suppose an analyst determines that new information about a company that he has found will have a small impact on the debt, changing its spread by, say, 50 basis points. That may not be enough to worry about if you have to find the cash bonds, so no one produces or trades on this information (and since it is never produced or traded on, it never gets into the price). But, in the CDS market it is possible to take a very large position so as to profit from even such a small change. CDS makes it profitable to trade credit risk when before such trades were not profitable. And this affects bond prices (through arbitrage), making them sensitive to the information that it was profitable to trade on in the CDS market.

This is an important change in how debt markets work. It means that there is more information in bond prices/spreads than before. They move more to reflect this information which it now pays to find and trade on. For example, CDS may reveal information leading to Greece's borrowing costs rising. This is accurate information, but unlike before when this information might not have been revealed, now Greece has to pay higher coupons at issue. This is essentially the charge being made by Mr. Papandreou, Mr. Gensler and others. In essence what they are saying is that they don't want this information revealed.

"Transparency" is a kind of mantra, but it is a reasonable question as to whether all information should always be revealed. "Efficient markets" theory is a positive theory not a normative theory. It doesn't say what information should be in prices, but just that available information (information which it is profitable to produce) will end up being in prices. There is a presumption that more information is always better than less information, but there is no basis for this assertion. If we were offered the choice of knowing now which of us would die of cancer, we would be worse off because some of us would not be able to buy insurance. There may be good reasons why from a public policy point of view we don't want information in prices. This might, for example, be related to the scarcity of collateral

prior to the crisis. But, that is what the debate is really about. In the new world of CDS, is too much information being revealed?