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Credit Default Swaps – Through The Looking Glass

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CDS contracts and credit derivatives are complex and powerful financial instruments that frequently have unforeseen consequences for market participants and the financial system. As former New York Federal Reserve President Gerald Corrigan told policy-makers and financiers on 16 May, 2007: “Anyone who thinks they understand this stuff is living in lala land.”

Financial innovation can offer economic benefits. A number of major benefits of CDS contracts are often cited by academic acolytes and fans, generally those promoting the product.

The first is that CDS contracts help complete markets, enhancing investment and borrowing opportunities, reducing transaction costs and allowing risk transfer. CDS contracts, where used for hedging, offers these advantages. Where not used for hedging it is not clear how this assists in capital formation and enhancing efficiency of markets.

CDS contracts also, it is claimed, improve market liquidity. It is generally assumed that speculative interest assists in enhancing liquidity and lowers trading costs. Where the liquidity comes from leveraged investors, the additional systemic risk from the activity of these entities has to be balanced against potential benefits. The current financial crisis highlights these tradeoffs.

CDS contracts also, it is claimed, improve the efficiency of credit pricing. It is not clear whether this is actually the case in practice.

Pricing of CDS contracts frequently does not accord with reasonable expected risk of default. The CDS prices, in practice, incorporate substantial liquidity premia, compensation for volatility of credit spreads and other factors.

CDS pricing also frequently does not align with pricing of other traded credit instruments such as bonds or loans. For example, the existence of the “negative basis trade” is predicated on pricing inefficiency.

In a negative basis transaction commonly undertaken by investors including insurance companies, the investor purchases a bond issued by the reference entity and hedges the credit risk by buying protection on the issuer using a CDS contract. The transaction is designed to lock in a positive margin between the earnings on the bond and CDS fees. Negative basis trades exploit market inefficiencies in the pricing of credit risk between bond and CDS markets.

In early 2009, the pricing of corporate bonds and CDS on the issuer diverged significantly. For example, the CDS fees for National Grid, a UK utility, were around 2.00% pa (200 basis

points) compared to National Grid's credit spread to government of around 3.30% (330 basis points). Similarly, Tesco, the UK retailer was exhibited CDS fees of around 1.40% (140 basis points) against a credit spread to government of around 2.50% (250 basis points).

In effect, market pricing of credit risk as between the CDS market and the bond and loan market was significantly different.

Another area of pricing discrepancy is the relative pricing of different firms. For example, in early 2009, bonds issued by borrowers rated "A" were trading at a higher credit spread than bonds of borrowers rated lower (say "B") in the bond market. At the same times, CDS fees for borrowers rated "A" were trading at a lower level than CDS fees of borrowers rated lower (say "B") in the credit derivatives market.

There are also notable discrepancies in the pricing of corporate credit risk relative to their sovereigns. In early 2009, Cadbury, the UK confectionery firm, was trading for 10 years substantially below the CDS fee of the UK government but Cadbury bonds were trading at a spread of around 2.00% (200 basis points) above UK government bonds. As people on one side of the Atlantic Ocean might remark: "Go figure!"

CDS contracts also are supposed to enhance information efficiency, improving availability of market prices for credit risk allowing more informed decisions by market participants. As CDS contracts are traded in the private OTC derivative markets, there is limited dissemination of market prices. This limits price discovery and therefore any informational benefits.

In reality, pricing and trading information is only available readily to large active dealers in CDS contracts. This informational asymmetry may advantage these dealers. Knowledge about trading flows in CDS contracts may allow these dealers to earn economic profits.

Benefits of CDS contracts must be balanced against any additional risks to the financial system from trading in these instruments. CDS contracts may create additional risks within the financial system. While CDS contracts did not cause the current financial crisis (excessive reliance of debt did), they may have exacerbated the problems and complicated the process of dealing with the issues.

The CDS market originally was predominantly a market for transferring and hedging credit risk. The contract itself has many attractive economic features and can serve useful purposes in hedging and transferring risk. Even this hedging application is dogged by some of the identified documentary issues that may reduce the effectiveness of CDS contracts as a hedge. Such problems may well be fundamental to the nature of the instrument and incapable of remedy, at least easily.

In recent years, the ability to trade credit, create different types of credit risk to trade, the ability to short credit and also take highly leveraged credit bets has become increasingly important. To some extent the CDS market has detached from the underlying "real" credit market. If defaults rise then the high leverage, inherent complexity and potential loss of liquidity of CDS contracts and structures based on them may cause problems.

The International Swaps and Derivatives Association ("ISDA"), the derivatives industry group, have recently implemented initiatives to "hard wire" the auction based protocols into the standard CDS documentation. They have also initiated changes in market practices,

such as fixed coupons for CDS contracts, designed to facilitate trading in these instruments. These actions increasingly focus on CDS contracts as an instrument for trading on default risk and credit spreads rather than one whose primary objective is the hedging of credit risk. The latter would emphasis less standardisation and a greater focus on matching the nature of underlying bond or loan being hedged.

The excesses of the CDS market are evident in the recent interest in contracts protecting against the default of a sovereign (known as sovereign CDS). For example, the CDS market for sovereign debt is increasingly pricing in increased funding costs for the US. The fee for hedging against losses on $10 million of Treasuries currently peaked at about 1.00% pa for 10 years (equivalent to $100,000 annually). This is an increase from 0.01% pa ($1,000) in 2007.

The specter of banks, some of whom have needed capital injections and liquidity support from governments to ensure their own survival, offering to insure other market participants against the risk of default of sovereign government (sometimes their own) is surreal.

The unpalatable reality that very few, self interested industry participants are prepared to admit is that much of what passed for financial innovation was specifically designed to conceal risk, obfuscate investors and reduce transparency. The process was entirely deliberate. Efficiency and transparency are not consistent with the high profit margins that are much sought after on Wall Street. Financial products need to be opaque and priced inefficiently to produce excessive profits or economic rents.

In October 2008, Alan Greenspan, the former Chairman of the Fed, acknowledged he was "partially" wrong to oppose regulation of CDS. "Credit default swaps, I think, have serious problems associated with them," he admitted to a Congressional hearing. This from the man who on 30 July 1998, stated that: "Regulation of derivatives transactions that are privately negotiated by professionals is unnecessary."

On 6 March 2009 Bloomberg reported that Myron Scholes, the Nobel prize winning co-creator of the eponymous Black-Scholes-Merton option pricing model, observed that the derivative markets have stopped functioning and are creating problems in resolving the global financial crisis. Scholes was quoted as saying that: " [The] solution is really to blow up or burn the OTC market, the CDSs and swaps and structured products, and … start over…" ISDA, the beleaguered derivatives industry group, predictably countered limply that: "… the notion that you would, as he said, blow up, the business in that way is just misguided."

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