Hearing before the committee of financial politics with respect to Regulation on short selling and certain aspects of CDS

Anne-Laure Delatte, Associate Professor at Rouen Business School and Associate Researcher at OFCE

The Regulation on short selling and certain aspects of credit default swaps ("CDS") sets out notification requirements and restrictions relating to short positions in shares and sovereign debt and, separately, a prohibition on uncovered sovereign CDS. It also grants powers to Member State regulators and the European Securities and Markets Association ("ESMA") to restrict or prohibit short selling activities and CDS transactions in certain situations.

1- Is the European regulation underpinned by empirical evidence?

Do empirical evidence on CDS and sovereign bond markets underpin the current regulation that restricts short selling and the use of uncovered CDSs on sovereign debt? What do we know about the influence of the CDS market on the sovereign bond market?

In the following I introduce recent findings of two academic investigations I have been carrying out with different co-authors that shed light on the role that the CDS have played during this crisis. Then I will briefly describe the market structure of the CDS market and emphasize its alarming concentration that has become obvious since transactions volume data are available.

A- Has the CDS market influenced the borrowing cost of European countries during the sovereign crisis?

The first paper challenges the widely-held belief that the relatively small credit default swaps (CDS) market cannot influence bond spreads in countries with long-established and large sovereign debt markets[1].

The net outstanding amount of CDS on European sovereign reference entities is only a small proportion of the underlying government bonds market (2 trillion USD in May 2010). Credit default swaps are a derivative financial product related to an underlying asset, a corporate or a sovereign bond. The CDS is intended to act as an insurance product allowing buyers to hedge against the default risk of any entity. It is a bilateral contract between a buyer and seller under which the seller sells protection against the credit risk of the reference entity.

[1] Has the CDS market influenced the borrowing cost of European countries during the sovereign crisis? A. L Delatte, M. Gex and A. Lopez-Villavicencio, Journal of International Money and Finance, April 2012.

The buyer pays a periodic premium to the seller. When the budget balance of a sovereign state deteriorates, the risk increases, which simultaneously increases the bond spread and the insurance cost, namely, the sovereign CDS premium. Normally, the higher the risk of default, the higher the insurance premium – not the other way around. An EU Commission report released in December 2010 argued that this small market could not influence the underlying cash market, that both markets are moving together and concluded that sovereign CDS were not having an adverse effect on the bond markets.

We took a sample of ten Western European sovereigns from 2006 to 2010, which we further split into core countries and "high yield" countries. Our findings are as follows.

For the high yield countries, Greece, Portugal, Spain, Italy and Ireland, the CDS always lead the bond spread, meaning that the insurance premium actually influences the risk of default. Our conclusion about core sovereigns is that the bond market leads when conditions are benign. However, this flips around when financial conditions deteriorate, and then CDS start leading bonds. The insurance premium actually influences the risk of default when market uncertainty is high. The higher the insurance premium, the higher the bond rate, i.e. the financing conditions of sovereign states. This means that in times of market distress the much smaller CDS market drive up the bond interest rates of sovereign nations.

In sum we showed that the activity in the CDS market has amplified the crisis. No country is safe from this perverse effect. This is because in every European country CDS are more active now than they used to be and they allow investors to easily take leveraged positions.

Now this first scientific evidence alone cannot justify setting a limit to speculative positions. In fact there is little doubt that derivative markets provide important economic benefits. They permit an efficient mechanism for hedging and provide a forum for establishing and disseminating price information. These so-called risk-transfer and price-discovery functions of futures markets are now well documented. So it is important to have a better understanding of the role financial speculation has played and is still playing during the European sovereign debt crisis.

B- Which role has the financial speculation played during the European sovereign debt crisis?

Do the financial markets play a positive disciplinary role by forcing the governments to adjust their fiscal policies? In this case the restriction on short-selling and CDS would simply impair the functioning of the market. Or on the contrary is speculation destabilizing and does it make sovereign states vulnerable to erratic speculative movements? The answers to these questions are important to determine subsequent policy responses to the crisis and assess the appropriateness of the current regulation.

We addressed this issue in a recent paper[2]. We took a sample of five peripheral European countries in which the sovereign yield has been most under pressure, Greece, Ireland, Italy, Spain and Portugal. We find that both the macroeconomic fundamentals and what we call “animal spirits” ignited the European sovereign crisis. More precisely we show that the surge in the sovereign bond spreads has been amplified by a shift from optimistic to pessimistic market sentiments. The progressive deterioration of the market sentiment about peripheral sovereigns has led investors to sell government bonds, which increased the interest rate and interest rate payments and thus led to the burden of public debt. The contagion from Greece to the rest of the peripheral countries has probably operated through simultaneous shifts in market sentiment.

Most important for the issue discussed here is that we obtained a more precise idea about what drives market sentiment during the crisis. We investigated different market signals that may have coordinated the expectations of market participants during the crisis. We showed that the sovereign CDS market, the rating agencies and the CDS of the banking sector have played dominant roles in driving market sentiments during this crisis. In other terms, market perception is influenced by the sovereign CDS market, rating agencies and the market's perception of risk in the banking sector.

C- The concentration of the CDS market

Similarly to most financial derivative products transaction in the CDS market are traded “over-the-counter” (OTC) as opposed to on a centralized exchange. An important and alarming specificity of this market however is its high concentration. It has been uncovered by different reports since 2010 when transactions in both corporate and sovereign CDS have been mandatorily submitted to the Depository Trust and Clearing Corporation’s Trade Information Warehouse (DTCCTIW) in the United States.

The SEC published a study that profiled all the actors in the credit default swaps market, in order to try to determine who’s who[3]. The SEC’s report looks at all CDS transactions for 2011, both in terms of monthly positions and transaction data. It reports that 87.2 per cent of the CDS trading activity is coming from the top 15 dealers, over 1000 entities involved in the CDS market in 2011.

Depending on the definition applied, concentration can actually be found higher. For example, the Office of the Controller of the United States reported that in the fourth quarter of 2008 the top 6 organizations[4] accounted for 99.6% of the total outstandings in credit default swaps and JP Morgan Chase alone represented 52.8% of the total.

---

[2] Is the European sovereign crisis self-fulfilling? Empirical evidence about the drivers of market sentiments, C. Bruneau, AL. Delatte and J. Fouquau. Working Paper.

[3] Memorandum, Division of Risk, Strategy and Financial Innovation of the U.S. Securities and Exchange Commission.

[4] JP Morgan, Bank of America, Citibank National, Godman Sachs Bank USA, HSBC Bank USA, Wachovia Bank National. The data come from the US focused organization DTCC, the reason why only American firm are in the top list.

The number of CDS contracts traded per day is actually very small: 59 for Spain, 49 for Greece, 38 for Italy, 15 for Ireland in April 2010 when the sovereign debt crisis started. Those numbers are inflated volume if we keep in mind that 83.7% of all trading is dealer to dealer and only 16.3% is by non-dealers, our true "end user" of the credit default swaps for sovereigns. If we take this into account the trading in the CDS of Greece for example by true non-dealer end users amounts to only 7.9 trades per day. For the top 20 sovereigns traded during the week, there were only an estimated 4.4 trades per day by non-dealers.

In sum the "big six" in the United States are controlling the credit derivatives market and slightly more than that internationally. They are playing among themselves. It means that there are just a very few people moving the price around in the dealer community. Under these circumstances, collusion issue cannot be ruled out: we can imagine that much of the "movement" in sovereign CDS might be due to dealers moving the price even though no one bought the CDS[5].

In total academic papers provide scientific arguments in favor of a strong regulation of the CDS market. All of the tax efforts we're currently making to balance the budget are very harmful at the socioeconomic level. This massive effort could be spoiled by financial speculation. This is precisely the objective of the Regulation which seeks to create a harmonised framework for coordinated action at European level.

2- An assessment of the Regulation: is it appropriate?

The Regulation sets out notification requirements and restrictions relating to short positions in shares and sovereign debt and, separately, a prohibition on uncovered CDS. Is this appropriate? Will it be efficient? Are there potential loopholes?

A- Notification requirement versus standardization: the case for standardization

Notification requirements relating to short positions in shares and sovereign debt will probably not allow the regulator to efficiently monitor the market.

As stressed by the Regulation transparency is key to ensure the efficient functioning and monitoring of the market. However more data does not imply more transparency. An important issue for the regulator is to receive and analyze the relevant data. It can be incredibly time-consuming and at the end not efficient. A key issue is therefore to find the structure allowing gathering and using automatically the relevant information. It is precisely the mission of clearing houses on standardized markets.

A clearing house is a financial institution that provides clearing and settlement services for financial transactions. By providing independent valuation of trades and collateral the clearing house produces the relevant information to monitor market activity. Standardizing trades improves transparency and price discovery. In the case of an overly concentrated market such as the CDS

[5] see Kamakura Blog: Sovereign Credit Default Swaps and Lessons from Used Car Dealers

market, standardization and the clearing through central counterparties are key to mitigate the opaqueness and the subsequent collusion between big dealers as it is suspected to occur currently of the CDS market. In addition by providing settlements services, the clearing house is automatically responsible for the security of the transaction system. To ensure this security, it has an authority to put constraints on trading positions, through margin calls on unsettled transactions for example (collateral request). In sum clearing houses belong to the market, they are endogenous to the functioning of the market, a pattern that make them natural and credible actors of its regulation.

As a consequence and to avoid the fragmentation of the financial reform process at the international level, it is very important that the current European regulation constitutes a complement and not a substitute to the reform of the OTC financial derivative market. In fact reforming the OTC derivative market has been at the top of the G20 agenda since 2009. While it also aims at enhancing transparency on the OTC market, the modalities are different from what is being implemented in Europe. The goal is fewer bespoke trades and more standardized trades. Important incentives such as capital requirements are already implemented to foster the standardization of OTC derivatives trades. It is very regrettable that the current European regulation is limited to a notification requirement, which should be seen as a first step towards real transparency. Only standardization and clearing house can realistically enhance transparency.

B- Prohibition on uncovered sovereign credit default swaps

A close regulation of the CDS market is definitely key to efficiently control short selling activity. Indeed buying a CDS without holding the underlying asset is a cheap way to short sell a bond. The reason is that in a short sale operation the investor needs to mobilize collateral to make sure he/she will be able to borrow the security at the time he/she needs them. In turn buying a CDS involves only cash for the premium but does not require collateral. In addition the CDS are extensively used by investors to reduce their capital ratio because holding CDS improves the quality of the bank' assets.

However in practice the prohibition of uncovered CDS seems tricky to implement. In fact to exercise an efficient control upon market participants, the regulator should have an access to their aggregate positions at a daily frequency. Yet the size of investment banks has become incredibly large, a fact that makes it unrealistic to obtain a snapshot of trading books and balance sheet at such a high frequency. To give a basic idea of what is realistic, the DTCC aggregates volume data of CDS transactions on a weekly basis, while volume is incredibly easier to get that aggregate trading books data. Under these circumstances, how is it possible to make sure that the underlying sovereign bond bought the same day as the CDS (as requested by the Regulation) will not have been swapped against another security using a swap contract the day after?

In addition the Regulation exempts market makers from the ban on uncovered CDS and short sales restrictions. This exemption is motivated by the fact that market making is definitely useful to provide liquidity in the market. However the major participants in the sovereign bonds and CDS markets are market makers. A market participant is considered as a market maker when his/her volume of transactions is sufficiently large and he/ she commits to price any transactions an end-user may ask. In sum every large investment banks are market makers. In practice thanks to this position market makers have an overall view of the market, they know volumes and price better than anyone else. And they precisely reap the benefits of this competitive advantage for proprietary trading.

Indeed it is not unusual that market makers are also big players in proprietary trading, a market activity that is by definition not motivated by hedging but by mere speculative objectives. In sum there is a realistic risk that the exemption concerns market participants which activity is precisely the one that the Regulation aims to limit.

C- The case for including corporate CDS

Last the current regulation restricts uncovered sovereign CDS only. However as mentioned earlier, our current research provides evidence that CDS on corporate entities have also played an important role in driving market sentiments. In fact the nexus of the financial sector and sovereign credit risk has been a feature of the European sovereign crisis in particular. To avoid a credit crunch and loss of real sector output, governments engaged in large-scale financial-sector bailouts that required immediate issuance of additional debt by the sovereign. This led to an increase in the sovereign's credit risk. In sum a run up in the premium of bank CDS was considered as a signal for the further deterioration of a sovereign fiscal situation. In consequence it is important to broaden the scope of the current regulation.

Conclusion

In total there are scientific evidence showing that under certain circumstances financial speculation can have destabilizing rather than a disciplinary effect. As a consequence it is important to set a stricter regulation of the financial markets. In particular there are specific financial instruments such as CDS that are used to bet against the market. It is therefore important to find the proper regulation of these financial instruments. Here I endeavored to attract policy-makers' attention on some remaining issues regarding the current regulation. First more information does not mean more transparency. Only standardization and clearing house can realistically enhance transparency. It is very important that the current European regulation constitutes a complement and not a substitute to the international reform of the OTC financial derivative market. Second the practical implementation of the complete ban of uncovered CDS remains doubtful. If the regulation exists without being practically implementable there is a risk of producing a false sense of security.