

Credit Default Swaps Really Do Change Behavior

But Are Policy Changes Warranted?

The idea insurance changes behavior should not be particularly radical; maybe home insurers such as Allstate (ALL) have had enough of writing policies in hurricane-prone regions, but as long as federal flood insurance is available and people covet oceanfront property, high-risk homes will be built.

Ask yourself how your trading would change if I gave you a free put or call option for every long or short position, respectively, you acquired. You would become more aggressive. What about credit default swaps, which are a form of insurance against bond or loan default?

Research Results

I had the pleasure of listening to a Webinar presented by Professor Marti Subrahmanyam of the NYU Stern School of Business last week. Some of the incentives created by CDS include what is referred to as an “empty creditor” problem; this is someone who is both long the bond and the CDS protection and therefore has no net economic exposure. However, these creditors can be shown to have a greater interest in pushing the debtor into bankruptcy as opposed to restructuring.

A second behavioral consequence arises from debtors’ increased debt capacity: Just as someone who takes a statin such as Pfizer’s (PFE) Lipitor may eat a higher-fat diet, a debtor whose bonds are insured may be tempted to take on greater debt loads while lenders become tougher negotiators and curb moves toward strategic default. However, the availability of CDS appears to attract more and therefore more marginal lenders into the equation. The creditor pool thus becomes less uniform in its interests and therefore less likely to work out a debt restructuring.

This is a very different result than we should and do expect from something such as hedging of wheat production. A farmer who sells wheat forward fixes the price at the opportunity cost of foregone higher prices. However, that hedger still has volumetric risk: Either the farmer delivers the wheat or must cover the quantity in the open market. An empty creditor has no further economic risk, which would be akin to the farmer selling a futures contract and forgetting about that whole planting thing.

What To Do

What is interesting is how these issues are not addressed in many of the financial reform proposals of Dodd-Frank, Basel III and others. You can clear CDS centrally or trade them on an exchange such as the CME Group (CME) or InterContinental Exchange (ICE) if you must, but that does nothing to end the lack of economic interest created by the empty creditors.

But – and this is a big “but” – it is still unclear whether the risks posed above are offset by greater availability of credit or even if the greater availability of credit should be regarded as a social good or simply as evidence of another credit bubble in formation. Moreover, just because a problem is identified does not mean a more restrictive legal or regulatory environment is indicated. History suggests market participants’ behavior changes to sidestep regulation and you change one initial intractable problem for a larger number of smaller but still intractable problems.

My guess is we will do nothing to address any of these issues until the next crisis. That often is the safest bet in town regarding collective behavior.