

Risk Management: Lessons from the Crisis

Information Content in CDS Spreads

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Introduction

- Credit Derivatives are at the center of discussions of and reactions to the crisis
- What role do they really play in banks and what is the impact on bond markets?
- What can we learn about the crisis and its impact from credit derivatives?
- What can we learn about government reactions to the crisis?

Information content of credit derivatives

- What is the impact on bond markets from the introduction and trading in CDSs?
- Do CDSs impact price discovery in the bond markets?
- What is the relation between sovereign and bank default risk before, during and after the crisis? What can CDSs tell us about the relation?
- Do banks use credit derivatives to impact loan pricing on syndicated loans, why?

Bond markets and CDS Introduction

- Declines in secondary market activity
- Drop in bond turnover
- Bonds become more inefficient after CDS trading begins
- Less liquidity in bond market
- CDS trading did not improve bond market quality

Bond markets and CDS Introduction,

- There is more price discovery in the CDS market which is similar to what we saw in the options markets
- There are more informed traders on the CDS market than in the bond markets

Comments DKN

- What is the net impact of the introduction of CDSs on discovery?
- The main trading of bond quality is through the CDS so we expect for this to be more informative – do we know more than before?
- Bonds were already inefficient, so CDS provides more information?

Lessons from CDSs: banks and sovereigns

- Banks credit spreads impact the spread on sovereigns leading up to the crisis
- Post intervention, more importance of sovereign spreads on price discovery mechanisms of banks' CDS series
- Financial sector shocks have larger impact on sovereign spreads but short lived.
- Relative price discovery of CDSs and bonds vary across countries

Comments - AS

- Why not look more closely at normal periods? Before the crisis.
- Why select two banks per country and selection criteria for bank beyond data?
- Do we have more information on the banks' balance sheets and specific bailout provisions for each?

Use of Credit Derivatives: Channels

- Examines four channels through which credit derivatives are used.
- Banks gross position in credit derivatives has a negative impact on corporate loan spreads
- The gains from risk management from banks is passed on to borrowers
- Benefits persist during and after the crisis
- There are real effects of credit derivatives that are present even after the crisis

General comments - NSW

- What's the number of banks per year
- What is the role of client activity of the banks? Some of the selling of credit derivatives could be for clients.
- Can we disentangle the actual use of the derivatives?

Conclusions

- Very informative papers that exploit the information content of the CDS market.
- Two papers connect the price discovery of the CDS market relative to the bond market and together show that there is cross country variation.
- More clarity on the use of credit derivatives for banks.
- All are recommended reads.