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The Senator Has No Clothes: Why a Ban on “Naked” Credit Default Swaps Is Ill-Advised and Impractical

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Senator Byron Dorgan’s (D–ND) proposal to ban what he calls “gambling” with “naked” swaps is deliberately calculated to evoke images of a wild weekend playing strip poker in Las Vegas. Regrettably it is Dorgan’s policy proposal that is bereft of intellectual or empirical cover. Dorgan’s game of politics on the Potomac is a far bigger threat to the economy than the financial products that Dorgan mischaracterizes.

Banning “Naked” Swaps. A credit default swap (CDS) is a contract providing for payments when a third party fails to pay a specified debt. One party obtains coverage on the debt by paying a premium (usually quarterly) to the other party. Dorgan proposes to amend the Restoring American Financial Stability Act, now pending in the Senate, to ban these contracts unless the debt at issue is owed to the party buying protection. Dorgan suggests that speculative use of CDS worsened the 2008 financial crisis.

While it is true that ill-advised CDS investments triggered the near collapse of insurance giant AIG, market-based reforms already adopted by the private sector and existing provisions of the Financial Stability Act more than adequately address abuses of derivatives.¹

Dorgan’s proposal is impractical because legitimate uses of CDSs are not limited to interests that might be insured. Restricting trading of derivatives would not help teetering firms (or nations), nor

would it promote financial stability. Credit derivatives enhance the liquidity—and thus increase the stability—of the market for debt and send useful price signals that benefit the entire market. Dorgan’s proposal would misguidedly limit these public benefits by restricting CDS use to a private insurance function.

Legitimate Uses of Credit Default Swaps. The first loose thread in Dorgan’s logic is that CDSs are not always used to hedge (i.e., protect against) default of the specific debt referred to in the instrument. CDSs are widely offered on corporate bonds. Dorgan would apparently prohibit persons who do not own the specified bonds from buying CDSs. Many persons other than bondholders, however, are creditors of a corporation, such as suppliers and landlords. While CDSs on a corporation’s bonds are an imperfect hedge against the non-payment of supply bills or rent, they are a reasonable proxy, because a company that fails to pay some of its bills is certainly at risk of failing to pay others.

Internationally, investors use “sovereign” CDSs (CDSs on government bonds) as a way to hedge against broader economic risks in a particular coun-

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try. For instance, CDSs on Greek government debt are obviously closely (though not precisely) related to likely economic conditions in Greece.

Swaps and Insurance: Legislating an Imperfect Analogy. Though CDSs are often compared to “insurance” on bonds, swaps are not the same as bond insurance (a separate product available for some bonds). The application of CDSs is far wider and the conditions for payments broader, and the flow of funds may shift from one party to the other during the course of the contract. The insurance analogy is too simplistic to provide a valid guide to policy for CDS contracts.

Any creditor of a company or investor in a nation has an “interest” in whether the company or country pays its bond debts—and a legitimate reason to buy a financial instrument protecting against default on that debt. Banning “proxy” hedges through a narrow definition of insurable interest would hurt the most marginal borrowers (by making lending to them more risky and reducing the liquidity of the market for their debt) and thus increase economic instability.

Condemning Speculators. The second severed seam in Dorgan’s fabric is the broadside condemnation of speculation, which Dorgan describes as “gambling.” Dorgan implicitly admits that speculators—investors who are willing, for a fee, to take on risk—are essential to financial markets by allowing one side to a CDS trade to take a speculative (non-insurable) position. Dorgan’s mistake is to assume he can artificially limit speculation to one side of every market transaction without harming or even destroying the market.

Liquidity in financial markets—the ability to buy and sell readily—requires a pool of persons ready to take on varieties of risks. Constricting the CDS market would make swaps less useful and more expensive. Investors could find themselves

locked into positions for lack of buyers for perfectly hedged positions.

For instance, a hedged bondholder might find it relatively easy to sell bonds into the unrestricted bond market but have difficulty selling CDS protection in a Dorgan-limited market. Moreover, CDS protection sellers often buy and sell protection on the same bonds either to offset (hedge) their own position or to change their investment positions in the course of a typical 10-year CDS contract. Dorgan’s insurability requirement would eliminate the ability of market makers to serve as middlemen by making offsetting sales.

All financial transactions involve risk and can be described as having an element of “gambling.” Investors buying stocks or bonds are gambling that the company they are investing in will be profitable. Investors with negative views about a company are often unpopular, but they serve an essential economic function by providing liquidity in the market and by providing price signals about a company’s prospects.

Closing the Eyes of the Market. Short sellers of stock and buyers of CDS debt protection do not cause corporate (or sovereign) woes any more than a thermometer causes frost. By attempting to ban traders with negative information or beliefs about the likely performance of corporate debt, Dorgan is attempting to stave off economic problems by closing the collective eyes of the market. In fact, all that such restrictions will do is make it harder to read the early warning signs of future economic problems.

Covering up information and restricting markets is no way to promote economic well-being. It is not swaps that are naked but the logic of the Dorgan Amendment.

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1. See Dave Mason, “Senator Dodd and Derivatives: How the Market Has Made Regulation Redundant,” Heritage Foundation WebMemo No. 2850, March 31, 2010, at <http://www.heritage.org/Research/Reports/2010/03/Senator-Dodd-and-Derivatives-How-the-Market-Has-Made-Regulation-Redundant>; Dave Mason, “Credit Derivatives: Market Solutions to the Market Crisis,” Heritage Foundation Backgrounder No. 2262, April 23, 2009, at <http://www.heritage.org/Research/Reports/2009/04/Credit-Derivatives-Market-Solutions-to-the-Market-Crisis>.