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Has the CDS market lowered the cost of corporate debt? ☆

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ABSTRACT

Many have claimed that credit default swaps (CDSs) have lowered the cost of debt financing to firms by creating new hedging opportunities and information for investors. This paper evaluates the impact that the onset of CDS trading has on the spreads that underlying firms pay to raise funding in the corporate bond and syndicated loan markets. Employing a range of methodologies, we fail to find evidence that the onset of CDS trading lowers the cost of debt financing for the average borrower. Further, we uncover economically significant adverse effects on risky and informationally opaque firms.

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1. Introduction

The development of the credit derivatives market has been credited as a source of substantial improvements to the financial system. Alan Greenspan observed that “the new instruments of risk dispersion have enabled . . . banks . . . to divest themselves of much credit risk These increasingly complex financial instruments have contributed . . . to the development of a far more flexible, efficient, and hence resilient financial system . . .”.¹ In turn, Paul Tucker argued that “the innovation of credit derivatives has plausibly taken us a further step toward complete markets, in effect providing a richer market for credit insurance than previously existed . . . (and) reducing the price of risk”.² In this paper, we investigate the claim that credit derivatives have reduced the cost of debt for corporate borrowers.

A credit default swap (CDS) is an instrument that provides its buyer with a lump-sum payment made by the seller in the case of default (or other “credit event”) of a reference entity. The protection seller charges a premium that is paid until

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¹ Speech before her Majesty’s Treasury Enterprise Conference (London, January 26, 2004).

² Speech at the Euromoney Global Borrowers and Investors Forum (London, June 23, 2005).

default or maturity, whichever comes first. If the credit event occurs, the buyer is compensated for the loss incurred as a result of the credit event.

Since CDSs create new hedging opportunities, it seems that these instruments could indeed contribute to a reduction in the cost of corporate debt. Until recently, corporate credit risk had been essentially untradable. Liquidity in the bond market has been limited because many investors hold their bonds until maturity. The secondary market for loans has experienced rapid growth in the recent years, but bank loans remain largely illiquid. Under these circumstances, the development of the CDS market provided banks and investors with a new, less expensive, way to hedge or lay off their risk exposures to firms. Even though the insurance provided by a CDS is tied to a specific security and not to the borrower, firms that have traded CDSs give their creditors added opportunities to diversify their credit exposures.³ There is evidence that banks are using the CDS market to hedge their risk exposures. If some of the savings arising from these diversification opportunities are passed on to borrowers, then firms with CDSs can take out loans and issue bonds at lower interest rates.⁴

CDSs could also lead to a reduction in the cost of debt by revealing new information about firms. The secondary market for loans is still a poor source of information on firms because only a reduced number of loans trade in that market. A high number of corporate bonds trade in the secondary market, but the liquidity problems that still characterize this market, coupled with the diversity of coupon structures and embedded options, also hamper the information content of this market. In contrast, CDSs' prices are a clean measure of the spread that investors require to bear a firm's default risk. In addition, since these derivatives offer investors risk-trading opportunities that are hard to replicate in the secondary loan or bond markets, CDSs' prices are a potentially important source of new information on firms.⁵ Indeed, Hull et al. (2004) found that the CDS market anticipates credit rating events.⁶ This informational role of the CDS market could contribute to a reduction in the cost of debt by reducing the information premium investors demand on bonds and by reducing the rents that banks extract from borrowers in connection with their informational advantage.⁷

It follows from these diversification and information channels that the development of the CDS market could indeed contribute to a reduction in the cost of corporate bond financing as well as bank funding. This paper investigates these hypotheses. Further, since the diversification channel will likely benefit riskier firms the most while the information channel will likely benefit informationally opaque firms the most, the paper considers these differences in an attempt to identify which channel has had a larger effect on the cost of corporate debt.

We find no evidence that the *average* firm with a traded CDS has benefited from a reduction in the credit spreads it pays to issue in the bond market or the spreads it pays to borrow from banks. To the contrary, we find that the onset of CDS trading has increased the cost of debt financing in both of these markets for the riskier firms as well as those that are more informationally opaque. On a positive note, we do find evidence of a small reduction in the spreads that safer and more informationally transparent firms pay to borrow in the bond market and from banks after their CDSs start to trade. These findings are quite robust. They also do not appear to be driven by sample selection. For one, they hold in samples of firms that access the debt markets both before and after their CDSs start to trade and in specifications with firm-fixed effects. Further, our findings hold when the analysis is limited to firms with traded CDSs as well as when a matched-sample approach is used. Finally, we document that the nature of selection into CDS trading involves firms that are either safe or are becoming safer, which creates a bias toward concluding that CDS trading reduces debt issue spreads, opposite of our ultimate conclusion. We suggest a reason why the development of the CDS market may have not contributed to a reduction in the cost of corporate debt.

The remainder of this paper is organized as follows. The next section presents our methodology and our data. Section 3 documents the impact of CDS trading both on the cost of bond financing and on the cost of bank funding for the average firm. Section 4 investigates the differential impact of CDS trading across borrower risk and opacity as well as CDS market liquidity. Section 5 concludes.

2. Methodology, data, and sample characterization

This paper identifies the impact of CDS trading on the cost of debt funding using two approaches. The first approach focuses on the sample of firms that become traded—referred to as the *traded sample*—and exploits differences in the timing of the onset of CDS trading across these firms. The second approach identifies a sample of firms that are never traded but have similar characteristics to those that do—referred to as the *matched sample*—and uses these firms as a control group. Each approach has its strengths and weaknesses. While the second approach does not require an assumption that timing is

³ Duffee (2007) discussed ways in which banks can use derivatives to hedge their credit exposures, and Duffee and Zhou (2001) and Parlour and Plantin (2005) presented models of banks' use of credit derivatives.

⁴ Minton et al. (2009) investigated U.S. banks' use of CDSs to cover exposures resulting from their lending activity, and Hirtle (2009) studied whether these instruments affect bank lending.

⁵ A CDS is like a traded insurance contract against credit losses; however, in contrast to an insurance contract, it is not necessary to hold an insured asset to claim "compensation" under a CDS. Thus, speculators can take long (short) positions in credit risk by selling (buying) protection without needing to trade the cash instrument.

⁶ See also Longstaff et al. (2004), Norden and Weber (2004), Blanco et al. (2005), Acharya and Johnson (2007), and Norden and Wagner (2007) for evidence that the CDS market is a source of information on firms.

⁷ See Santos and Winton (2008) and Hale and Santos (2009) for evidence on banks' informational rents.

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