Discussion of

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HAS THE CDS MARKET LOWERED THE COST OF CORPORATE DEBT

by

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Conference on Risk Transfer Mechanisms and Financial Stability
PUT THE PAPER INTO PERSPECTIVE

NEW MARKET ADDED TO INCOMPLETE MARKET

- theoretical
  - general
  - loan market
  - derivatives markets

- empirical
  - futures
  - options
  - loan market
  - credit derivatives

Ashcroft/Santos
Does CDS Trading Impact EX ANTE Bond Spread and Loan Rates?

- reduction of incompleteness
- improvement of information
- reduction of screening and monitoring cost

Event Study and Matched Sample

General Result: CDS trading has no effect on bond spreads lowers loan rates if no loan controls

Refined Result: transparent, low risk borrowers benefit opaque, high risk borrowers suffer

- Carefully done Empirical Study
- Unexpected Results
THEORETICAL ARGUMENTS

(1) Rate Setting

• Bond Spreads: Screening Component – NO Monitoring Component
• Loan Rates: Screening Component – Monitoring Component
• CDS Prices: Reflect Deliverable Instruments
  • Senior, Subordinate
  • Old Instruments before CDS trading
  • Reflect Reduced Screening / Monitoring?
• Other Syndicates: Competition, Reputation

⇒ Does CDS Trading Increase PURE CREDIT SPREAD?
FIRM-SPECIFIC ANALYSIS

BOND

Nielsen Comp. (VNU Group B.V.)

- Pure credit risk premium without liquidity in CDS: $\bar{\sigma} = 120.7$ bp = bd
- Pure liquidity premium without liquidity in CDS: $\bar{\sigma} = 3.4$ bp = bl
- Correlation premium without liquidity in CDS: $\bar{\sigma} = 6.7$ bp = bc
FIRM-SPECIFIC ANALYSIS

Nielsen Comp. (VNU Group B.V.)

- Pure credit risk premium with liquidity in CDS: $\bar{\theta} = 97.4 \text{ bp} = bd$
- Pure liquidity premium with liquidity in CDS: $\bar{\theta} = 22.7 \text{ bp} = bl$
- Correlation premium with liquidity in CDS: $\bar{\theta} = 10.4 \text{ bp} = bc$
(2) What makes Hedging of **Bond Risk** by CDS different from Hedging of **Loan Risk**?

- Bonds are considered for sale: no monitoring
  ⇒ Loan rate lower than bond spread (same firm)
  (Cook / Spellman (2006))

- Loans more probably considered for **sale** have **higher rates**
  (Kamstra / Roberts / Shao (2006) but Güner (2006))

- Loans more probably considered for **securitization** have **higher** default rates
  (Keys / Mukherjee / Serin / Vig (2008))

⇒ Comparison of bonds and loans **probable for sale**
   not **probable for sale**
EMPIRICAL ARGUMENTS

- Period from 2001-2003 important
  - Strong increase of first CDS trades
  - Enron and WorldCom turbulences
MEAN CREDIT RISK, LIQUIDITY AND CORRELATION PREMIA

Investment Grade

credit risk premium bd and sd

liquidity premium bl and sl

correlation premium bc and sc
EMPIRICAL ARGUMENTS

• Period from 2001-2003 important
  Strong increase of first CDS trades
  Enron and WorldCom turbulences

• Stratification of investment and subinvestment grade bonds / loans
MEAN CREDIT RISK, LIQUIDITY AND CORRELATION PREMIA

Subinvestment Grade

- Pure credit risk premium: bd and sd
- Pure liquidity premium: bl and sl
- Correlation premium: bc and sc
MEAN CREDIT RISK, LIQUIDITY AND CORRELATION PREMIA

Investment Grade

- Credit risk premium: bd and sd
- Liquidity premium: bl and sl
- Correlation premium: bc and sc
EMPIRICAL ARGUMENTS

- Period from **2001-2003** important
  - Strong increase of first CDS trades
  - Enron and WorldCom turbulences

- Stratification of *investment* and *subinvestment* grade bonds / loans

- CDS effect for *traded* bonds and loans

- *Gaps* in CDS trading after first trade
ONSET OF CDS TRADING

Caja de Ahorros de Valencia Castellon y Alicante Yield Spread
Caja de Ahorros de Valencia Castellon y Alicante Mid CDS
EMPIRICAL ARGUMENTS

- Period from 2001-2003 important
  - Strong increase of first CDS trades
  - Enron and WorldCom turbulences
- Stratification of investment and subinvestment grade bonds / loans
- CDS effect for traded bonds and loans
- Gaps in CDS trading after first trade
- Minor comments
  - bond spread for callable / putable bonds
  - issue price vs. fixed reoffer price
  - CDS: relation of reference entity, deliverable obligation to bond / loan
IMPORTANT SUBJECT

INTERESTING PROBLEM

CAREFULLY DONE EMPIRICAL STUDY
END