Credit Default Swaps on Trial
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CHICAGO – The lawsuit filed by the US Securities and Exchange Commission against Goldman Sachs for securities fraud, charging the bank with misrepresenting the way a collateralized debt obligations (CDO) had been formed, has revived public disgust at credit default swaps (CDS), the instrument used to bet against these CDOs. Before the 2008 financial crisis, CDSs were an esoteric product, known only to a restricted number of sophisticated investors and specialized academics. Today, they are a household name, synonymous with unruly speculation, boundless greed, and, ultimately, systemic instability.

Indeed, CDSs are blamed as one of the main causes of the financial crisis. The legality of Goldman Sachs' behavior will be determined by a court of law, but CDSs' odious reputation is jeopardizing the survival of this instrument in the court of public opinion.

Riding the populist wave, several politicians have proposed a ban on CDSs. The recent Greek crisis has further galvanized the anti-CDS camp. After all, isn’t it the fault of the CDS market’s avaricious speculators that Greece was on the verge of default and that Greek public employees have had to endure deep wage cuts?

In a word, no. Far from being the spawn of the devil, CDSs are a useful financial instrument that can improve not only financial stability, but also the way that companies and countries are run. Banning them will do more harm than good. Any attempt in that direction is detrimental, because it would divert attention from the useful goal of disciplining the CDS market to make it more transparent, stable, and efficient.

One key advantage (if not the key advantage) of capitalism over central planning is the information conveyed by market prices. When the demand for potatoes at the current price exceeds supply, the price of potatoes rises, signaling scarcity. Individual farmers do not need any bureaucratic directive to decide whether to plant more potatoes: an increase in prices creates an incentive to plant more potatoes; a decrease in prices is a signal that they should plant less.

The same is true with stock prices. An increase in the stock price of steel manufacturers suggests an increase in the demand for steel, which induces entrepreneurs to start more steel plants and investors to provide them with the money. Conversely, a decrease in the stock price of steel manufacturers leads entrepreneurs to liquidate existing plants and dissuades investors from committing more resources to the sector.

Unfortunately, sometimes prices fail to perform this signaling function properly, as the dot-com and housing bubbles in recent years showed. During the dot-com bubble, prices signaled huge demand in the Internet sector. For this reason, hundreds of millions of dollars were wasted in advertising improbable companies on TV and building network capacity beyond any foreseeable need. During the housing bubble, prices signaled a severe scarcity of houses. So billions of dollars were poured into new developments in remote locations where nobody wants to live.

Given the large misallocation of resources in such cases, it is vital to understand why prices failed to provide an accurate signal to investors. Why did the United States, with the most developed financial market in the world, experience two major bubbles in less than a decade? An expansive monetary policy is partly to blame, but the real problem is an institutional setting that favors bullish sentiment.

Pension funds, mutual funds, and investment banks are all long in the stock market. Shorting a stock is difficult and risky: it is difficult because borrowing stocks is hard to do, and it is risky because shorting has limited upside but infinite downside. In other words, the traditional securities available to investors make it easier to bet in favor of a company than against it, causing prices to be affected more by irrational exuberance than by panics.

In this respect, CDSs are unique. Because they function as insurance on borrowers' ability to meet their obligations, they make it easier to express a negative opinion on a company or a security. To express a negative view via the CDS market, investors do not need to locate securities to borrow (a prerequisite to shorting), and they risk only a limited premium, while they have the opportunity to gain many times that.

It was the CDS market that allowed the negative -- and correct -- view of the housing market held by John Paulson and others finally to be embedded into market prices. They made the bubble burst. While painful for the rest of society, this is healthy. The longer a bubble lasts, the more damage it causes.

The same reasoning applies to the Greek crisis. The CDSs on Greece provide a useful signal of the country's compromised financial situation. It is thanks to the spike in the CDS market that the Greek government tightened its budget and improved its fiscal position. Medical tests, too, often bring bad news, but abolishing medical testing does not solve problems, it only hides them, making them worse.

The reason that politicians and corporate managers alike hate CDSs is precisely because CDS rates are so useful and so prompt in exposing their mistakes. Nobody likes to be found wrong. For this reason, politicians and powerful businessmen often cajole the press, the credit rating agencies, and even the analysts to portray their actions in a positive light. As the main source of negative information that is not sensitive to power, the CDS market is feared, and politicians want to eliminate it.

Of course, the CDS market is not perfect. In fact, it is not really an organized market, but only an informal virtual exchange. The existing rules are designed not to make it transparent or resilient, but to make it more profitable for large institutions like Goldman Sachs and JP Morgan. So intervention is needed to formalize the CDS market and force appropriate collateralization, so that no government has to step in to rescue any counterparty. But regulating the CDS market does not mean banning it. To do so would only sow the seeds of the next bubble.

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