



Banning naked CDS shorts: a bridge too far

Anu Munshi, partner at B&B Structured Finance, outlines the case against banning naked sovereign CDS shorts

First a proposal in the US in 2009 to ban CDS trading unless investors owned the underlying bonds or loans, which was fortunately defeated by the US Senate in 2010. And now the European Parliament has voted to push for a ban on naked short selling of CDS linked to sovereign debt.

We've read the widespread criticism of naked short selling via CDS and how it can push corporates and sovereigns into default or a web of spiraling cost of debt. Widening CDS spreads can cause cashflow problems for issuers by increasing their cost of financing, but bad fiscal management causes their CDS spreads to widen in the first place. There is also no publicly available evidence of naked CDS shorts being the key factor in issuer defaults or distress.

Banning naked CDS shorts isn't a good move for a variety of reasons. The CDS price of an issuer tells you about the market perception of its creditworthiness. Because CDS prices trade constantly, CDS are more volatile than ratings but increasingly more important, especially given regulators' desire for market participants to reduce their reliance on rating agencies.

Having a liquid and robust two-way CDS market is essential to having pricing in credit markets that are tradable and therefore reliable. Barring naked CDS shorts will constrain a fully functioning two-way credit market and reduce the reliability of an important market barometer.

Many market participants, particularly banks, go short CDS on issuers to whom they have derivative counterparty exposure rather than to whom they have given outright loans. This is particularly true of exposure to sovereigns, with whom banks transact large swaps on the back of government bond issues.

Derivative counterparty exposures are constantly changing and harder to hedge perfectly with CDS, making for logistical challenges in hedge reporting. As counterparty risk management is a priority for governments, regulators and banks alike, it is important to think through the consequences of banning CDS shorts that serve as hedges but may be harder to verify.

Finally, if naked CDS shorts on European sovereigns are banned, speculators will find other ways to express their views – by shorting European bank CDS or shorting the euro, for instance. Where do the bans end?

Most market participants support increasing disclosure requirements to achieve greater transparency and the push to centrally clear CDS to reduce counterparty risk. But banning a particular type of transaction altogether is a bridge too far.

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