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Hedging bans on sovereign risks will push up debt costs

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INSIGHT

On Monday, the European Parliament's Committee on Economic and Monetary Affairs agreed its negotiating stance on the European Commission's proposed regulation on short selling and certain aspects of credit default swaps (CDS).

One element of the parliament's position that is likely to worry observers is the proposed limit on the ability of companies to enter into CDS referring to a European member state. A sovereign CDS position, which offers financial protection against the impact of a decline in credit-worthiness of a given state, would be allowed only if the company held assets whose price would be harmed by the default of that state.

The first question that springs to mind is why this desire to limit sovereign CDS activity? In short, the issue here is the role of speculation in sovereign CDS markets, and its alleged negative impact on sovereign bond spreads, something that has received a good deal of attention over the course of the sovereign debt crisis that began in the first half of 2010. The parliament sees a ban as the means to protect European issuers from such activity.

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Yet looking at the evidence, we are not convinced that a limit on sovereign CDS would do anything to protect beleaguered sovereign issuers, given that sovereign CDS has, at most, a minor influence on bond spreads. As the European Commission aptly explained in its in-depth report on the sovereign debt crisis: "The CDS spreads for the more troubled countries seem to be low relative to the corresponding bond yield spreads, which implies that CDS spreads can hardly be considered to cause high bond yields for these countries." Perhaps unsurprising when you consider that data cited by the International Monetary Fund shows that net exposures to sovereign CDS contracts account for only 0.5 per cent of total government debt. It's also worth noting that the level of sovereign CDS exposures and activity is publicly available and supervisors have access to more detailed information. On the whole, it appears that, contrary to the parliament's hopes, a ban is unlikely to contribute towards the wider financial stability of Europe in the way anticipated.

Second, it is important to understand that trying to limit sovereign CDS will in fact create a number of difficulties for those active in these markets. A limit on particular sovereign CDS activity could well lead to less liquidity, higher spreads and greater uncertainty for European companies – manufacturers, services providers, pension funds – seeking to hedge risk. This would not be a good outcome for those companies, or for risk management more broadly. Bans are also enormously difficult to enforce, especially when they apply on a regional basis to products that can be traded globally.

In the parliament's defence, it has clearly understood the vital role that sovereign CDS plays for companies and for the health of Europe's economy. The parliament has made allowances both for hedging activities and for market-making, as part of an effort to ensure that risk management disciplines aren't undermined. However, the issue that many will be reflecting on is the workability of those carveouts. For one, interpreting exemptions can, in practice, prove exceptionally difficult. What assets are you allowed to protect with a sovereign CDS contract? Is hedging of financial contracts permissible? What if you want to enter into a sovereign CDS position before you purchase an asset, while its cost may be relatively low? The parliament's solution would defer these sorts of questions to the European Securities and Markets Authority, to be tackled at a later date. Many would prefer greater clarity at this stage.

This added uncertainty is also likely to make member states nervous. For example, under current rules, a supplier of IT services to a state-backed healthcare clinic could protect itself with a sovereign CDS contract: the most likely reason for the clinic not paying would be due to financial stress at the state-level, against which the CDS would offer protection. Why would you invest if you had doubts about the legality of a position that would protect your investments? This goes for bond markets too: if CDS protection ends up becoming more costly or uncertain, then member states will have to compensate investors for the increased risk, leading to higher funding costs for member states. From corporates to capitals, many will rightly be concerned at the parliament's position on sovereign CDS trading.

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As for what happens next, the European Council is close to finalising its position on the issue of sovereign CDS, at which point the horse-trading begins in earnest. To date, the council has not supported the prospect of a ban on sovereign CDS positions. So let's hope that the final outcome isn't one that denies companies – whether corporates or investors – the benefits that sovereign CDS provides.

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