Betting on insecurity

The financial lobby has exploited the opacity of financial markets to avoid curbs on speculation against EU member state economies. The lack of precise information on what happened with Greek, Irish, Portuguese and Spanish bonds might – ironically – have protected the speculators from tighter regulation.

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Throughout 2010 financial speculation against member states economies were a major topic for discussion among politicians and in the media. First in Greece, then Ireland, Portugal and Spain. In all four cases the interest rate on sovereign bonds (loans to governments) reached peak levels over the course of the year - loans became considerably more expensive for governments. Many politicians condemned speculation in the bond markets which had in their view driven the price of new loans up. Speculators, they were said, were effectively betting on the governments defaulting on their loans.

Surely it should be expected that measures would be taken at the EU level to avoid such situations. Not least given that the volatility in the markets had put the stability of the euro in doubt. And at first it sounded as if strong new rules had political support. In June 2010 Angela Merkel and Nicolas Sarkozy issued a joint letter urging the EU to consider prohibiting instruments that could be used to speculate in bonds, known as 'naked credit default swaps' (or naked CDS). They said: "the return of strong volatility in the markets makes it necessary to question certain financial methods and certain products such as naked short-selling and credit default swaps"[1]. Germany even imposed a unilateral ban.

But as time has passed, ambitions have been scaled down, and there's a danger that speculators could come out unfettered from the affair.

Part of the explanation for this can be found in the way the financial lobby has played its hand. The financial sector is notoriously opaque, including to regulators, and this has allowed financial sector lobbyists to manipulate the debate on regulation. The European Commission for its part appears to have accepted their terms of the debate. Being unable to get the full picture of the workings of the bond market, the Commission has opted for a cautious solution that will hardly disturb speculative attacks in the future.

This approach is clear from a Commission report[2] on speculation in sovereign debt. Prepared in spring 2010, this report was designed to feed into the preparation of new draft legislation on financial regulation. The draft proposal was published in September 2010 and a final version is expected to be adopted some time soon.

The report did not enter the public domain until early December 2010, when it was released to a Dutch paper by the Commission. This allowed the report to be part of the final debate on new legislation.
Its contents were immediately spun by the financial lobby, mindful of the upcoming political decisions. They claimed it provided the ultimate proof that speculators were innocent. But, as we shall see, when looked at carefully, the report actually shows that crucial decisions on this legislation were based on one-sided investigations conducted in the dark.

The background
When the eurocrisis broke in early 2010, several experts strongly recommended banning certain speculative financial instruments, in particular a kind of derivative called naked CDS. CDS are often bought by large financial institutions from other financial institutions, some CDS are bought as a kind of insurance against losses that the institutions may incur on loans granted from them to eg. Greece (by buying so-called sovereign bonds). Others are simply bets that the country in question will default on its debt, with no link whatsoever to fresh investment or actual loans to the troubled Southern European country. These instruments are called “naked CDS” and are purely speculative. The more popular an investment CDS on a country’s sovereign bonds become, the less trust investors have in that country, and the more expensive it will become for that country to raise new money.

The case against naked CDS – if experts in the area are to be believed – is not necessarily based on enormous pools of money being bet on this market.

“Small trades can signal information that then influences other market participants. If they then move together, in a ‘herd’, there may be very large price effects,” Professor Richard Portes from London Business School told Corporate Europe Observatory[3].

In other words: even though the market in sovereign CDS (CDS on bonds) is relatively small, it could influence the bond market disproportionally.

Wolfgang Münchau, a financial commentator with the Financial Times, was clear about their limited value. He wrote: “There is not one social or economic benefit. Even hardened speculators agree on this point. Especially because naked CDSs constitute a large part of all CDS transactions, the case for banning them is about as strong as that for banning bank robberies”[4].

Whether or not Münchau is right about the value to society, he has been proved wrong if he expected the financial sector to accept a ban. When the sovereign debt crisis in EU member states triggered sufficient political momentum in favour of restrictions on speculation, the biggest lobby organisation in the field, the International Swaps and Derivatives Association (ISDA), quickly launched a counter-offensive. In March 2010 the lobby group released a much-quoted paper denying any significant effect of speculation. The small size of the CDS market, they argued, was in itself proof that these instruments did not move prices[5].

ISDA went on to say that in its view “...the CDS market is far from opaque. Market participants and the general public have ready access to data to evaluate market activity.” According to ISDA, the information available on the website of the private financial statistics company, the Trade Information warehouse of the the Depository Trust & Clearing Corporation (DTCC) is more than enough to conduct a thorough investigation[6].

The report and the debate
Since key facts on the issue appeared to be disputed, the Commission decided to do its own investigations to help guide its proposal. In the course of this endeavour the above-mentioned report was produced. Written by Commission staff, the report acknowledges the need to defend

the bond market from speculation, but mainly focuses on the risk of liquidity in the CDS market drying up, which it says would negatively impact the proper functioning of the bond market. Therefore, the report proposes to only use a ban on 'naked CDS' in "emergency situations".

When the Commission's proposal, based on this report, was released in September, the financial sector saw the basic design as a victory, but was slightly worried that the 'emergency measures' might actually be used[7].

What was the basis of such a weak proposal? The Commission's report[8], leaked to the press in early December, gave an insight. On 6th December, the Financial Times quoted the report as saying it found "no evidence of any obvious mispricing in the sovereign bond and CDS market". The findings, it said: "..are likely to be seized on by banks and hedge fund traders, who felt they were unjustly accused of contributing to the crisis situation in Greece this year"[9].

The financial industry had been right. It would give nothing but trouble to ban the speculative naked CDS, or so it was claimed.

1. Did the report produce evidence?

The report was indeed seized on by the financial lobby upon release. The head of the hedge fund lobby organisation AIMA (Alternative Investment Management Association) Andrew Baker stated: "Given that the commission's own report has concluded that sovereign CDS trading did not cause the sovereign debt crisis… those policymakers who are still advocating radical curbs on the sovereign CDS market" should "take note"[10].

Many more papers and websites in the financial press followed this line and reported that no proof of speculation was produced by the Commission.

The biggest associations, ISDA and its close allies AFME (Association for Financial Markets in Europe) and ISLA (International Securities Lending Association), also seized the opportunity. In a short paper the three major lobby organisations made four references to the Commissions report as "proof" that speculation was irrelevant and that CDS were important for liquidity[11].

One MEP, known as a staunch defender of the interests of the City of London, took the matter one step further and claimed the report to be ultimate proof that even the temporary bans, as introduced by the Commissions proposal, would be damaging. British Conservative Syed Kamall MEP, who had fiercely opposed other MEPs' proposals to ban naked CDS, said: "I have been arguing since the beginning of this debate that without credit default swaps on sovereign debt, yields will rise increasing the cost of government borrowing. The Commission's leaked paper reaffirms this position. It is a shame the Commission did not listen to its own experts when drafting legislation,"[12].

Surely this left proponents of a ban on naked CDS with their backs against the wall? Especially if you accepted the statements of the financial industry and selected media reports at face value.

What ISDA, its allies and many others did not mention was that the Commission's spokesperson Chantal Hughes had in fact stressed that the report showed "no conclusive evidence one way or the other"[13]. And nor does it claim to disprove a detrimental effect of speculation. The fundamental problem for the authors seemed not to be that they had been called on to investigate non-existent speculation, but that they were not able to find the necessary data.

The overall approach of the report does support the financial industry's key claim that restricting CDS could disrupt 'liquidity' in the market, concluding that this would make bonds a harder sell, but at the same time it acknowledged potential dangers. “CDS trading could potentially also open up scope for a manipulation of prices, and this could lead to destabilisation,” it read[14]. The bottom line of the report on the question of curbing naked CDS was quite clear: “Empowering regulators with certain emergency measures” was “justified”[15].

2. Are markets transparent?

While ISDA lobbyists were already claiming in March 2010 that both market participants and the public has ready access to evaluate the market through information from the DTCC Trade Information Warehouse[16], the Commission’s civil servants found that: “The DTCC data cannot be used for spotting market manipulation.”[17]

And who can wonder? A closed club of nine American and European banks organised in a committee in New York[18] dominate the global derivatives market, they dominate ISDA and influence decisively the level of transparency DTCC provides.

That the sovereign CDS traders enjoy secrecy was clear to the Commission from the outset. “These people don’t like being out in the light of day”, Single Market Commissioner Michel Barnier said in May 2010. “We’ll flood them with light”.[19]

The report concludes that access to more detailed information on the bond markets would be needed in order to conduct a clear analysis. However, even in the absence of this kind of vital information, the authors of the report go on to warn against the effects of a ban on naked CDS, based on the financial industry’s claims that such a ban would harm liquidity in the bond market.

3. Would a ban on naked CDS harm liquidity?

This view on the effects of a ban on liquidity seems to imply that the authors of the report have managed to analyse the role of naked CDS in depth. But one of the more surprising elements of the report is the way it handles naked CDS. While CDS for hedging (ie ‘insuring’) and CDS with no direct interest in the underlying asset (ie. for speculative purposes) – may share some characteristics, they are also very different. Investors that hedge could lose from a default, while holders of naked CDS could make a lot of money on the demise of an economy. So, you would expect a report that supposed to investigate the effect of naked CDS and the implications of a ban to deal with them in a way that respects their particular characteristics.

Yet the report actually says very little about naked CDS. A ban on naked CDS is covered in a separate chapter, which boldly concludes that according to “several academics, prohibiting naked positions in credit default swaps could dramatically impact the market”. Which presumably is a serious warning against damage to liquidity, and something to pay attention to. Yet the report refers only to a single source to back up this bold claim - an article by financial investor and academic René Stulz[20]. But the problem with using this article as ‘evidence’ against the need for a ban on naked CDS is that it doesn’t actually discuss naked CDS. It’s an article on CDS, but does not distinguish between the different types of CDS, and for the same reason it does not conclude that a ban on naked CDS would ‘dramatically impact the market’[21].

As the report doesn’t distinguish between CDS and naked CDS, it cannot be used to argue that naked CDS are of any value to society, let alone that a ban would damage liquidity. It also echoes the financial industry’s line, bundling the two types of CDS together to defend naked CDS from being banned. Which is what the biggest lobby organisations in the field (ISDA, ISLA and AFME) did when they issued a warning that “..without a liquid sovereign CDS market those hedging risks related to government bonds would instead move to short or sell any bonds or other country-related assets, putting additional and more substantial pressure on the country and its economy."[22] But since banning 'hedging risks related to government bonds' was never considered, the warning makes no sense in this context.

4. Will emergency bans be effective?

While the report does not support an outright ban on naked CDS, a reader looking for some indications as to how an emergency ban might be effective, is left in the dark. Surely an emergency situation would arise if the economy of a Member State was in trouble? Will it be easy to impose a temporary ban if this is the case? Apparently not.

The authors argue that a "...drawback of a ban is that it can send a very strong message to the financial markets about the gravity of the situation of the country(ies) for which the ban will be set in place".[23] And that implies it would be very costly.

But do they really claim that it will be easier to impose a ban when it is needed the most, ie. in times of crisis? When looking at the behaviour of EU governments when confronted with a crisis in Ireland or Portugal, they did their utmost not to raise suspicions in the financial sector that the situation might be grave. They preferred to present themselves as being in full control. Following the report's logic, a future ban on naked CDS in an emergency situation, therefore, looks improbable.

Mimicking the industry

The Commission's report and the reactions it provoked, provide a clear reflection of the whole debate on speculation in sovereign debt since early 2010. Basically no-one has been able to find all the necessary information to get to the bottom of the role of sovereign CDS in the debt crisis, due to the opacity of financial markets. This seems to have given the financial sector – from AIMA to ISDA – a certain air of confidence and untouchability. They cunningly spin the lack of hard proof that naked CDS play a negative role as an argument against curbing CDS markets.

In response to questions from Corporate Europe Observatory, the Commission's spokesperson Chantal Hughes, emphasised that the report does not contain a finished analysis on the effect of speculation in the bond markets, and is only an interim product. What is missing, then, CEO asked:

"For example, there are no records of transactions (trades) taking place, it's difficult to assess who traded what and when," she responded[24].

Given that the current debate on speculation in sovereign bonds will probably not be repeated for several years, it might have been considered necessary to fill this void before drafting the proposal. The Commission, or Member States, could have insisted on an investigation similar to the one announced in February 2010 by the Justice Department in the US, which asked a handful of major hedge funds to retain their trading books for inspection to certify whether these funds had been used to speculate against the euro. But nothing similar has happened in the EU[25].

The consequences of not getting to the bottom of this are dire. In the absence of solid evidence, the EU has opted for a watered down proposal with no teeth, probably out of fear from disturbing a part of the financial market they haven't been able to scrutinise.
This becomes even clearer from the Commission spokesperson's reply to Corporate Europe Observatory on the significance of this lack of precise information: "That's why the aims of the proposals we made last September aim above all at more transparency – registration of trades, greater disclosure of short selling, flagging etc."

While this has a logic to it, it also underlines an uncomfortable truth. The momentum created by the outrage at speculators will not result in strong rules, quite simply because these markets are so opaque that the Commission knows little about them, and because the Commission – and Member States – have chosen not to put their foot down and remedy the situation. As a result there is only a slight chance that effective safe guards against speculation in bonds will result.

References

[1] Joint letter, Nicolas Sarkozy and Angela Merkel, see reference in Euractiv.com, 9 June 2010, and in Bloomberg.com, 9 June 2010. This was preceded by a similar letter in March 2010 with the support of Eurogroup's chair Juncker and the Greek Prime Minister: http://www.ft.com/cms/s/0/e7ba5862-2c7c-11df-be45-00144feabdc0.html

[2] European Commission (DG MARKT and DG ECFIN); "Report on sovereign CDS", 2010, http://www.fd.nl/csFdArtikelen/WEB-HFD/y2010/m12/d06/20852775 (from hereon 'the report')

[3] See Corporate Europe Observatory; "Financial Warmongers", April 2010, http://www.corporateeurope.org/lobbycracy/content/2010/04/financial-warmongers-set-eu-agenda

[4] Wolfgang Münchau; "Time to outlaw naked credit default swaps", Financial Times, 28 February 2010.

[5] ISDA; "ISDA Comments on Sovereign CDS", 15. March 2010, http://www.isda.org/media/press/2010/press031510.html

[6] www.dtcc.com/products/derivserv/data/index.php

[7] AIMA statement;"AIMA responds to new European Commission proposals on short selling and OTC derivatives", 15 September 2010, http://www.aima.org/en/media_centre/press-releases.cfm/id/30499B93-53B6-43C0-BB9849B7D3AA3C83 See also the statement from ISDA, 15 September 2010, http://www.futuresmag.com/News/2010/9/Pages/Global-industry-groups-comment-on-European-OTC-derivatives.aspx

[8] European Commission (DG MARKT and DG ECFIN); "Report on sovereign CDS", 2010, http://www.fd.nl/csFdArtikelen/WEB-HFD/y2010/m12/d06/20852775

[9] Financial Times; "Brussels gives sovereign CDS-trading all clear", 6 December 2010.

[10] FinAlternatives, 9 December 2010, http://www.finalternatives.com/node/14846

[11] ISDA, ISLA & AFME; "Sovereign CDS", Position Paper, December 2010.

[12] Clearing and Settlement.com, 7 December 2010, http://www.clearingandsettlement.com/2010/12/mep-slams-ec-policy-on-short-selling-and-cds/ The statement clearly shows that Syed Kamall has understood very little from the report. The report indeed argues for the proposal later released; emergency bans rather than an outright ban.

[13] Bloomberg, 8 December 2010.

[14] The report, page 20, see footnote 2.

[15] Ibid., page 4.

[16] ISDA; "ISDA Comments on Sovereign CDS", 15. March 2010, http://www.isda.org/media/press/2010/press031510.html

[17] The report, page 4. The authors note that a large number of data on the bond markets which is not available would be necessary for at regulator to detect market manipulation.

[18] http://www.nytimes.com/2010/12/12/business/12advantage.html?pagewanted=2

[19] Reuters: "Barnier says Credit Default Swap-traders set to face mandatory reporting", 17 May 2010.

[20] The report, page 33. Footnote 32 refers to René M. Stulz; "Credit default swaps and the credit crisis", Journal of Economic Perspectives, vol.24, Winter 2010, page 73-92.

[21] René M. Stulz; "Credit default swaps and the credit crisis", Journal of Economic Perspectives, vol.24, Winter 2010, page 73-92.

[22] ISDA, ISLA & AFME; "Sovereign CDS", Position Paper, December 2010, page 3.

[23] The report, page 36.

[24] Written response from Chantal Hughes to Corporate Europe Observatory, 22 February 2011.

[25] See for instance Wall Street Journal; "US Probes Bearish Euro Bets", 3 March 2010, http://online.wsj.com/article/SB10001424052748704486504575098021150940494.html Results of the probe is not in the public domain.