NOTES FROM THE VAULT

March 2010

Center for Financial Innovation and Stability

Financial Speculation in Credit Default Swaps

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- A speculator is someone who assumes a risk with the hope of gain.
- Buyers of credit default swaps are in a similar position to short sellers of stock in some ways: They sell what they don't own and hope to gain from adverse developments affecting the underlying security.
- Complaints about speculators in the credit default swap market are more about the information reflected in market prices than the actual trading in credit default swaps.

Speculators and speculation have been pilloried far and wide in news stories recently even though there is little new about speculators' recent activities. The Prime Minister of Greece suggested that the stark choice his country faced in its debt crisis was "Will we let the speculators strangle us, or will we take our fate in our own hands?" (Kyriakidou 2010).

Who is a speculator?

The definition of *speculate* is an informative way to start thinking about these speculators and their apparent effects on a whole country. The first meaning of *speculate* is "to meditate on or ponder a subject," and the second is "to assume a business risk in hope of gain." The two different meanings are a reminder that assuming a business risk in hope of a gain generally is related to meditating or pondering the subject. Few speculators will be successful if they give no thought to what they are doing.

While interesting starting points, these definitions are inadequate for thinking seriously about financial speculation. Virtually every business decision involves risk, and these decisions invariably involve a hope of a gain. By this definition, virtually anyone who engages in business is a speculator. This view is overly broad in the context of the current discussions.

Complaints about financial speculation are about speculation that involves assuming financial risk—more precisely (and to distinguish speculators from hedgers) about investors who take positions that increase the risk of their overall portfolio.

Why would someone assume risk? The question almost answers itself: because bearing risk has a positive expected payoff and the portfolio is willing to assume more risk in exchange for the positive payoff. But anyone who buys stock instead of putting her funds in a bank's insured CD is a speculator in this sense. Just as with business speculation in general, virtually anyone who engages in financial transactions for gain is a speculator.

Speculation and credit default swaps

The concern about financial speculators is clearer in one particular context in which it has surfaced recently—namely, government debt in some European countries.

> Policy makers are laying the blame for the region's sovereign-debt woes on the credit-default-swap market, amid talk of banning the buying of default insurance unless the buyer holds the underlying bonds. (Barley 2010)

Buyers of a credit default swap make periodic payments to the seller and receive a payment from the seller if a "credit event" occurs, such as a failure to pay on the underlying debt. Credit default swaps are an example of a derivative security: a security that derives its value from some other security on which its value is based. Trading credit default swaps does not necessarily involve ownership of the underlying debt. Instead, payments related to the credit default swap are based on events associated with the underlying debt.

Credit default swaps and short selling

Credit default swaps are contracts that provide insurance in the event of default on bonds or other debt securities. The purchase of a credit default swap by a holder of the debt insures the holder against credit losses on the debt, which is akin to selling the credit risk on the debt. When a speculator does not own the underlying government debt and buys insurance to cover credit losses, the speculator is selling the credit risk on the debt and hoping to gain from adverse developments concerning the debt.

Hence, buyers of credit insurance on debt they don't own are in a similar position to short sellers of stock, who sell stock they don't own. [1] In both cases, the speculator trades what he doesn't own and hopes to gain from adverse developments concerning the security's issuer. It's hardly surprising, then, that speculators are not viewed favorably by the issuers, or for that matter, by most other people.

Purchases of credit default swaps by those who don't own the debt increase the cost of insurance and the apparent credit risk of the underlying bonds.

Buyers of credit default swaps are similar to short sellers of stock in another way. Their activity, if undertaken by enough speculators, lowers the price of the underlying assets in financial markets. The logic for stocks is simple: short selling increases the supply of stock and lowers the price. The logic for credit default swaps is bit more complicated. Purchases of credit default swaps by those who don't own the debt increase the cost of insurance and the apparent credit risk of the underlying bonds. This increase in the apparent credit risk lowers the price of the underlying bonds. Hence, both activities decrease the price of the underlying assets.

Proposals to ban the purchase of default insurance except by owners of the debt also are similar to proposals to restrict short selling of stock. They are attempts to suppress a part of the financial market that gains from adverse developments in the underlying institution.

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[1] Dwyer (2009) discusses the continuing controversy concerning short sales and the connection to centuries-old antipathy toward speculators.

There is, of course, an interesting and telling aspect of the proposal that only holders of the underlying debt be able to buy credit default swaps. The parties on the other side of these transactions—sellers of credit insurance—are speculators as well. The sellers are hoping to gain by selling the insurance with no subsequent credit events concerning the debt. There is no particular reason to think that selling credit insurance reduces the risk of any speculator's portfolio, any more than buying credit insurance reduces the risk of another speculator's portfolio.

Speculators' buying and selling of credit default swaps provides information about their assessment of the credit risk associated with a borrower. If the prices of credit default swaps reflect market froth stemming from speculators' hyperactive trading, this fact simply sets up profit opportunities for other speculators. Greek bonds ultimately sold at a yield of 6.3 percent—3.26 percent higher than relatively risk-free German bonds (Wilson and Paris 2010).

The complaint about speculators is not really about speculation per se but instead is issuers' concern about market activity associated with a lower value of the issuers' securities. This source of the complaints also is similar to short sales of stock.

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He thanks Larry Wall for very helpful comments on an earlier draft.

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