

# “Do Sovereign CDS and Bond Markets Share the Same Information to Price Credit Risk?”

by

Óscar Arce, Sergio Mayordomo

and Juan Ignacio Peña

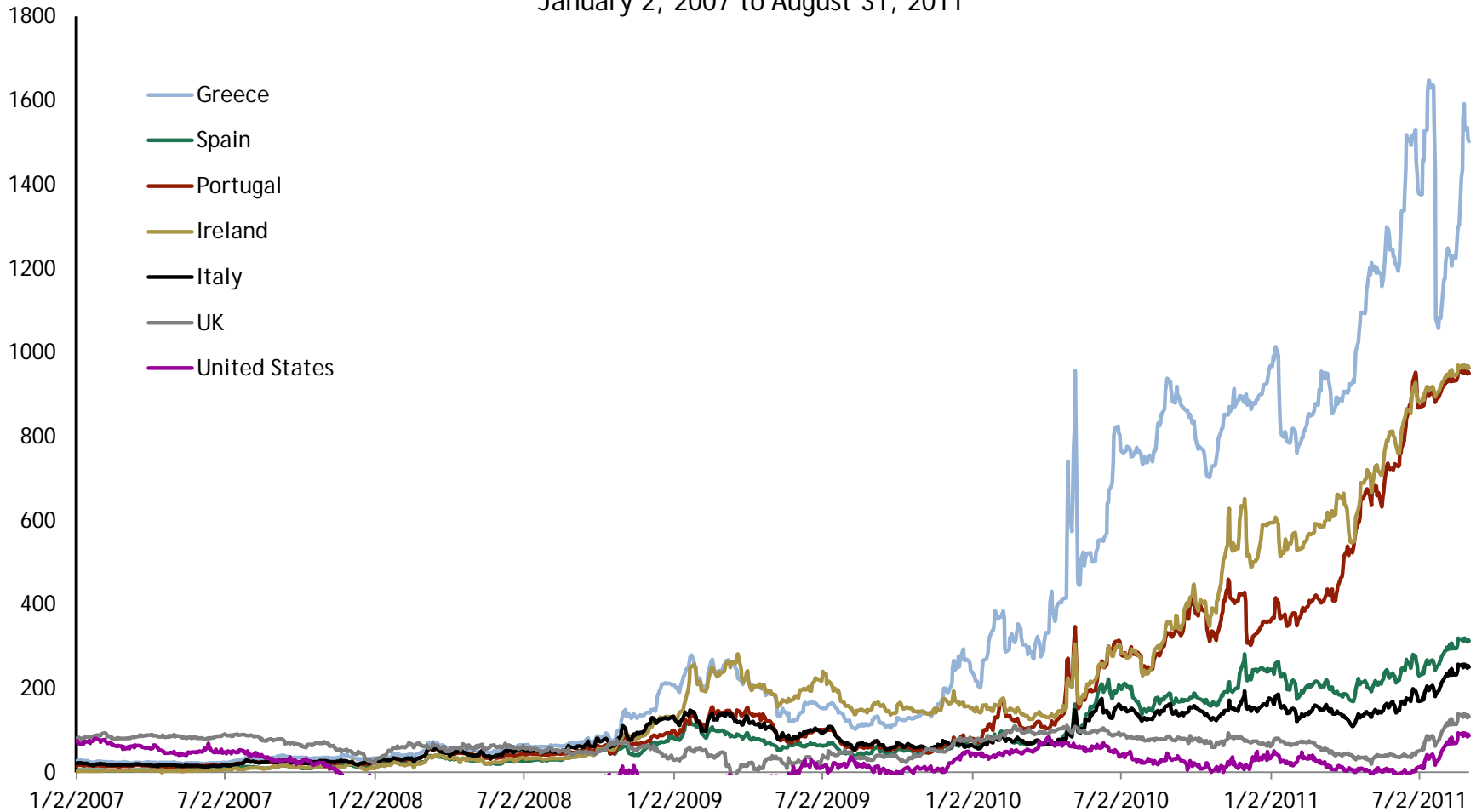
Comments by Gerald P. Dwyer

# The Question

- Are speculators driving the CDS market?
- Is the information reflected in the CDS and bond market largely speculators' interest in taking on risk – gambling?

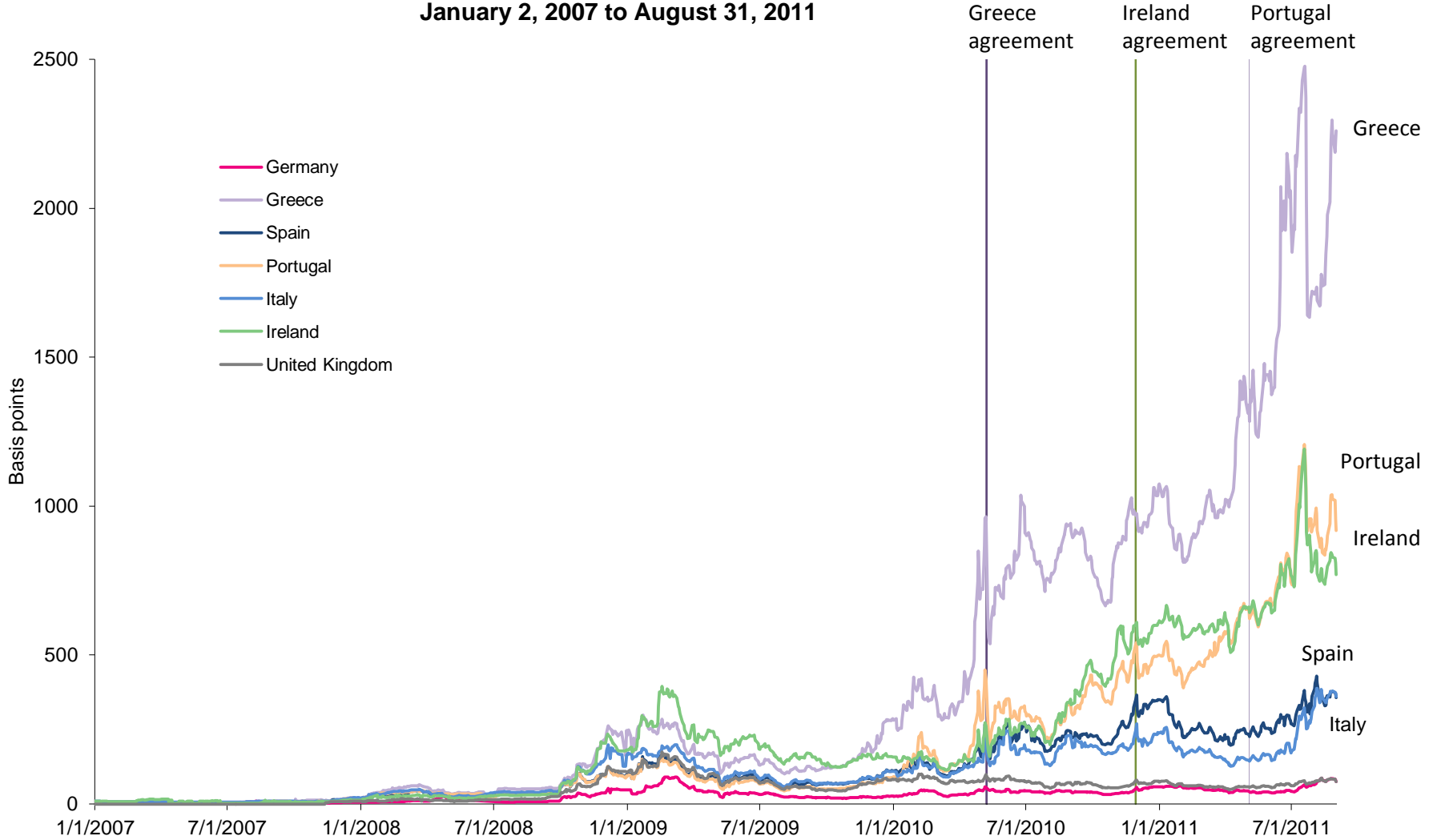
# European Bond Spreads

Basis points, 10-year bond spread to German bonds  
January 2, 2007 to August 31, 2011



Source: Bloomberg

# European CDS Spreads January 2, 2007 to August 31, 2011



Source: Datastream, Bloomberg

# Bonds Spreads and CDS Spreads

- Bond spreads over the riskfree rate compared to CDS spreads over Germany
- Persistent deviations of the CDS spreads over the bond spreads for six countries
  - Start with the climax of the Financial Crisis of 2007-2008

# Determinants of the Basis

- Determinants of the difference between CDS and corresponding bond spread (basis)
  - Counterparty risk
  - Liquidity
  - Financing costs
  - Domestic and global risk premia (VIX)
  - Spillovers
  - Lagged basis

# Table 3

|  | 1/2004-9/2010 | 1/2007-9/2010 | 1/2008-9/2010 |
|--|---------------|---------------|---------------|
| Counterparty risk net of global risk   | -0.017        | -0.044        | -0.157***     |
| Ratio bond/CDS liquidity   | -0.082**      | -0.083*       | -0.086*       |
| Financing costs  | -0.592        | -0.676        | -0.877        |
| Global risk (VIX)  | 0.008         | 0.004         | -0.011        |
| Squared of country stock index returns   | 637.908       | 659.727*      | 690.787*      |
| Shock spillovers from bond to CDS spreads<br>relative to spillovers from CDS to bond spreads | 0.735**       | 0.720**       | 0.642**       |
| Lagged basis   | 0.946***      | 0.944***      | 0.941***      |
| Constant   | 0.212         | 0.494*        | 1.430***      |
| Adjusted R-squared   | 0.93          | 0.93          | 0.92          |

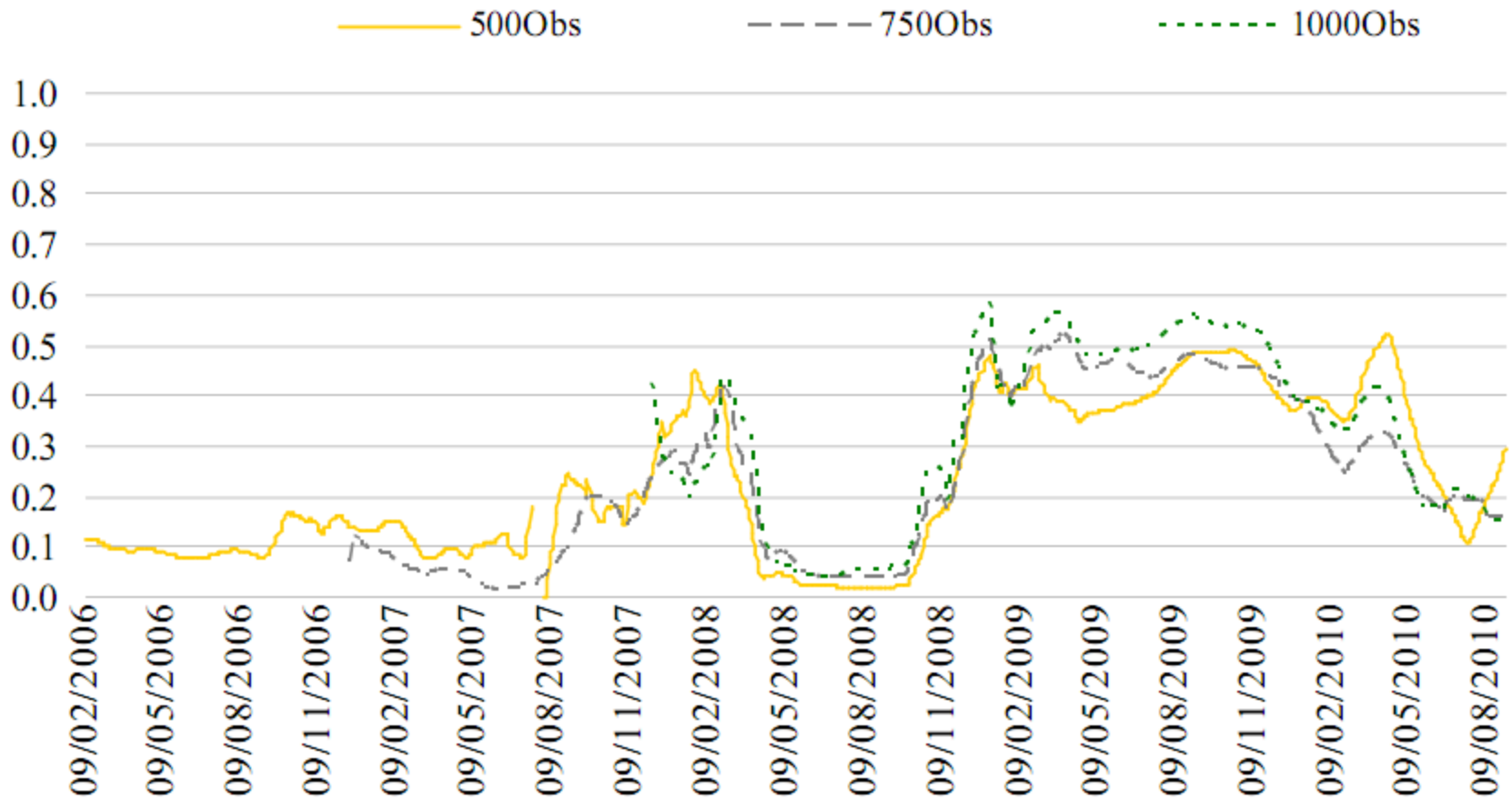
# Table 4

|  | 1/2004-9/2010 | 1/2007-9/2010 | 1/2008-9/2010 |
|--|---------------|---------------|---------------|
| Positive lagged basis  | 0.975***      | 0.974***      | 0.970***      |
| Negative lagged basis  | 0.907***      | 0.903***      | 0.900***      |
| Counterparty risk net of global risk   | -0.070        | -0.091**      | -0.200***     |
| Ratio bond/CDS liquidity   | -0.132        | -0.132        | -0.134        |
| Financing costs  | -0.444*       | -0.518**      | -0.681**      |
| Global risk (VIX)  | -0.006        | -0.009        | -0.024        |
| Squared of country stock index returns   | 599.536*      | 617.781**     | 642.989**     |
| Shock spillovers from bond to CDS spreads<br>relative to spillovers from CDS to bond spreads | 0.487***      | 0.457***      | 0.387**       |
| Constant   | 0.239         | 0.472*        | 1.367***      |
| Adjusted R-squared   | 0.93          | 0.93          | 0.92          |



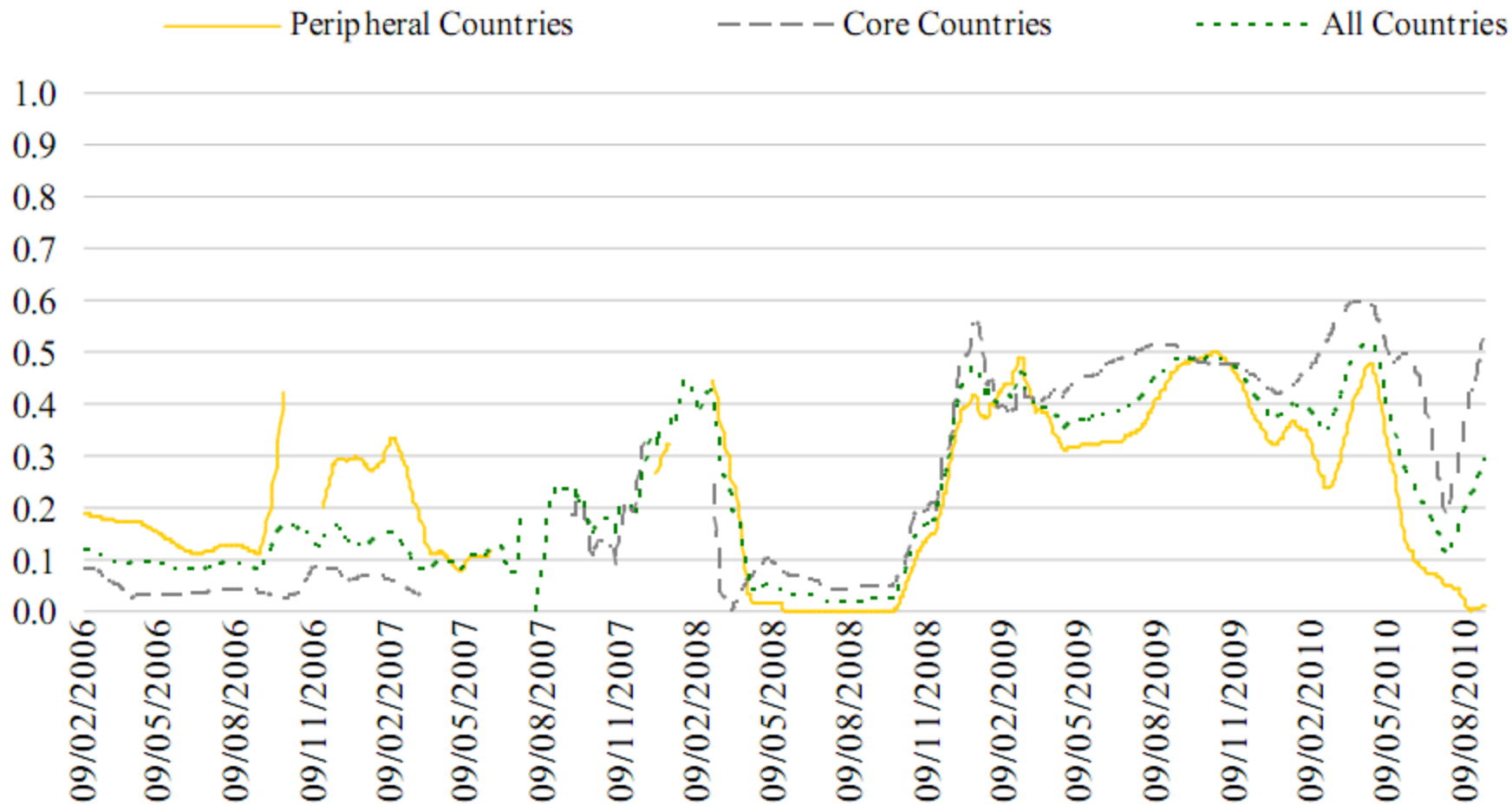
# Figure 1

## EMU Price Discovery Metrics



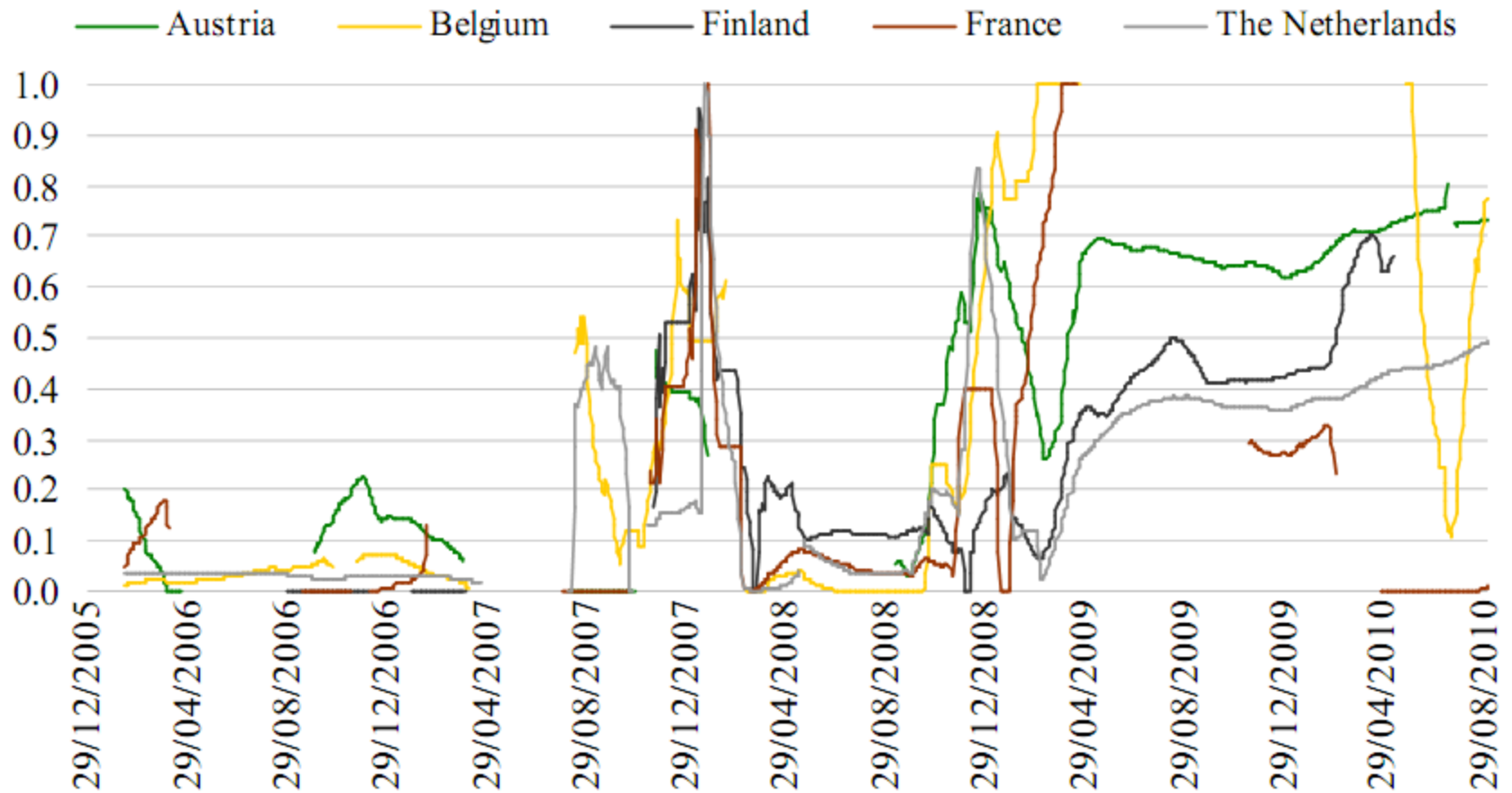
# Figure 2

## Groups of EMU Countries – Price Discovery Metrics



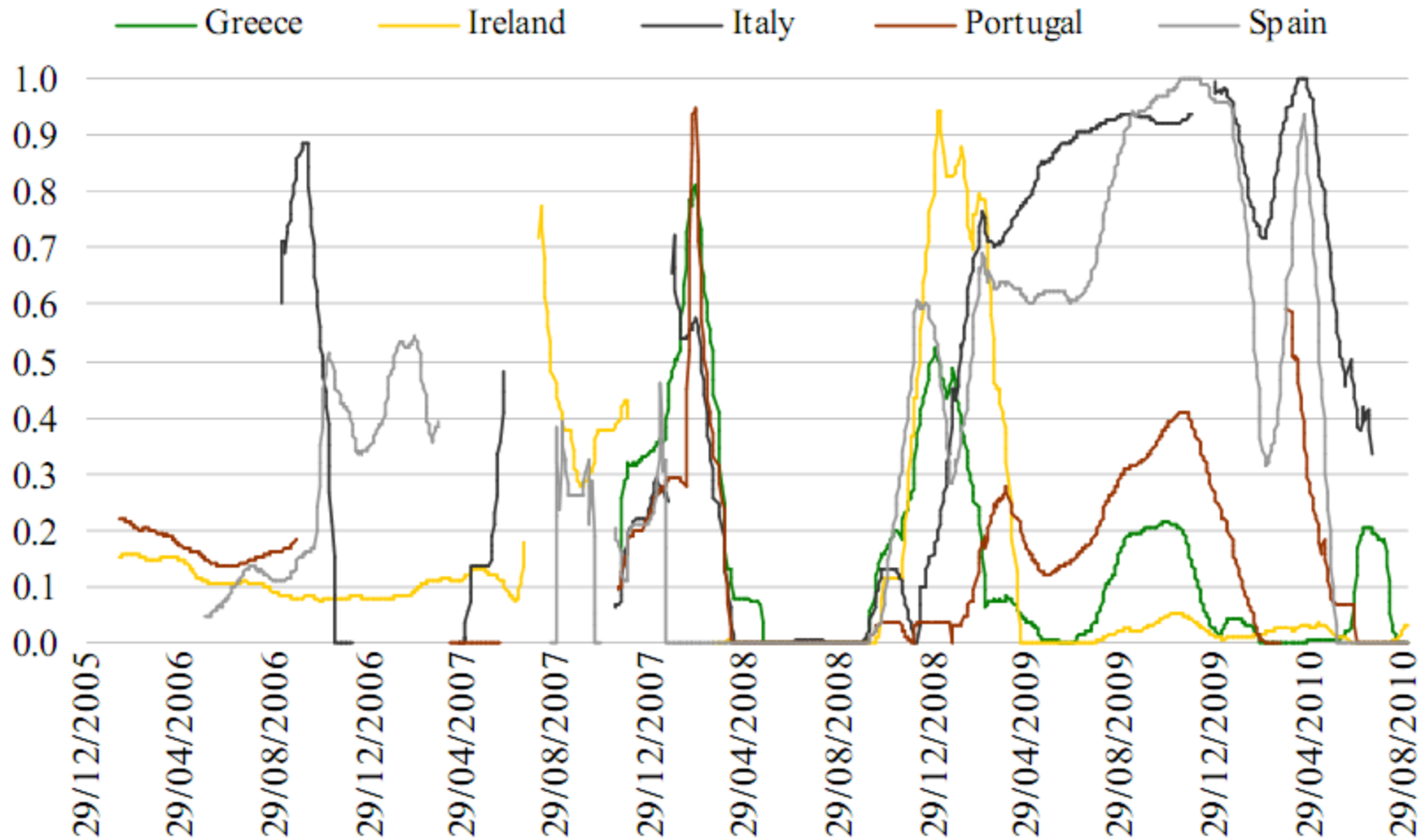
# Figure 3A

## Individual Countries' Price Discovery Metrics



# Figure 3B

## Individual Countries' Price Discovery Metrics



# Determinants of Price Discovery

- Financing costs
- Counterparty risk net of global risk
- Global risk (VIX)
- Bond / CDS liquidity
- Bonds purchased by ECB

# Summary

- An excellent study of a controversial issue
- All very consistent with CDS markets being important for pricing credit risk efficiently

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- An excellent study of a controversial issue
- All very consistent with CDS markets being important for pricing credit risk efficiently
- Don't see much that suggests speculators are obscuring information