

The Anatomy of the CDS Market: A Discussion of the markets

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Is the CDS market better than the bond market?

- Both are dealer markets
- Bond dealer has a far more complicated inventory management problem
 - Bonds with a variety of maturities, coupons and other features
 - CDS dealer typically dealing with only three (various maturities)
- Does this inventory management matter?
 - This paper shows bond turnover positively related to Herfindahl
 - Previous work prior to “Big Bang” in 2009 shows that as CDS dealer’s position gets more complicated (larger number of longs and shorts) liquidity is worse (Or Shachar, “Exposing the Exposed:...”)

Single name CDS

- Paper illustrates declining net notional for single name corporate from \$1.2 t in late 2008 to \$800 b in late 2012
- CFTC data shows that the decline continues with corporate net notional down to \$711 b in the first week of June 2013
- Has hedging/speculative demand gone down?
- Is the bond market better?
- Is the CDS market worse?
- While the CDS indices remain important, what is the future of single name CDS?

TRACE and the Bond markets

- Goldstein, Hotchkiss, Sirri construct, for NASD, a trial sample of reporting bonds and a comparable control sample and analyze
- TRACE had no significant effect on trade activity
- Using a difference in differences approach and controlling for bond characteristics
 - Small trade spread increased by 33 bps from 300
 - Medium size: declines 50bps from around 100+
 - Large trade: insignificant drop from 45 bps

Other developments

- Electronic “auctions” and quote display
 - Quotes cannot be “hit”—phone market
- Limit order book--not so much
 - Blackrock and Aladdin not going anywhere?
 - Blackrock recently contributed equity to MarketAxess
 - MarketAxess says it is looking into the possibility of a true limit order book
- Dealers have considerable power, and Institutions may value non-anonymity

But there have been changes

- Hendershott and Madhavan examine 2010-11 data and note the following average spreads for investment grade (in bps)

Trade Size	MarketAxess	Voice
<100k	44	176
100k-1MM	28	94
1-5MM	21	30
>5MM	18	22

Quality of CDS Markets

- Blanco, Brennan and Marsh (2005) find that CDS prices lead bond prices incorporating payoff relevant information faster in data from 2001-02.
- Bai and Collin-Dufresne find a weakening of this during the financial crisis
 - Also the appearance of negative basis

Developments in CDS Markets

- Big Bang made many dealer inventory issues go away perhaps leading to lower spreads
- We (academics) do not have intra-day, post-netting data on the CDS market
 - No quotes
 - No transactions
- Single name corporate swaps show declining open interest

Regulation

- We need more data (always the academic's plea and should be regulators')
- To the extent CDS market is an alternative bond market, regulation should not impede ability to act as a market and should perhaps support it
- Dealers hate transparency (which means there must be lots to like about it)
 - Could it arise on its own? Not likely
 - Foster internationally competing, transparent markets