

The ban on naked CDS takes effect

By Anne-Laure Delatte

The [small CDS market](#) serves as an instrument for coordinating speculation against European states. To stop the speculation, the European Union recently adopted a new regulation that came into force on 1 November. Unfortunately, this new law, though pioneering and ambitious, suffers from flaws that render it ineffective. This provides an example of how the interests of a single economic sector can capture policy.

Quick primer on finance: how to speculate against a State

Two methods have won their spurs: short sales in the bond market and naked sales on the CDS market. Let's take two examples. If you think that Spain will not be able to meet its commitment to reduce its deficit in 2013, you could make money by betting against it the next time it issues bonds. To do this, you need to find an investor on the market who is prepared to buy Spanish bonds when they are next issued. You sell your customer bonds at that point while wagering that the price will be lower than what they think. You do not buy the titles at that time, as you can buy them at the time of delivery. You win if your expectations were correct: if the price of Spanish bonds declined due to the deterioration in the country's economic situation, then you will buy them for less than the purchase price that you agreed to. You are engaging in short selling.

There is another way of operating that the new European law also tries to counter. You make your bets on the market for credit default swaps (CDS), that is, the market for insurance against a Spanish default. It is smaller, it is concentrated, and it is easier to affect than the bond market. There's no

need for Spain to declare bankruptcy to pocket your winnings! Buy Spanish CDS (on state or Santander bonds) today and sell them when the risk has increased: you resell the protection for more ... One detail: do not actually burden yourself with Spanish bonds. They are useless since it is on the resale of the CDS that you make your profit. Your intention was never to insure the bonds... The CDS are tradable goods whose price evolves according to supply and demand. And this is precisely the advantage of a small liquid market: you can move the market with lesser amounts...

The Directive that took effect on 1 November 2012 banned these two strategies: short selling sovereign bonds and naked trading in sovereign CDS. If you now want to bet on the CDS market, you are required to hold in your portfolio the securities that the CDS protects, or at least very similar ones.

At last, a courageous law! A ban on naked CDS, which was considered in the United States and then abandoned in 2009, is a pioneering act by Europe! It's no longer possible to speculate against Europe's states...

Except that:

The ban does not apply to "market makers". Who are they? To be sure that a market works, certain operators are committed to always buy or sell a security to anyone who so wishes (they simply determine the price of the transaction). This ensures market liquidity. For example, Morgan Stanley is a very active market maker on the entire CDS market; the bank provides continuous prices for all market transactions. "So these market makers are useful. Can you imagine if we even included these operators in the ban on naked CDS? There would be no more liquidity!" This is the essence of the argument used by the major banks to negotiate their exemptions and the specific argument used to justify the exemption of these market makers from the ban on naked sovereign CDS sales in Europe. The

market makers won: they can continue to trade CDS without holding the underlying bonds.

But wasn't the point made [in the previous post](#) that this market is in fact highly concentrated? That 87.2% of transactions were carried out by the 15 largest banks in the world ... all of which are market makers? In other words, the new rule will be applied to everyone ... except the main players on the market. It seems that the big French banks are currently in discussion with the [European financial markets authority](#) (ESMA) over the exact definition of a market maker to ensure that they too are exempt.

Of course. But the hedge funds too? They aren't market makers, they're clients. So the Directive must apply to them!

Except that:

Only the sovereign CDS market is concerned. It is still possible to hold CDS on a bank issue without holding the title. So it will be easy to circumvent the ban on betting against a State by betting against one of its banks (Santander in the example above). One shudders when contemplating the fragility of Spain's banks...

In conclusion, the idea for such a law was commendable. But the devil is still and always in the detail. The financial sector has defended its interests during the drafting of the law. It is urgent to develop the means to counterbalance this during negotiations. The Finance Watch association has been created specifically with this objective: to be present and make the voice of civil society heard during the preparation of financial reforms. The only problem is, it's David against Goliath...