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## Credit

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# Sovereign CDS investors given short shrift

## Naked short ban more far-reaching than first thought

- Naked sovereign CDS shorts banned from 1 November.
- Exemptions for market makers and those wanting to hedge risk.
- List of permissible hedge assets not known, but likely to be quite broad.
- Hedge funds targeted quite broadly, possibly even beyond European jurisdiction.
- Short positions will be grandfathered limiting potential for a technical squeeze.
- Liquidity should drop with some sovereign CDS names hit more than others.
- SovX already suffers from marginal liquidity, a big drop could see it grind to a halt.
- Ban confined to sovereigns potentially increasing selling pressure on proxies such as financials, utilities and municipals.

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# Short shrift

**A short shrift used to be the period of time when the condemned could make a confession before execution, but nowadays it has come to mean an unsympathetic treatment of something. Both meanings seem applicable to the upcoming ban on sovereign CDS. While we've expected it for a long time, the final draft of the legislation banning the naked shorting of CDS might well be stricter than we first thought. However, broad exemptions are still given: market makers, primary market dealers, bond hedgers and CVA desks can carry on, albeit with more paperwork. The provisional list of 'correlated assets', against which investors will be permitted to use short sovereign CDS positions as a hedge, should be relatively broad. The bad news is that European regulators have cast their net widely, hoping to capture trades in the US and Asia even though they would seem to be outside of their jurisdiction. Given that they have access to the DTCC's list of net positions by counterparty, the CDS market is suddenly less opaque than it used to be. A trader shorting CDS in Connecticut might find a European regulator knocking on the door of their Mayfair office. Even if they're skeptical of the legal position, the risk of additional regulator attention will almost certainly limit their appetite in our view.**

**This is bad because hedge funds and those with short time horizons provide a lot of the liquidity needed for an efficient two-way market in our view. Markets dominated by hedgers only, such as Italian sovereign CDS, tend to be inefficient despite huge volumes, with participants all the same way round. If the fast money exits then we believe liquidity and efficiency will suffer. Trading may even virtually grind to a halt in sovereign CDS names where liquidity was only marginal anyway: eastern European names, Ireland, Austria, the SovX index and perhaps Belgium.**

**While it is not possible to be completely definitive in the absence of the technical details, this piece looks at some of the implications of the current legislation. It looks at who is covered and impacted trade types and provides a timeline and detail on grandfathering. We look at distortions and what the trading implications are. We remain unconvinced by some of the compromise legislation that seeks to permit CDS trading for short periods under certain market conditions.**

**We believe this unsympathetic treatment is intentional. Back in March 2010 we argued in "You can't blame the mirror for your ugly face" that CDS markets are much smaller and less influential than is perceived. 'Speculators', hedge-funds and bankers remain a convenient scapegoat. Many legislators will regard a punitive CDS regime with negative side-effects in terms of decreased liquidity as a beneficial intended consequence in our view. We regard them as part of a wider policy of EU financial repression. [1] An unintended consequence for regulators might be that investors seek to circumnavigate the rules by switching asset class and choosing to short financial or corporate CDS as a proxy to shorting sovereigns.**

**It is fortunate that the shrift is not too short, as this should limit the potential for an immediate technical squeeze. The new rules on shorting will not apply until November 1st so the period of adjustment will be gradual. Existing shorts (prior to 23 March) can be grandfathered until maturity, so it is not necessary to take current positions off or rotate into cash shorts. The sovereign CDS basis might flex as investors adjust to the new information, but we think there are structural reasons for the basis to remain wide. We also think that as different CDS markets attract different types of investors the market impact will not be uniform.**

## Timeline of events

Although the political-level agreement on the EU Regulation on sovereign CDS naked shorts was reached last autumn, the definitive legal text has only appeared in the Official Journal of the EU in the last few days. This provides ESMA with the legal authority to draft binding technical standards. Although formal consultations have

[1] **For more detail see Heading for the Great Repression?, H Lorenzen, 20 March 2012.**

closed we don't expect these to be really finalized and made public until the middle of April at the earliest. It is these technical standards that will provide us with details such as an exact list of what constitutes an allowable hedge and the form of the reporting requirements.

The next key date is November 1st, at which time many of provisions are scheduled to come into force. Trades put on between now and then will have to be taken off on that date. While trades that existed prior to March 23 can be grandfathered until they mature.

The key points here are that there is no sudden 'drop dead' date and that there is no compulsion to close out existing trades. This considerably reduces the possibility of market disruption as participants scramble to comply with legislation by closing out positions.

## Hedgers exempted

It seems large swathes of investors will be excluded from the ban, although until the details are released, it is hard to be definitive. The bulk of CDS trading is interbank, and should carry on with barely a blip from this legislation. Market making, correlation desks, CVA desks, government bond desks and loan books, who are all major users of CDS, will be able to carry on trading albeit with increased reporting requirements and scrutiny. Most bank prop desks, who politicians wanted to target in our view, have been wound down and were never a massive part of the sovereign CDS market in the first place.

The reason many of these desks are emerging unscathed is that their primary purpose is hedging risks, either direct risk in terms of government bonds, or correlated risks such as municipal loans. Correlation desks are hedging portfolio risks coming from legacy bespoke CSO books, CVA desks are hedging counterparty risk from derivatives transactions and loan books are looking to hedge illiquid positions.

This is good news for basis trades which will be exempted as investors are essentially hedging bond positions one way or the other. The basis may see a long term structural shift in some markets but basis trades themselves can be traded.

The exact list of what will count as an allowable hedge will be published in the technical standards in April. However, the initial indications seem to be quite broad and include equities, loans, receivables and guarantees. We can make some educated guesses too. For example, we believe given that hedge ratios are subjective, they are unlikely to be fixed and it is also likely that hedge ratio suitability only needs to be determined at the outset, rather than monitored on an ongoing basis as FX or other market factors change.

## Hedge funds targeted globally

It is those wanting to use sovereign CDS to take a negative view that are directly targeted. CDS relative value trades – Spain versus Italy, say – will not be permitted. Relative value trades are important for keeping derivative markets in-line with one another and to diminish supply and demand imbalances. Going forward, only market makers will be in a position to do these trades, creating the potential for distortions.

The legislation explicitly targets non-European entities for reporting purposes even though it appears to have no jurisdiction. Given that CDS are becoming increasingly transparent, it seems likely that non-European institutions' trades will be known by

European regulators via the DTCC to which they have detailed access. Therefore, a hedge fund based in the US can short European sovereigns only to the extent that it does not fear any repercussions to any interests in Europe given that its positions will likely be known (or could be discovered). For some smaller foreign hedge funds this will not be a problem. For many with European interests, even the threat of regulator attention might be enough of a deterrent for them to decide to focus their attention elsewhere. Hedge funds make up a not insignificant proportion of total transactions; losing them would damage liquidity in our view.

Reporting requirements for shorts have yet to be specified but are likely to be detailed and hedge funds are unlikely to welcome the additional burden or the prospect of additional regulatory scrutiny.

## Emergency measures

We think some of the emergency suspension measures in the legislation might be ineffectual. The legislation contains caveats that enable, for short periods of time, the ban on sovereign CDS to be lifted as an emergency measure. Equally, more stringent restrictions could be levied too. This is designed to allow stresses caused by dysfunctional markets to be alleviated.

Short trades during a period when a ban is lifted would likely be subject to grandfathering. If they weren't the rule would be fairly ineffectual.

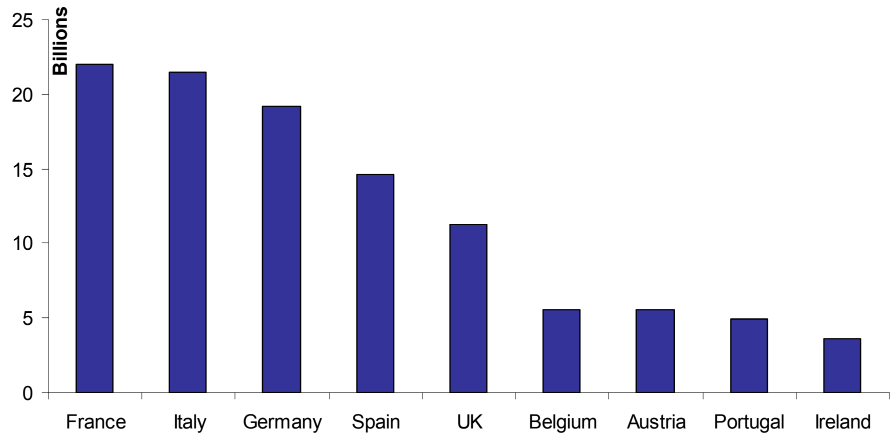
The problem with this is it seems hard to imagine that market participants are going to spring back into place in the height of a crisis. A CDS market takes a while to develop if it has been inactive, and we think it unlikely that investors would want to suddenly start trading it and then stop six months later.

## CDS liquidity likely to drop

If fast-money pulls out of sovereign CDS then we expect absolute volumes will drop and the market will become more one-sided. In CDS names where there are no hedgers the risk is that volumes fall below a critical threshold, and the name becomes illiquid (more of a psychological threshold than an absolute one).

It is hard to predict which names will struggle as much depends on how the sovereign debt story develops. But, it seems likely to be unequal. Some markets, such as Italy, that are more dominated by CVA desks should still see investor interest, although it may be even more one-sided than it is currently. It is probably countries with few hedgers that are already marginal in terms of liquidity (see Figure 1), such as Ireland and Austria, that will suffer the most. Eastern European names in the emerging market space will probably become harder to trade.

**Figure 1. Sovereign CDS Net Notional, $bn**



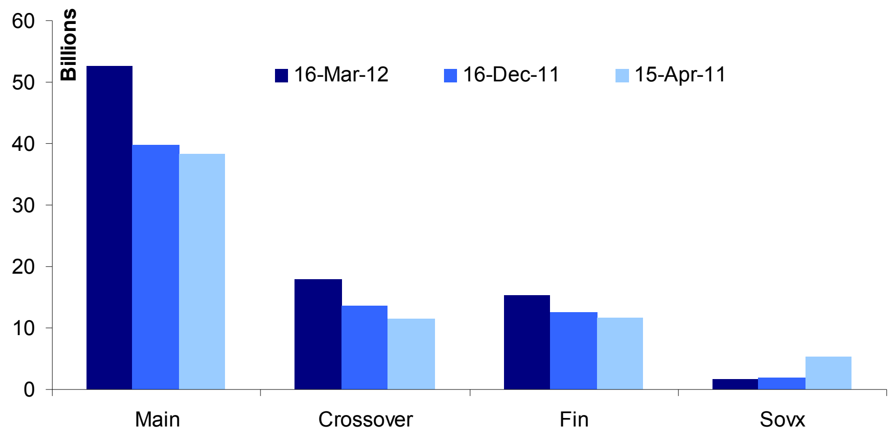

Source: DTCC, CIRA

## SovX might become a liquidity victim

Figure 2 illustrates that SovX is much less liquid than other corporate indices and even has less outstanding net notional than all the sovereign CDS in the graph in Figure 1. In contrast, corporate indices such as Crossover are far more liquid than any of their single name constituents. Derivatives of sovereign CDS, such as options and indices, also explicitly fall under the same shorting restriction as single name sovereign CDS. Market makers will remain exempt, but the investor-base will be very one-sided, with fewer able to short. Given that liquidity is already marginal, this could prove fatal.

SovX's fate will be dependent on the definition of allowable hedging in the technical standards. Many investors will have government bond portfolios but few will have bonds from Cyprus and Germany in equal measure. It seems likely that hedging rules will be generous in this regard and that it will count and investors will be allowed to use it as a portfolio hedge. If not, then it will likely become completely illiquid at the next roll as a smaller market will make it hard for it to survive.

**Figure 2. At $1.6bn net notional, down form $5.2bn SovX isn't that liquid,**
Net on-the-run outstanding, $bn




Source: DTCC, CIRA

## Proxies

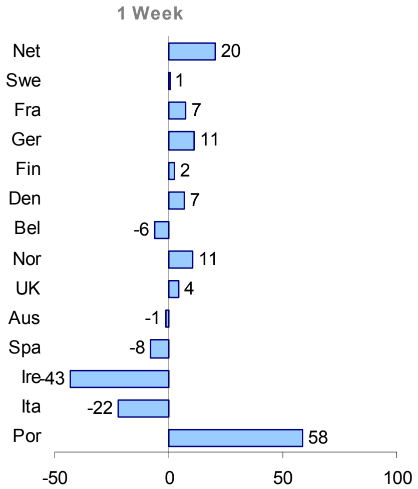
One reaction we get from hedgers and those wanting to take a view is that if they can't short sovereigns they'll find a proxy to short instead. Potential proxies include banks, utilities, municipals or anything that might be correlated. As sovereign CDS rise above about 150bp we empirically note that correlations with corporates and financials increase sharply (as we illustrate in When Sovereigns Dominate Corporates)[2]. Therefore, proxy hedging can be quite an effective way of taking a view on a sovereign. Clearly this is detrimental to the proxy or proxies. The smaller and less liquid the name, the more it is likely to be skewed. Sovereigns should be more resilient by comparison with much bigger debt markets behind them.

## Shorting bonds

Shorting bonds has not been banned in the same way and investors are free to short bonds so long as the positions are declared above certain notional thresholds. These thresholds are part of the technical definitions that have yet to be published. Shorting bonds through repo is typically a more short-term way of shorting sovereigns, and lacks the ability to lock in a cheap premium for a long period of time in the same way that CDS provides. It seems likely that demand for short positions in bonds will increase. However, securities lenders who don't like controversy and are not paid enough to take risks do not always consistently lend bonds, especially in volatile periods.

[2] Hans Lorenzen, September 2011

**Figure 3. Sovereign Basis Week Change, bp**




Source: CIRA

## Sovereign basis

The sovereign basis has been volatile in the last few days as investors have shuffled positions. We think the basis could compress a bit in key periphery names as almost a knee-jerk reaction. Or rather, as a result of the expectation that investors will rotate out of CDS positions into cash. We think this compression will be limited for now, although volatility could persist for a time.

Actual market technicals will probably only compress basis over the longer-term. As we mentioned previously, this legislation has been long expected and investors have until November before the ban. Also, legacy trades can be grandfathered which means there is no particular rush to take trades off. If anything, the fact that old trades can be kept on makes them more valuable. Therefore, the absence of a sudden drop dead date means that the effect of basis compression is likely to be more gradual.

There are still good reasons why an increasing number of investors might need to hedge bonds, counterparty risk and other sovereign risks. Therefore, we don't expect the basis to collapse, although it may well decline over a 6-12 month period as fewer investors are able to short.

## Conclusion

In the short-term we don't expect a sudden reaction to the passing of this legislation. Longer-term, we believe liquidity is likely to suffer and trading less balanced as the market looses the benefit of those trading in and out of sovereigns more frequently. CDS that only have marginal liquidity currently should suffer the most, but those used for hedging frequently might find that volatility increases as the market becomes more one-sided.

We regard a healthy two-way market as the best way to find a fair price for assets. We believe investors that short healthy assets will lose money and we regard a 'Darwinian process' as part of finance. The experience of 2007 and 2008, illustrate that long-only markets can be more volatile, and often less transparent, than markets where shorts are permitted. However, this view of markets is not universal and many will regard some of the liquidity negatives we've highlighted as positives.

# Appendix A-1

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