Does the Tail Wag the Dog? The Effect of Credit Default Swaps on Credit Risk

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Summary

Credit default swaps (CDS) are derivative contracts that are widely used as tools for credit risk management. However, in recent years, concerns have been raised about whether CDS trading itself affects the credit risk of the reference entities. Using a comprehensive dataset of North American corporate CDS transaction records over the period 1997-2009, we find strong evidence that the bankruptcy risk of reference firms increases after the inception of CDS trading. This effect of CDS trading on credit risk is economically large: The odds of bankruptcy more than double after CDS trading begins for average firms. This finding is robust to the selection and endogeneity in CDS trading. Therefore, rather than being an instrument providing insurance against borrower default, CDS trading can increase the likelihood of borrower default ("the tail wags the dog"). Our main contribution is documenting a real effect of the trading of CDS on the survival probabilities of firms. Our findings have important implications for investors and policy makers. Investors need to consider the impact of CDS trading on the likelihood of bankruptcy in their pricing of corporate debt. Financial regulators and policy makers need to take the increase in credit risk following CDS trading into account in their regulatory actions. In particular, banking regulators need to incorporate this effect in their risk weighting formulae, while securities regulators may require further disclosures of CDS positions, so that investors are made aware of the extent of the potential impact of CDS trading on credit risk.