Time to outlaw naked credit default swaps

By Wolfgang Münchau
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I generally do not like to propose bans. But I cannot understand why we are still allowing the trade in **credit default swaps** without ownership of the underlying securities. Especially in the eurozone, currently subject to a series of speculative attacks, a generalised ban on so-called naked CDSs should be a no-brainer.

Naked CDSs are the instrument of choice for those who take large bets against European governments, most recently in Greece. Ben Bernanke, the chairman of the Federal Reserve, said last week that the Fed was investigating “a number of questions relating to **Goldman Sachs** and other companies in their derivatives arrangements with **Greece**”. Using CDSs to destabilise a government was “counter-productive”, he said. Unfortunately, it is legal.

CDSs are over-the-counter contracts negotiated by two parties. They offer the buyer insurance on a bundle of underlying securities. A typical bundle would be €10m worth of Greek government bonds. To insure against default, the buyer of a CDS pays the seller a premium, whose value is denoted in basis points. Last Thursday, a CDS contract on five-year Greek bonds was quoted at 394 basis points. This means that it costs the buyer €394,000 per year, for five years, to insure against default. If Greece defaults, the buyer gets €10m, or some equivalent. What constitutes default is subject to a complicated legal definition.

A naked CDS purchase means that you take out insurance on bonds without actually owning them. It is a purely speculative gamble. There is not one social or economic benefit. Even hardened speculators agree on this point. Especially because naked CDSs constitute a large part of all CDS transactions, the case for banning them is about as a strong as that for banning bank robberies.

Economically, CDSs are insurance for the simple reason that they insure the buyer against the default of an underlying security. A universally accepted aspect of insurance regulation is that you can only insure what you actually own. Insurance is not meant as a gamble, but an instrument to allow the buyer to reduce incalculable risks. Not even the most libertarian extremist would accept that you could take out insurance on your neighbour’s house or the life of your boss.

Technically, CDS are not classified as insurance but as swaps, because they involve an exchange of cash flows. The CDS lobby makes much of those technical characteristics in its defence of the status quo. But this is misleading. Even a traditional insurance contract can be viewed as a swap, as it involves an exchange of cash flows. But nobody in their right mind would use the swap-like characteristics of an insurance contract as an excuse not to regulate the insurance industry. The fact that, unlike insurance, CDSs are tradeable contracts does not change the fundamental economic rationale.

The whole idea of modern financial products is to replicate the payment streams of other, more traditional instruments, while offering better conditions. Selling a CDS is like buying a bond. Buying a CDS is a way of shorting a bond – or of insuring against its default. But that does not change the fact that once you strip away the complex technical machinery, you end up with a product that offers insurance – even though it is a lot more versatile than a standard insurance contract.

Another argument I have heard from a lobbyist is that naked CDSs allow investors to hedge more effectively. This is like saying that a bank robbery brings benefits to the robber. A further stated objection to a ban is that it would be difficult to police. There is no question that a ban of a complex product, such as a CDS, involves technical complexities that commentators like myself probably underestimate. It is conceivable, for example, that the industry might quickly find a legal way round such a ban. Then again, we would not consider legalising bank robberies on the grounds that it is difficult to catch the robber.

So why are we so cautious? From conversations with regulators and law-makers, I suspect they are not always familiar with those products, to put it kindly, and that they may be afraid of regulating something they do not understand. They understand, or think they do, what a hedge fund is. Restricting hedge funds is something they can sell to their electorates. Hedge funds were not at the centre of the crisis, but they are a politically expedient target. Banning products with ugly acronyms that nobody understands seems like unnecessarily hard work.

I do not want to exaggerate the case for a ban. This speculation is neither the underlying cause of the global financial crisis, nor of the eurozone's underlying economic tensions. But naked CDSs have played an important and direct role in destabilising the financial system. They still do. And banks, whose shareholders and employees have benefited from public rescue programmes, are now using CDSs to speculate against governments.

Where is the political response? The Germans want to bring it to the Group of 20, but they hesitate to do anything unilaterally. Christine Lagarde, the French finance minister, was recently quoted as saying: "What we are going to take away from this crisis is certainly a second look at the validity, solidity of sovereign [credit default swaps]."

A second look? I wonder what they saw when they looked the first time.

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Global Insight: Lagarde wants look into murky market

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The Derivative Project | March 2 12:36am | Permalink Report

The Derivative Project is presenting comments to Congress to bring together a unified voice on banning credit default swaps. Simultaneously, we are urging Corporate Resolutions that will ban business with the 5 major CDS users. Please take action at www.thederivativeproject.com today.

jmconvey | March 2 12:24am | Permalink Report

@Grasshopper.....I think these instruments in the US sub prime dynamic owe their origins further back than 2006. I believe you should look closely at the S&L crisis of the mid to late 80's for the answer.....no offence intended.

Additionally the whole question of the "exotic" approach to creating a gambling environment within economics, does not sit well and never has, with most macro economists of the more stable school of thought, as to defined, structured and less explosive Global trade dynamics. Those with sufficient age and experience that is, and who can serve as witness to the comparative economic results of the last 25 years. Certainly Hayek may be used as a supportive argument, as well as the Ayn Rand "unfettered marketplace" arguments, to verify the previous dynasty of "Trickle down" methodology of the last 25-30 years. But the truth, which speaks loudly at present, is that bubble economics will always result in a marketplace that resounds with the ethic that gambling and inappropriate speculation are acceptable, as well as borderline fraudulent approaches. (It could be argued that if Madoff had had a good law firm he would never have been discovered).
All signals now point to a better regulation environment, which will allow for leveling of exposure to "bubble" risks and also deter the need for isolationist trade policies or uneven currency manipulations in a new global economic environment.
At least I hope so, as I am too old to continue fighting against what has been this very damaging "Las vegas" dynamic, within my discipline.

jmconvey | March 1 11:58pm | Permalink Report

Just because the so called "brightest and the best", can divine some revolutionary new way of profiting, from the misery of societies and countries, doesn't mean they should! Yet this heinous practice continues unabated, at Goldman Sachs and JP Morgan et al. I have pointed out before that these people are gamblers, not bankers, and need "remedial training" in ethics and risk analysis, not to mention basic economics 101, regarding the original purpose of a properly structured capitalist model. e.g; "To enhance the sovereign wealth and economic health of the democratic structure, through a system of stable trade and financial conveyances, enabling accessible credit availability, against a background of proven asset valuations, aptly defined and firm concepts of liquidity, and a dependable and secure banking structure."

Any one got any argument with these basic and sensible protocols? Guess what? They have been ignored, and as protocols relegated by the "neo trade dynamic" to the scrap heap, as useless and outdated, and unduly restrictive for the new and supposedly more sensible "grow at all costs economics" of the last 30 years? Thanks to the, " trickle down, deal and fee making greed mania" on Wall street, and across the Globe, this ignorance of the common sense of the forefathers of economics and trade protocols, was accepted as the new ethics for the 21st century. Many did not agree over the years, (myself included) and were ignored. In essence shouted down as imbecilic and out of touch with reality.

It is gratifying to now see so many "people of consequence" in journalism and economics, finally begin speaking out and documenting their opinions, against these parasitic practices! It is about time, and I hope it is not too late! Also that the political will in Washington and London etc, can and will re affirm the need to protect the peoples sovereign wealth, against the systemic degradation caused by this or any future inappropriate speculation!

Ethan Teas | March 1 10:23pm | Permalink Report

Many other parties have pointed out the disconnects in fact, logic, and analogy that Munchau puts fort. Merely commenting to second them. Munchau's ability to mix metaphors and confuse some of the notable issues related to these contracts is surprising for a well regarded paper like the FT. Recently, editorial standards have gotten a little limp (see also Niall Ferguson's counterfactual Greek Crisis to US article) - I'm for editorial freedom, but I imagine that the FT is also out to manage a well regarded brand. Perhaps teaming an jr. economist with historians/journalists would be a good first step. I suggest they step it up a bit...

Likinius | March 1 10:02pm | Permalink Report

Kudos to Wolfgang Munchau for nudging regulators asleep at the wheel. ...

Cassandra | March 1 9:32pm | Permalink Report

Some members of the US congress want to introduce transparecy into the opaque
market of CDS's:
http://www.bloombe...aLITNoPZn7Uo&pos=6

The usual suspects that profit from this game that made for them 35B are against it claiming that this opaqueness increases their profits.!!

Three cheers for the Efficient Market Hypothesis on which the system is supposed to be based

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Student Question | March 1 8:19pm | Permalink Report

Mr Münchau,

If the Greek government wants to borrow money from a free market, shouldn't the market decide the price, free of regulation?

If the Greek government requires some from of special protection, is that not the responsibility of supra-national institutions?

The philosophy being that it is better to temper capitalism with economic equality than the reverse.

James beadle | March 1 4:39pm | Permalink Report

Are naked CDS positions impacting prices? Yes, probably. Does it matter fundamentally? Not so clear, at the margin - yes. But bonds are less often priced off CDS spreads as they are usually more liquid than these contracts. So, the biggest use for CDS seems to be to influence a marginal market and attract media attention.
How to solve? Unclear that banning naked positions is the problem, presumably more not less liquidity will improve efficiency. Idea: reduce the size needed to trade CDS allowing more players into the game.
Side point: What if I buy debt and CDS at the same time, then sell the debt because I feel it's pricing has diverged from fundamental value? Can I keep the CDS (in which I still see value)? I agree about the issue, not about the solution.
James Beadle, market-melange.com

Erol Riza | March 1 4:02pm | Permalink Report

CDS did not create the problems of Greece. What a lot of the commentors are missing is that the speculation on Greek bonds which is used for the holders of Greek CDS insurance means that the yields on Greek bonds rises far above what is justified. The Greek PM has asked for Greece to be able to borrow at yield levels that are closer to other EU members; this is a very logical request and had naked CDS not been around the shorting of Greek bonds would not have taken the proportion it has taken. If anyone does not understand the link between CDS and shorting of Greek bonds he kight as well go back to the basics of CDS and how they tade versus the undrlying. It is not as if Greek CDS trade without reference to an underlying Greek bond. If you reat a term sheet of CDS you will note a refrence security. The insult to injury is when investment banks create trades to profit from the misery they inflict on a country. This is shameful to put it mildly and is in part the cause of all the synthetic CDO/CLOs that were the cause of the destruction of many banks.

Grasshopper | March 1 3:07pm | Permalink Report

If you borrow the sovereign bond and sell it short, you end up economically in the same position as buying naked CDS on sovereign credit (of course you need also to hedge the interest rate exposure away to isolate the credit exposure. But you see it is no problem to replicate naked CDS on sovereign credit).

So would you like to ban also securities lending on goverment bonds? Mr Munchau, I am missing this argument in your article.

If you agree on a ban of securities lending you should also think about why the "Neuer Markt" skyrocketed in 1999. One reason was that there were not enough shares available to borrow as most of the shares of the companies in the "Neuer Markt" were held by the owners themselves. The bubble had time grow because there were no instruments to short those assets. What followed when this bubble bursted is well known.

Another example of a market with no efficient instruments to short the exposure is the US Subprime mortage market. CDS on this kind of exposure were invented not until 2006. Once again the bubble had enough time to grow ... unfortunately many thought that "Subprime" was tiny and did not think about contagion.

Speculation helps to reduce volatility, because "Smart Money Investors" usually sell credit (or shares, etc.) in anticipation and when everybody would like to dump their holdings of those assets "Smart Money Investors" are usually the only ones to buy and therefore help to stabilize the market.

Without efficient instruments to short exposure we will see many more bubbles to burst in the future.

Hopefully there will be enough Ouzo available for pain relieve.

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helvetius | March 1 2:12pm | Permalink Report

Disconnection from ownership of the underlying instrument is one of the defining characteristics of derivatives. If they were tied to ownership of the underlying, they wouldn't be derivative - that's why they're called what they're called. In this sense, the concept of a "naked" derivative is practically a redundancy. Derivatives are no more mean to wear clothes than cats or dogs.

By their nature, time risk derivatives (forwards, futures, options) _cannot_ be tied to the underlying because, at least in their physical commodity market origins, the underlying has not yet been produced, therein lies the risk element.

However, despite the foolishness of praising "good" hedgers versus "bad" speculators (common amongst politicians and tabloids, but something I would have thought the FT was a bit beyond?), there is a grain of sense in Munchau's concern about credit derivatives.

It's not that taking default 'insurance' against a nominal exposure you don't have is in itself illegitimate. Today's lengthening, international supply chains, means that companies are exposed to risks further down the supply chain from their direct suppliers, often in different jurisdictions to the ones they do direct transactions in, where supplier failure would cause them losses. Yet you can't (easily or cheaply) get insurance against such indirect risks - hence there is a legitimate risk management role for such 'insurance' against events for which you don't have direct exposure.

The problem with credit derivatives (and I don't recall Munchau supporting George Soros when he called for CDS to be banned back in 2008) is to do with their role in allowing the creation of credit without the level of reserves required by banking regulations. As such CDS have been the financial alchemy behind CDOs, the whole originate-distribute model and the rise of the whole Shadow (for which read, "reserve-lite") Banking sector.

What Bernanke got wrong in his 2000 statement that derivatives would help to reduce systemic risk by spreading risk more evenly, was that that only applies if the aggregate amount of risk remains equal. One of the effects of the de-coupling of derivatives from underlyings is that it also allows the multiplication of aggregate risk, rather than just its redistribution. Together with the opacity due to the dominantly OTC nature of most credit derivatives, resulted in the global financial panic leading up to the 10 October 2008 ISDA auction of Lehman Bros CDS.

Credit derivatives create a specific problem that is not going to be solved until two things happen.

1. Market transparency through central clearing on exchanges (also mitigates counterparty risk)
2. Regulatory requirement for liquid capital reserves to be held against credit derivative exposure, in the same way, and for the same reason, as banks are required to hold against their loan book (and similarly for insurance companies).

#1 Appears to be on the current agenda, although progress is slow and the rearguard action being fought by the lobby is fierce. But #2 doesn't seem to be making much of a showing. Until it does, and until legislators (and, it would seem, some FT commentators), actually acquaint themselves with the mechanics of derivatives in general and credit derivatives in particular, we can look forward to future shadow banking crises like the one we have recently lived through.

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rr2739 | March 1 12:50pm | Permalink Report

Naked CDS should be banned. Unlike the example of "gambling" used in previous comments. If I go and bet 00 at Roulette, I don't have society on the hook for my mistake. In the world where nobody is allowed to fail, a big enough organization utilizing this strategy will be back with hands out at governent coffers and most likely receive the money. As long as this mentality exists, naked CDS needs to be reined in.

Fund manager | March 1 12:05pm | Permalink Report

This is a friendly comment to Mullah Wolfgang Munchau's desire to ban more freedoms

Your comment on banning CDS made me ache in pain. I do not use them but I understand them and respect everybody elses' freedom to use them.

Your line of reasoning would bring us quickly into Taliban rule

CDS are a gamble between two willing parties who trade freely and have opposing views. Ultimately only one can be right.

Your reasoning would lead to banning the sale of assets we do not own in the hope that we can deliver them more cheaply....and that's a fairly fundamental thing.

Your reasoning would lead us to ban all forms of gambling. Right...People gambling on the scores of football games are no different.

One further step in attacking individual freedom, ... sex between consenting adults does not bring as direct use to the young population-starved nations of Europe so why don't we just allow intercourse only for reproductory reasons. That would be done according to your logic (and not for the first time in history)

You are right in pointing out that politicians are thick as a plank of wood and they prefer to bully easily identifiable groups like hedge fund managers. That's typical Europe. We find a scapegoat, ideally a minority. Blame it for our problems and sacrifice them. That makes us all feel better about not accepting our own shortcomings.

OK politicians should ban CDS....and we should rename them SDC's...and problem solved, no more CDS's... voila.

Relax, live and let live

Incredulous | March 1 11:02am | Permalink Report

I have to say, I'm very surprised to see such an ill-informed article in the FT. AN Other more or less sums up everything that's wrong with it, but here's the bullet points:

-Greece was not brought down by CDS
-Speculation IS socially useful, especially because it gives an appraisal that is backed by something other than politician's words
-CDS is only one of many types of risk transfer, and they all have an insurance analogy

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Damianos Damianos | March 1 10:21am | Permalink Report

Thank you, Mr. Munchau, for throwing more light on this important issue and for being among the first to speak up.
As Jim Rickards showed (www.ft.com/cms/s/0...-00144feab49a.html) the first victims of this robbery are the investors in the hedge funds that write or buy the CDSs. The issuers don't pay a euro more in interest on the outstanding bonds, just because some punters betted on them or bought and sold them in the secondary market. As the CDS "market" is extremely thin and unregulated the buyers of such "insurance" must take it on faith that the writers have the capital to honor the trillions of potential claims. AIG and Lehman clearly did not. But the premia (historically hundreds of times larger than actual payouts) are for keeps, as are the hedge funds managers' fees and carry.
Volatility further increases the premia and the fees. It also increases business for rating agencies, key protagonists of the current crisis short on memory and shame but long on gravitas.
The sovereign issuers suffer because all this noise increases the perception of risk and hence the yields on new bond issues. Profligate sovereign issuers must pay higher interest on their bonds than disciplined

ones, and they have. Investors in the bonds of the former, say over the last half century, have in fact received a higher coupon (than of the latter) every year and their full principal at maturity. No wonder yields converged.
But since all countries now need to borrow heavily for their stimuli and to support the same financial players who are targeting them, it is only rational for the sovereigns to strengthen their collective defenses against the abuses of the punters with OPM. Taking a closer look at the CDSs will be only the beginning.

Greycoat | March 1 10:00am | Permalink Report

Just introduce a small insurance fee for naked CDSs payable to a financial stability fund. For example 10% on top.

OMFG | March 1 9:37am | Permalink Report

There are so many points in this piece that are wrong or ill-informed it is hard to know where to start. However, given the author chooses the moment of Greece being "destabilsed" by CDS then this seems a good place to start. In fact this conjecture isn't even supported by the author - nobody could actually claim that Greece's budget woes have been created by CDS. So then, why write this article now? What has changed in the world? Greece has been forced to admit that it has been falsifying economic statistics. It entered into Interest Rate and FX swaps in order to hide the true extent of it's fiscal problems. Why did they do that? Because "speculators" bet against them? No. This was part of the Euro project and nothing to do with the "speculators". The Greeks say they declared to the ECB the transactions the Fed are investigating - so why aren't the French and German governments blaming the Greeks, the ECB, or themselves?

So what use do CDS serve? Did they make the situation worse? Researchers, economists, bankers, hedge funds are all allowed research the facts and quite rightly pointed out what the European governments couldn't - Greece was a risk to every single EU taxpayer. Isn't that a public service? If those same people were not allowed to express this opinion through CDS, then how would the market do it? ...sell Greek stocks, debt, or other assets...would that flight have been better for Greece? Would the money return to illiquid investments once the crisis was over? In fact, the use of CDS certainly prevented even more money leaving the country and therefore created less risk for the companies and individuals invested in Greek companies.

The crisis has forced the Greek government to admit the size of the problem, start to address it appropriately, and bring out in the open the extent of work needed to be done to save the Euro project. It's not a pretty picture but at least voters now know the truth...and why do the politicians have such a problem with that?

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gw | March 1 9:31am | Permalink Report

@ A.N.Other,

What Mr Münchau means by saying you can´t insure what you don´t own is the concept of Interest. You can take out life insurance for yourself, partner and kids bcs you have an insurable interest there. You also insure your own property e.g. against fire - but there is very good reason your neighbor can neither take out insurance on your property nor on your life. - One of the problems discussed last year in this context was that as owner of certain CDS there could be an advantage of forcing a company to default - and that is socially not justifiable and should not be tolerated.

This said, as pointed out in my first posting below, I think the analogy with insurance is wrong. What´s needed is market regulation, giving transparency that is lost in the otc trade.

- Has it ever occurred to you that otc markets, due to their relative smallness and illiquidity are subject to manipulation and could in fact send the wrong price signals to markets? Just think about Greece. Do the existing short positions really justify the almost hysterical market reaktions?

Greek sov debt trading at EM levels is a joke. Someone seems to have lost any sense of proportion there. May this gross exaggeration be due to wrong price signals from the cds market?

Erol Riza | March 1 9:26am | Permalink Report

Evreka, at last an FT writer has seen that naked CDS are simply socialy unacceptable. MR Munchau deserves credit for highlighting this fact which should have been on regulators radar long time ago. For those who are not aware investment banks issued structured notes with leveraged bets on countries going bust. Other trades were fist to default trades which meant that a basket of countries where identified and investors rceived a high rate so long as no country defaulted. These rades have nothing to do with insurance but everything to do with profit for the banks. Buying insurance when a bank has an underlying exposue to a credit (be that corporate or sovereign) is offstting the risk but sleculating on country's or corporates is ertainl nothing to do with hedging. Moreover, banks which acts as advisors to clients have to keep Chinese walls; does anyone beleive this was religiously implemented at some of the investment banks which have been providing CDS. On top of this disreputable type of transctions one has the hedge funds which were probably buying protection in the form of CDS and shorting Greek bonds to widen the spread on greek bonds and hence profit from the CDS side. One hopes that Mr Munchau's proposal finds favour with rgulators and naked CDS are BANNED. The world will be a better place.

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repotrader | March 1 6:20am | Permalink Report

speculation in cds and widening cds are a reaction to the underlying problem ie concerns about governments fiscal position amidst allegations of fudged numbers, corruption, low tax base, ballooning deficits etc etc. To blame the trading community whilst abdicating governments and companies of any responsibility to balance books is erroneous. The product itself is not at fault. Bring in regulation sure but banning naked trading of it outright will not help the situation. If governments/firms do not believe the speculators to be correct in their view they can always take the other side or act to crush them ala HKMA in the 90s

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A.N. Other | March 1 5:58am | Permalink Report

Sorry I used the wrong name Wolfgang - early in the morning. Perhaps a moderator can edit the last post where necessary? Thanks.

A.N. Other | March 1 5:56am | Permalink Report

I agree with Robert Polevoi - what is different about a CDS compared to an option position?

"A naked CDS purchase means that you take out insurance on bonds without actually owning them."

Ditto for being long S&P puts or calls, or a naked CDS sale (insuring against price rises as opposed to falls, just as important for someone who needs yield for example).

"It is a purely speculative gamble."

Firstly, this is not true - it can be a hedge. E.g. long CDS on Greek debt, long a bunch of corporate high yield bonds, protecting a corp bond fund against losses from volatility from Greek debt spilling over and affecting his largely unrelated positions.

Secondly, even if it was a speculative gamble - so what? Is Mr Munchau suggesting speculation is useless? Oh wait...

"There is not one social or economic benefit. Even hardened speculators agree on this point."

Social benefits: 1. Liquidity 2. Price discovery (price of sovereign debt more accurately reflects fundamentals) 3. Profit (this should be obvious, but consider the extra tax revenues alone, quite useful for closing yawning budget deficits) 4. Superior allocation of economic resources (capital flows from clueless morons who underwrote risky sovereign debt, to people who analyzed them properly - the latter ought to be allocating capital not the former. As Buffett points out, good capital allocation is critical for any economy).

The only downside of speculation is when it is done grossly inaccurately e.g. market bubbles. Given recent events, the CDS market is hardly the one at fault here - rather it was real estate and financial institutions. Does Mr Munchau want to ban real estate investment, making property loans, or the purchase of bank stocks? Same logic seems to apply - the later ridiculous stages of buy to let speculation was not only socially useless but socially harmful. I don't see his articles asking to ban house purchases, what's wrong with this, why the double standards Walter?

In other words, rank speculation has the same benefits in the CDS market as it does in any other market such as stock index futures, soybean futures,

"Especially because naked CDSs constitute a large part of all CDS transactions, the case for banning them is about as a strong as that for banning bank robberies."

Ludicrous hyperbole, more fitting for a News of the World headline than the FT. Key distinction - a CDS trade is a voluntary economic exchange by two parties, done because they both want to do it. A robbery requires use of violent force or threat to coerce one party, where there is a victim who *does not want to* give up their money. Does Mr Munchau not understand the difference between voluntary exchange and violent coercion?

"Economically, CDSs are insurance for the simple reason that they insure the buyer against the default of an underlying security."

ANY risk-transfer tool serves an insurance-like purpose. Stock index futures, short sales, calls, puts, caps, collars, interest rate swaps. What is so different about the CDS risk-transfer compared to these others?

"A universally accepted aspect of insurance regulation is that you can only insure what you actually own."

Wrong. I can insure against my own death, the weather, my partner dying, my companies CEO, business partner, or top salesman dying (key man insurance), losing my job, becoming disabled, a collapse (or boom) in stock prices, or pure market volatility. I don't own any of those things.

"Insurance is not meant as a gamble, but an instrument to allow the buyer to reduce incalculable risks."

Says who? Neither you nor the government get to decide what other people are "meant" to do. We live in free countries not a Chavez-style command economy. Even if your central point about speculation being "socially useless" (more so than the sports cars, luxury watches, or vintage wines your newspaper advertises) was correct, so what? If I am legally and morally entitled to bet on a boxing match, a political election, a throw of the dice or a card game, then I am surely entitled to speculate on the price of financial assets. If it's legal for me to have unprotected sex with 100 people, commit suicide, or put my entire life savings into property with 20:1 leverage, then why on earth should it be illegal to speculate on bond prices? Do you understand the concept of liberty at all?

No country has a right to issue bonds at the price of its choosing. Therefore no harm is being done by accurately pricing debt to reflect default risk. If CDS buyers become too aggressive, then there is sure profit to be made by selling the relevant CDS positions. Banning CDS trading would reduce the price transparency and accuracy of sovereign debt and default risk, and it would criminalize the freedom of contract of consenting adults. Both those are not only socially useless, they are socially harmful and immorally illiberal.

Kudeta | March 1 5:47am | Permalink Report

Naked puts, naked shorts, naked CDSs, synthetic CDOs, a pox upon them all. They serve no economic purpose, but turn the financial marketplace into a disreputable ghetto.

Robert Polevoi | March 1 1:17am | Permalink Report

I have never heard a clear explanation of why a naked CDS position is so fundamentally different than a naked put option (leaving the issue of OTC vs exchange-traded aside) that the former should be eliminated while the legitimacy of the latter is unquestioned. A put is insurance if it is covered and a speculation if is naked, just as with the CDS. I'm not saying that there isn't a distinction between options and CDS, but I have never heard it plainly addressed, and I can't help but feel that Herr Munchau is ducking this very obvious question. Is the fact that the option can be exercised without regard to the reason for the price movement in the underlying security (e.g, changes in prevailing bond yields), while the CDS is exercised only in the case of a default (or other credit damaging event) the basis for a material distinction as to economic legitmacy? If so, I don't understand why, and would appreciated comments in response.

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and_then_theres_reality | March 1 12:05am | Permalink Report

"Insurance is not meant as a gamble, but an instrument to allow the buyer to reduce incalculable risks."
Incalculable risks? That's what a market full of hedgers and speculators does - as a group it calculate odds and payouts on an event occurrence.
-If no one is allowed to trade naked in CDS, who do you supposed to sell this insurance to those who own the sovereign debts and need to hedge? There is no natural naked seller of the insurance to them.
-Banning naked CDS trades is effectively either closing the market or materially increasing the costs to those purchasing it as market liquidity will be far thinner.
-One can only conclude as King of Crunch did, that banning CDS will simply result in less appetite for holding debt of whatever entities, sovereign or corporate, in which CDS trading is banned.
-No CDS trading = higher rates of interest for governments and corporations.

Karl-Heinz Klaer | February 28 11:32pm | Permalink Report

Mr Münchau is right.

The last figure I saw about CDS was a volume of 606.000 billion dollars. Yes: billions, currently, worldwide. And why? Because CDS don' t cost really - a bit difficult to explain here but for the community the fact why... And if you don' t want to believe then please take a look again: 600.600 billions, who could pay for that?

I shall never understand why serious people hold Warren Buffet in great esteem but won' t grab his word that CDS are weapons of mass destruction.

And, my dear British friends, don't be mistaken, there is an easier target than Greek bonds. How was it when I was young, in 1992?

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gw | February 28 10:35pm | Permalink Report

Mr Münchau,
I believe this is a valid point. However the Insurance Idea in respect of CDS has been discussed extensively last year and over-stretched, imo.
I do not believe the analogy with insurance to be a valid one. CDS are an instrument, as you correctly point out, that allows you to short bonds. This can be used insurance-like, it can be used for speculation as well. The situation is not different from options on equities or futures. All are "dual-use" products. With the latter no-onse ever raised the insurance argument.

So banning naked trading in CDS opens up discussion on a much broader field. I think this is the reason no-one wants to touch it really. Like banning short-selling. you will remember the outrage and the discussions also in this paper.

As long as the general creed agrees that speculation is legit, that it only exposes the existing fault lines, that it, by doing so, gives valuable information to the market, I think there is no justification to ban naked CDS.

However, a major improvement would be to close dow the OTC market in CDS. I think, that´s where the worst scams originate. Regulate the market, put it on the exchanges.

So: no need to ban CDS, gat at otc markets instead. it´s much easier, too.

The King of Crunch | February 28 9:56pm | Permalink Report

So if a bank has, say, exposure to a government via an interest rate swap that government has done (and on which governments do not post collateral), it should not be allowed to hedge itself against the risk of that government defaulting? Or if a company becomes worried that its increasingly indebted government is going to tax it out of existence, it too should simply grin and bear it?

A ban on CDS - naked or otherwise - will almost certainly lead to people dumping their government bondholdings as the only other plausible way of reducing their exposures.

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