Not so bad after all: Credit default swaps cushion stock prices against credit downgrades

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Professor Ornthanalai joined the University of Toronto's Rotman School of Management in 2012 after working as an assistant professor of finance at the Georgia Institute of Technology. Credit: Rotman School of Management

Credit default swaps (CDS) were heavily criticized for being a major contributor to the 2008/09 financial crisis.

But a new study shows that these market-based insurance tools have also served as a stabilizing force, protecting against stock price plunges and higher borrowing costs in the event a firm receives a downgrade from a credit rating agency. CDS are typically bought by lenders to hedge against a borrowing company's potential default on its loans.

"We're trying to shed a different light, showing that CDS is not such a bad thing. It can have a positive outcome for capital markets," says Chayawat Ornthanalai, an associate professor of finance at the University of Toronto's Rotman School of Management who co-authored the study with two other researchers.

The researchers looked at the experience of 644 companies between 1996 and 2010. Some 283 of them saw the introduction of CDS contracts on their debt during that period. Those companies covered by CDS saw a 44 to 52 percent reduction in drops to their stock prices after a credit downgrade, compared to companies with an identical downgrade but with no CDS.

And while they still absorbed some impact, having their debt covered by CDS meant downgraded companies did not take as heavy a hit to their operations, with fewer reductions in their debt and investments and less significant increases to their borrowing costs, compared to companies not covered by CDS. Firms with the greatest drop in stock price, despite having CDS, tended to be those in the "speculative grade" category—with ratings in the lower grade strata—or with more conditions attached to their loans that were linked to their credit rating.

The researchers caution that CDS contracts aren't a replacement for the information provided by credit ratings, but their results suggest that CDS can act as a complement, using a market-based indicator of a firm's default risk instead of an analyst's opinion.

Prof. Ornthanalai says people shouldn't confuse the positive uses of CDS highlighted in his research with the situation leading to the financial crisis.

"CDS was not the main issue," he says. In some cases, CDS got "tied into pools of badness," created by the abuse of collateralized debt obligations (CDOs), where debt from multiple sources was repackaged into a single product and sold by banks and corporations to buyers.

As well, some investors engaged in highly speculative and predatory trading against the potential default of a company in which they had no other direct interest, a situation Prof. Ornthanalai compares to "insuring your relatives and then murdering them for the insurance money."

Provided by University of Toronto

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