Did CDS trading improve the market for corporate bonds?

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\textbf{A B S T R A C T}

Financial innovation through the creation of new markets and securities impacts related markets as well, changing their efficiency, quality (pricing error), and liquidity. The credit default swap (CDS) market was undoubtedly one of the salient new markets of the past decade. In this paper we examine whether the advent of CDS trading was beneficial to the underlying secondary market for corporate bonds. We employ econometric specifications that account for information across CDS, bond, equity, and volatility markets. We also develop a novel methodology to utilize all observations in our data set even when continuous daily trading is not evidenced, because bonds trade much less frequently than equities. Using an extensive sample of CDS and bond trades over 2002–2008, we find that the advent of CDS was largely detrimental. Bond markets became less efficient, evidenced no reduction in pricing errors, and experienced no improvement in liquidity. These findings are robust to various slices of the data set and specifications of our tests.

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1. Introduction

A major innovation in the fixed-income and credit markets since the turn of the century is the introduction of the credit default swap (CDS), a credit insurance contract with a payoff linked to that of the default or change in credit characteristics of an underlying reference bond or issuer. Innovation, however, is a double-edged sword with likely mixed positive and negative outcomes. The creation of new securities could complete markets and favorably impact information generation and dissemination, as well as liquidity, yet, such innovations could also have negative externalities if the gains accrue to only a few market participants and cause an adverse impact on the rest of the market. In this paper we examine whether the advent of the CDS market improved the secondary corporate bond market in terms of its underlying efficiency, market quality, and liquidity.\textsuperscript{1} Taking a time series perspective, we examine the following question: did an issuer’s bonds become more efficient and liquid after CDS trading was instituted on the reference instruments of the issuer? From a cross sectional perspective, we query: Are bonds...
of firms with traded CDS contracts more efficient and liquid than bonds of firms without any CDS contracts?

Did corporate bond trading decline after the introduction of CDSs because traders were able to implement a credit view better and more cheaply in the CDS markets? Fig. 1 shows the mean size of bond trades relative to the date of inception of CDS trading for our sample of firms with traded CDS contracts benchmarked to a control sample of firms with no CDS introduction. The mean trade size falls in the two years following CDS introduction, indicating an evident decline in secondary bond market activity. Similarly, Fig. 2 depicts a likely drop in mean turnover of bonds of issuers with CDS contracts once CDS trading begins, with no appreciable change for control sample bonds.

Figs. 1 and 2 indicate that bond trading could have declined, but it is likely that bond market efficiency improved if the CDS market generated useful information that was quickly reflected in bond prices. As our empirics show, relative to other asset classes the informational efficiency of corporate bonds is poor both before and after the advent of CDS trading, and interestingly, bonds become more inefficient after CDS trading commences. This suggests that the CDS markets had a detrimental effect on bond market efficiency. Bond market quality showed no signs of improvement after CDS introduction. Also, using various measures of liquidity we find that post-CDS, on a relative basis, more liquidity attributes deteriorated than improved.

The prior literature on bond market efficiency examines lead–lag relations between corporate bonds and equity markets as a way of assessing the relative efficiency of bonds to equity (e.g., Kwan, 1996; Hotchkiss and Ronen, 2002; Downing, Underwood, and Xing, 2009; Ronen and Zhou, 2013). The findings are mixed. Our goal in this paper is different from that of the prior literature. Whereas we
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