



# Insider trading in credit derivatives<sup>☆</sup>

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## Abstract

Insider trading in the credit derivatives market has become a significant concern for regulators and participants. This paper attempts to quantify the problem. Using news reflected in the stock market as a benchmark for public information, we find significant incremental information revelation in the credit default swap market under circumstances consistent with the use of non-public information by informed banks. The information revelation occurs only for negative credit news and for entities that subsequently experience adverse shocks, and increases with the number of a firm's relationship banks. We find no evidence, however, that the degree of asymmetric information adversely affects prices or liquidity in either the equity or credit markets.

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## 1. Introduction

[B]anks must not use private knowledge about corporate clients to trade instruments such as credit default swaps (CDS), says a report [by] the International Swaps and Derivatives Association and the Loan Market Association...[M]any banks and institutions are trading CDS instruments in the same companies they finance – sometimes because they want to reduce the risks to their own balance sheets. (Financial Times, April 25, 2005)

Credit derivatives have been perhaps the most significant and successful financial innovation of the last decade. The use of credit derivatives has been cited as an important reason for the observed robustness of banks and financial institutions to the historically high global levels of corporate defaults during the period 2000–2004. As Alan Greenspan recently observed, “The new instruments of risk dispersion have enabled the largest and most sophisticated banks in their credit-granting role to divest themselves of much credit risk by passing it to institutions with far less leverage. These increasingly complex financial instruments have contributed, especially over the recent stressful period, to the development of a far more flexible, efficient, and hence resilient financial system than existed just a quarter-century ago.”<sup>1</sup> In addition, markets for credit derivatives have helped banks create synthetic liquidity in their otherwise illiquid loan portfolios.<sup>2</sup> Not surprisingly, the growth in the size of this market continues unabated as products are expanding to cater to emerging markets, and indices such as iBoxx and iTraxx are becoming industry benchmarks for credit conditions.

If credit derivatives are to seamlessly provide insurance and liquidity-creation roles, then the orderly functioning of these markets becomes an important policy objective. Credit derivatives, however, like all forms of insurance, are subject to moral hazard (see [Duffee and Zhou, 2001](#)) and asymmetric information risks. In this paper, we are concerned with the latter of these risks. Specifically, if a creditor of Company X has private information about the likelihood of default, or can itself influence default, then this creditor might try to exploit its privileged information by buying credit insurance on X from a less-informed counterparty. Or if loan officers who deal directly with X pass on inside information to the traders buying credit derivatives, the institution on the other side of the trade could get a rotten deal. If fears of such behavior are widespread, the liquidity of the market could be threatened.

Of course, asymmetric information and insider trading problems potentially exist in most markets. But the credit derivatives market may be especially vulnerable since, almost by definition, most of the major players are insiders. Firms have a much closer relationship with their private financiers, such as banks, than with investors in their public securities such as stocks and bonds. In particular, firms often provide material and price-sensitive information, such as revenue projection updates or acquisition and divestiture plans, to relationship banks well in advance of release to the public. Trading desks of many banks

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<sup>1</sup>From Greenspan’s speech “Economic Flexibility” before Her Majesty’s Treasury Enterprise Conference (London, 26 January 2004). A contrasting view is that if regulations such as capital requirements are ill-designed, then credit derivatives can result in inefficient transfers of risk between banks and insurance companies ([Allen and Gale, 2005](#)).

<sup>2</sup>In an important recent example, Citigroup distributed a large portion of its exposure to Enron through issuance of credit-linked notes at regular intervals in the two-year period preceding the default of Enron; as a result, Enron’s collapse had a minor effect on Citigroup’s balance sheet.

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