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PRESS RELEASE

What determines euro area bank CDS spreads?

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In recent years, market participants and supervisors alike have begun to look to bank credit default swap (CDS) spreads as indicators of bank credit risk. Bank CDS spreads are regularly cited in central banks' and international organizations' publications, they have been incorporated in regulatory initiatives to deal with "toxic" assets on banks' balance sheets and, more recently, they have been proposed as a trigger mechanism in a number of regulatory initiatives aiming at dampening pro-cyclicality in the financial system. However, little is known about the determinants of these spreads. Furthermore, the considerable increase in bank CDS spreads observed at the heart of the financial crisis (up by several hundred basis points for some banks) raises the question as to what extent credit risk accounts for much or all of the changes in these spreads.

This working paper presents an empirical analysis of the determinants of CDS spread changes on euro area banks before and after the start of the crisis. Variables reflecting the individual credit risk of banks, CDS market liquidity and general economic conditions are used to explain changes in CDS premia. The variables relating to general economic conditions also potentially capture system-wide risk or risk aversion of investors.

The analysis reveals four main results. First, the determinants of changes in bank CDS spreads exhibit significant time variation. This finding, which echoes similar results in studies of bond spreads, implies that models which attempt to explain changes in bank CDS spreads must be re-estimated frequently in order to give the right "signals". This is important, as supervisors and monetary policy makers may take different actions depending on whether changes in CDS spreads appear to be driven by credit risk, liquidity or business cycle factors. Second, variables reflecting the credit risk of individual banks are not significant in explaining bank CDS spread changes, either in the period prior to the crisis or in the crisis period itself. However, some of the variables proxying for general economic conditions are significant, but their importance and sign have changed over time. These findings suggest that policy-makers should not rely solely on financial institutions' CDS spreads as market indicators of credit risk. Ideally, the behaviour of CDS spreads should be examined together with other market indicators (e.g. Expected Default Frequencies, equity prices, etc.) to obtain an accurate assessment of credit risk. Third, CDS market liquidity became a significant factor in explaining bank CDS spread changes when the crisis broke out in the summer of 2007. This finding suggests that the role of CDS market liquidity should explicitly be taken into account when analyzing CDS spreads. This is important, as most studies still do not treat liquidity as being an important determinant of CDS spreads. Finally, the fact that the model's explanatory power diminishes greatly in the months preceding the beginning of the crisis is consistent with the analyses of several international organizations (e.g. IMF), which noted in the spring of 2006 manifestations of strong risk appetite which may have led to severe underestimation of economic risks or overestimation of liquidity in levered instruments. In other words, there was a lack of credit risk pricing in the system.