Positioning in the CDS Market: Evidence from the DTCC Data*

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Abstract

This paper investigates the determinants of the amount of credit protection bought (or equivalently sold) in the market for credit default swaps (CDS). Combining new data on net notional CDS positions outstanding from the Depository Trust & Clearing Corporation (DTCC) with a number of other data sources, we find the following main results: (1) Firms with more assets and high debt relative to assets have more CDS outstanding. Looking at disaggregated balance sheet data, the effect of debt on CDS is mainly driven by bonds outstanding. (2) Investment grade firms have more CDS outstanding. (3) Disagreement, in the form of analyst forecast dispersion, is associated with more CDS outstanding, suggesting that investors use the CDS markets to 'take views' on default probabilities. (4) Firms that recently lost investment grade status (fallen angels) have more CDS outstanding, suggesting that investors exposed to these firms use the CDS market to hedge. (5) The effect of disagreement and lost investment grade status on CDS outstanding is driven by firms whose bonds are illiquid, suggesting that investors use CDS markets to take views or hedge exposures when trading in the underlying bond is expensive.

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