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New EDHEC-Risk Research Sees No Evidence of Causal Link between Credit Default Swap (CDS) and Sovereign Debt Prices

In newly-released research by Dominic O'Kane, Affiliated Professor of Finance at EDHEC Business School, EDHEC-Risk Institute has performed a theoretical and empirical analysis of the relationship between the price of eurozone sovereign-linked credit default swaps (CDS) and the same sovereign bond markets during the eurozone debt crisis of 2009-2011. The working paper, entitled "*The Link between Eurozone Sovereign Debt and CDS Prices*," tests the claim that speculative use of CDS by market participants had caused or accelerated the rapid decline in 2010-11 of bond prices in eurozone periphery countries, a claim that led to the decision by the European Parliament and member states on October 18, 2011, to make the ban on so-called "naked" CDS permanent.

The EDHEC-Risk research shows that CDS spreads do not drive the sovereign bond spread in all circumstances, and that in various countries and at various times, the opposite effect is present. The results are in line with those of a recent report from the French regulatory authority, the AMF, entitled "*Price Formation on the CDS Market: Lessons of the Sovereign Debt Crisis (2010-)*," even though the latter study is less comprehensive than EDHEC-Risk's working paper. EDHEC-Risk is keen to stress that certain conclusions in the AMF report should be analysed with care. A causal link between rising CDS spreads and their decision-making character has not been established or proven in the report, which moreover does not include a formal test on the subject.

According to the author of the EDHEC-Risk report, Dominic O'Kane, "CDS spreads are a cleaner and more transparent measure of market-perceived credit than bonds since CDS are not limited by supply, are as easy to buy as to sell, and have a lower cost of entry." He also stated that, "It would be wrong to suggest that the 200bp level highlighted by the AMF report is the level at which the CDS market "causes" the bond market spreads to increase. A more valid explanation would be that the CDS market establishes a truer estimate of forward-looking sovereign risk which is not reflected in the bond market where some market participants are required to hold high-quality Eurozone debt. The significance of a CDS spread of 200bp is that this corresponds to the approximate capitulation level at which these Eurozone bond investors no longer see the sovereign as a "safe haven" due to its deteriorating credit fundamentals and risk of a major downgrade in its credit rating. What we then see is the bond spreads catching up with the "fair value" that had already been established in the CDS market. The CDS and bond markets then begin to move together. Recent events have confirmed this. The widening of Greek CDS spreads before bond spreads in 2010, which was criticized at the time by various governments, was correct and was due to the CDS market being an earlier predictor of default than the bond market."

EDHEC-Risk considers that by banning "naked CDS" the market is removing one sovereign risk mitigation tool from the toolkit of banks. EDHEC-Risk fears that this can only have the negative and unintended consequence of increasing average sovereign funding costs. The ban will make the market less liquid and will prevent many participants from easily hedging the sovereign risk that they wish to avoid. These participants include investors in infrastructure projects as part of public-private partnerships, equity investors who wish to avoid the sovereign risk included in certain stocks, banks who wish to hedge the sovereign risk of their commercial loans, and trading desks buying protection in order to hedge their credit value adjustment (CVA) risk.

A copy of the EDHEC-Risk study can be found here:

EDHEC-Risk Working Paper Link between Eurozone Sovereign Debt and CDS Prices

Contact:

For further information, please contact **Carolyn Essid**:

Tel.: +**33 (0)4 93 18 78 24** – E-mail: **carolyn.essid@edhec-risk.com**

About EDHEC-Risk Institute

Since 2001, EDHEC has been pursuing an ambitious policy in terms of international research. This policy, known as "Research for Business", aims to make EDHEC an academic institution of reference for the industry in a small number of areas in which the school has reached critical mass in terms of expertise and research results.

Among these areas, asset and risk management have occupied privileged positions, leading to the creation in 2001 of a major research facility: EDHEC-Risk Institute. This institute now boasts a team of 80 permanent professors, engineers and support staff, as well as 18 research associates from the financial industry and 6 affiliate professors.

EDHEC-Risk Institute is located at campuses in Singapore, which was established at the invitation of the Monetary Authority of Singapore (MAS), the City of London in the United Kingdom, and Nice, France. In addition, it has a research team located in the United States.

The philosophy of the institute is to validate its work by publication in prestigious academic journals, but also to make it available to professionals and to participate in industry debate through its Position Papers, published studies and conferences. Each year, EDHEC-Risk organises two conferences for professionals in order to present the results of its research, one in London (EDHEC-Risk Days – Europe) and one in Singapore (EDHEC-Risk Days – Asia), attracting more than 2,000 professional delegates.

To ensure the distribution of its research to the industry, EDHEC-Risk also provides professionals with access to its website, www.edhec-risk.com, which is entirely devoted to international risk and asset management research. The website, which has more than 50,000 regular visitors, is aimed at professionals who wish to benefit from EDHEC-Risk's analysis and expertise in the area of applied portfolio management research. Its monthly newsletter is distributed to more than 1,000,000 readers.

EDHEC-Risk Institute also has highly significant executive education activities for professionals. In partnership with CFA Institute, it has developed advanced seminars based on its research which are available to CFA charterholders and have been taking place since 2008 in New York, Singapore and London.

EDHEC-Risk Institute has an original PhD in Finance programme which, in addition to its highly selective residential track for young talents worldwide, has an executive track for high level professionals who already have masters degrees from prestigious universities and significant industry experience. Complementing the core faculty, this unique PhD in Finance programme has highly prestigious affiliate faculty from universities such as Princeton, Wharton, Oxford, Chicago and CalTech.