Dr Hedger or Mr Speculator: the Multiple Strategies of CDS Traders

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Abstract :
Investors may use Credit Default Swaps (CDS) for multiple purposes: hedging, speculation, or arbitrage. In this paper, we build a large panel of individual corporate credit risk exposures for banks, insurers, and investment funds, which we match to CDS holdings. Using the timing and relative sign of debt and CDS positions, we develop a simple methodology to disentangle trading strategies and show hedging corresponds to a third of outstanding positions. Our data allows us to study how CDS affect outstanding credit risk and its allocation, with mixed effects for financial stability. On the one hand, CDS contribute to an increase in exposures at default and we find evidence of increased reach for yield behavior by speculators. On the other hand, CDS tend to reduce credit risk concentration since speculators use them as a substitute for debt investments, while hedgers cover in priority their largest exposures.