

The Impact of Government Backing Announcements on CDS spreads

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Corporate Finance

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EXECUTIVE SUMMARY

The central question of this thesis is what influence U.S. governmental backing announcements have on credit default swap (CDS) spread changes of U.S., European and Japanese financial institutions during the financial crisis 2008 to 2009. To this end, I propose the following three research questions:

- a) How do CDS prices react to governmental backing announcements, i.e. what is the magnitude of CDS spread changes at the event date?
- b) Is there a differential impact for sub-segments within the financial sector as well as across the three regions of interest (United States, Europe, and Japan)?
- c) What is the relationship between CDS spread changes and certain firm characteristics?

To answer the first two questions, I employ a classical event study methodology. A relevant event is defined as an announcement made by the U.S. Treasury Department, the Federal Deposit Insurance Corporation or the Federal Reserve between January 2008 and March 2009, which comprises the following support measures: government investments, loans and guarantees, or any combination of these. After a selection process I am left with five announcements over the defined period, leading to a final sample of 40,855 daily observations on CDS spreads of 69 U.S. financial institutions, 51 European financial institutions, and seven Japanese financial institutions. To investigate announcement day effects, I compute cumulative excess CDS spreads (CESs) over several event windows around the event.

To answer question c), I carry out different regression analyses to assess the relationship between excess CDS spread changes and certain firm characteristics. In detail, I test the so called “too-big-to-fail” argument by adding firm size to my regression model. Also, I include firm age in my analyses to test whether “younger” firms have higher probabilities of default and thus higher CDS spreads than more established firms. Moreover, I examine whether a certain level of ownership concentration exerts influence on CDS spread changes, as the exis-

tence of larger shareholders may lead to “monitoring and influencing effects” in the sense of modifying the probabilities of future default. Further explanatory variables used in the regression model are free float, country of origin, industry classification and year categorization.

I find that CDS spreads of U.S. financial institutions significantly change in response to U.S. government backing announcements. There is also evidence that those announcements have a significant effect on European financial institutions, although the reaction is weaker in the latter case. Further, CESs for various financial sub-sectors indicate that depository institutions and insurer are affected to the highest degree by support announcement. However, CDS spread changes following governmental backing announcements are not always significantly negative as I would expect. The reason may be that CDS spreads are influenced by other events than those under consideration in this study or that in some cases investors have not been fully convinced by the efficiency and adequacy of announced support measures.

The regression analyses show three main empirical facts: (1) a certain level of ownership concentration is significantly related to CDS spread changes, suggesting that the existence of large shareholders may lead to “monitoring and influencing effects” in the sense of modifying the probabilities of future default; (2) U.S. government backing announcement have a major impact on the CDS spread changes of domestic financial institutions, whereas foreign financial institutions do not seem to be affected to such an extent; (3) firm size is not a significant factor influencing CDS spread changes, suggesting that there is no evidence for the so called “too-big-to-fail” argument. Other conclusions are difficult to be drawn due to insignificant results obtained from my analysis. A comparison to prior empirical studies is not possible, because there are none using the same or similar factors as I did. Intuitively, the result that selected firm-specific variables almost have no influence on CDS spread changes may suggest that market prices already incorporate all the relevant firm-specific information.