Executive Summary

Credit Default Swaps were a crucial factor in the previous financial credit crisis. On one hand, they strengthen the financial stability by providing an instrument for risk management regarding credits. On the other hand, they created systematic risk due to the resulting worsened credit analysing and monitoring, the “too-big” or “too-interconnected” to fail problem and the so-called debt decoupling, arising due to the ability of separating economic interests of creditors from inherent control rights.

Corresponding with an exceptional growth of this opaque OTC market, participants and supervising authorities asked for changes. In 1999, the International Swap and Dealers Association (ISDA) issued a standard contract, which has been revised in 2003, to improve the standardization of CDS. After the crisis in 2007 and 2008, additional arrangements have been adopted to enhance transparency and not least the liquidity in the world of CDS.

In this paper, we take up on this subject of liquidity regarding CDS. By examining bid-ask spreads and volume data in form of open contracts and outstanding notional, we analyse the development of the liquidity in the market. Looking at the bid-ask spread we find out that liquidity was influenced significantly by extraordinary circumstances like the downfall of Lehman Brothers or Bear Stearns. Furthermore, we point out the high correlation of bid-ask spreads and the CDS Spread. In our second part of the analysis, we compare the liquidity of CDS with the liquidity of corresponding stocks. Thereby, we find two interesting findings. First, we compare the bid-ask spreads of stocks of American financial institutions with the corresponding bid-ask spreads of the CDS. Our results show that stocks’ illiquidity increased during 2007 and 2008, while the CDS bid-ask spreads heavily reacted to above-mentioned circumstances. After the worst period of the crisis, the liquidity of the stocks enhanced again and stayed on a very low level. Second, we found a very high correlation of the amount of traded stocks and the bid-ask spreads of CDS. While the bid-ask spreads of the CDS increased and therefore the liquidity decreased, the amount of traded stocks experienced a converse development. This is probably explainable by the fly-to-quality phenomenon observed by Shen (2007), which shows the preference of investors for more liquid and less risky securities in difficult market situations. Funding liquidity plays another important impact on the traders’ demand by shifting it towards securities requiring less collateral or margins (Brunnermeier and Pedersen (2009)). When we split our sample into a group of institutions that are very active in the CDS market and those that are not, we see no differences in the CDS bid-ask spread but in the stocks market, where the dealers stocks’ showed a significant higher volume of trades.