

Economics Seminar, Indian Statistical Institute, New Delhi.

SPEAKER: Rajiv Sethi, Columbia University

TITLE: Economic Consequences of Speculative Side Bets: The Case of Naked Credit
Default Swaps

DAY & DATE: Friday, 6th August 2010

PLACE: Seminar Room 2

Abstract:

We examine the effects of naked credit default swaps on equilibrium debt contracts, project choice, and the likelihood of default when investors have heterogeneous beliefs about the future revenues of the borrower. Although such contracts are zero sum side bets, their existence can have important economic consequences. They induce investors who are optimistic about the future revenues of borrowers, and would therefore be natural purchasers of debt, to sell credit protection instead. This diverts their capital away from potential borrowers and channels it into collateral to support their speculative positions. The resulting shift in the terms of lending against borrowers can cause some projects with positive net present value to remain unfunded, or to be replaced by riskier projects with negative net present value. It can also result in an increased likelihood of default and the selection of equilibria in which rollover risk is amplified. The efficiency effects of such contracts are generally ambiguous and belief-dependent, although we identify circumstances in which they result in an unambiguous efficiency loss.

<http://www.isid.ac.in/~pu/seminar.html>