Credit default swaps and corporate cash holdings

By Sarah Wang, Marti Subrahmanyam & Dragon Tang

Discussion by Michael T. Chng, Deakin University

December 7, 2012
2013 PBFEAM Call for Paper

- Pacific Basin Finance, Economics, Accounting and Management (PBFEAM) Conference
- 4-5 July 2013, Park Hyatt Melbourne
- Please check SSRN FEN or ARN for details
- Conference website: Please google PBFEAM 2013
- Two special issues of RQFA & RPBFMP
- Submission due date: End of February 2013
Research question: Does the introduction of CDS contract affects a firm’s level of cash holding?

Conceptual argument (hedged)

- CDS increases credit supply by allowing capital providers to transfer credit risk.
  - This credit-supply effect implies a decrease in cash holding.

- CDS-protected creditors engage in tougher debt renegotiation; more observable signal of credit deterioration through CDS spreads.
  - This creditor/CDS-feedback effect implies an increase in cash holding.
Most studies on the CDS market are linked to either asset pricing or price discovery.

The authors contribute to the literature with a study that links CDS to corporate finance.

Key variable is CDS trading activity:

- Discrete: 1 after CDS introduction.
- Continuous: Number of live CDS contracts (open interest?); Notional CDS over Total Debt.
Dimensions covered by the study

Comprehensive list of controls on corporate cash holding:

- Industry cashflow risk
- Cashflow/Assets
- Book-to-Market; Size
- Leverage; R&D/Sales
- Capital expenditure; Dividend dummy etc

Endogeneity of CDS trading:

- Identify and apply two IVs: bond turnover and analyst coverage.
- Difference-in-difference analysis.
- Propensity score-matching to compare between CDS (treatment) and non-CDS (control) firm sample.
Testable propositions

The authors test the following two main hypotheses:

- **Hypothesis 1**: Cash holdings increase after CDS introduction.
- **Hypothesis 2**: Increase in cash holdings is more evident in firms with weaker credit conditions.

Hypothesis 2 is formed conditional on Hypothesis 1.

Hypothesis 1 is formed conditional the creditor/feedback effect outweighs the credit supply effect i.e. an empirical question.
Main findings

- The introduction of CDS increases corporate cash holdings, with the mean cash holding increasing from 8.2% to 10.2%.

- Effect is more pronounced in firms with weaker credit conditions i.e. more financially constrained.

- The positive impact on corporate cash holding is robust to control variables and endogeneity adjustments.
General comment

Overall impression:

- A succinct and sharply focused paper.
- Substantive work to enhance the power of the empirical tests and validity of the results.
- An attempt to motivate the paper’s findings in terms of policy implications.
General comment

The policy implications of the ‘real effects’ of CDS trading could be highlighted better. It is only briefly mentioned on p4 and then again towards the end on p23.

- p4: In regulating the CDS market, how would the CFTC and/or SEC benefit from this paper’s finding, given the main focus is on the presence/absence of a CDS market?

- p23: Would an average 2% increase in cash holding (relative to total asset) have a substantively adverse effect on real investment activity?

- Let’s assume it does. Does that imply we should ban firms from issuing CDS contracts?
Is there a way of enhancing the economic importance of the observed increase in cash holding?

- p3: “Given the mean cash ratio of 8.2%, this (2% increase to 10.2%) represents a 24.4% increase in cash holdings!”

- p11: Mean cash ratio is 8%, such that 0.7% increase is economically significant.
Specific comment

The GFC-effect on cash-holding.

- p21: I think the section discussing the substitution between line-of-credit and cash holding can be used to account for the likely overall increase in cash holding by firms post-GFC.

p20 middle: The authors find even more evident impact of CDS trading on the cash holding of unrated firms.

- They attribute this to the fact that unrated firms are even more financially constrained than junk-grade firms.

- A caveat: Investors of unrated firms rely more on the CDS market for credit-related signals. This stronger CDS feedback effect would at least partially drive the more evident impact that CDS trading has on cash holdings.
Typographical comments

- p3 near-bottom: “For our sample of CDS firms,...”
- p6 bottom-half: “Besides the conventional factors that affect...”
- p6 bottom-half: “…,Palazzo (2012) further documents that a firm’s cash holdings positively relates to aggregate...”
- p15 middle: “Other than size, Bond Turnover and Analyst Coverage are also...”
- p21 near-middle: “…may not be available when it is needed most.”
- p21 near-middle: “They show that aggregate risk affects firms’ choice ...”
- p21 bottom-half: “As expected, Line of Credit is significantly negative.”
This is an empirically meticulous paper.

The empirical rigor seems to overshadow the conceptual motivation and contribution of the results.

I am sure the authors can easily address the preceding slight imbalance.

I am glad to have an opportunity to discuss what I think is a sharply focused paper on a timely topic.

Thank you, and hope to see you all in Melbourne in July 2013!