Safe-Haven CDS Premiums

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Abstract

We develop a model in which a derivatives-dealing bank faces capital charges from uncollateralized swap positions with sovereigns, and buys Credit Default Swap (CDS) contracts to obtain capital relief. CDS premiums depend on margin requirements for buyers and sellers of CDS contracts, the value of capital relief for the dealer banks, and the return on a risky asset. We explain the regulatory requirements that lead derivatives dealers to buy CDS and translate volumes of derivatives contracts outstanding between sovereigns and banks into CDS hedging demand. We argue that CDS premiums for safe sovereigns are primarily driven by regulatory requirements.

CDS premiums, capital charges, CVA, CDS-bond basis; JEL: F34, G12, G15