Summer Research Paper

Credit Default Swaps and Credit Demand

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Abstract

Credit Default Swap (CDS) is widely regarded as the reason for tough creditor and increased credit supply. However, borrower's reaction to that is rarely considered in existing literature. This paper studies the effect of CDSs on borrow-lending relationship using a limited commitment asymmetric information model. It shows that CDSs increase credit supply and decrease credit demand by strengthening creditor's bargaining power. Moreover, credit demand is differently influenced by CDSs for different quality borrowers. Low quality borrowers are more affected by CDSs and less likely to borrow in equilibrium. In a competitive credit market, the equilibrium credit decreases especially for low quality borrowers. Using the data from Compustat and Bloomberg, the empirical results suggest that the introduction of CDSs increases firms' borrowing, which is mainly driven by high quality firms. The higher the quality, the larger the firm's leverage increase. For low quality firms, the leverage is actually decreased by CDSs. Furthermore, CDSs have a negative impact on credit demand by examining leverage change in credit demand shocks.