Does the EU’s MiFIR Review make single-name credit default swaps transparent enough?

By Randy Priem

Regulation 2024/791 ("MiFIR Review") was published in the Official Journal of the European Union on 8 March 2024. This newly adopted legislation requires single-name credit default swaps (CDSs) to be made subject to transparency rules, only however if they reference global systemically important banks (G-SIBS) or those referencing an index comprised of such banks.

In this blog post, I discuss the suitability of the revised transparency requirements for single-name CDSs of the MiFIR Review. On the one hand, it seems that the new requirements are limited in scope as any referencing entity that is not a G-SIB will not be majorly impacted (see, in more detail, my recent working paper). Indeed, CSDs referencing G-SIBS represent only a small fraction of the market: i.e., 8.36% based on the total notional amount traded and 5.68% based on the number of transactions (source: DTCC). It follows that a substantial percentage of the single-name CDS market will not be captured. On the other hand, this post cautions against creating even more far-reaching transparency requirements than those provided for in the MiFIR Review: more transparency could, in practice, be detrimental for financial markets as it could result in higher trade execution costs and volatility and could even discourage dealers from providing liquidity.

Single-name credit default swaps and why they are opaque.

CDSs are financial derivative contracts between two counterparties to ‘swap’ or transfer the risk of default of a borrowing reference entity (i.e., a corporation, bank, or sovereign
entity). The buyer of the CDS – also called the ‘protection buyer’ – needs to make a series of payments to the protection seller until the maturity date of the financial instrument, while the seller of the CDS is contractually bound to pay the buyer a compensation in the event of, for example, a debt default of the reference entity. Single-name CDSs are mostly traded in the over-the-counter derivatives markets, typically on confidential, decentralized systems. A disadvantage, however, of over-the-counter derivative markets is that they are typically opaque, in contrast with, for example, listed financial instruments.

Over-the-counter derivative markets have very limited access to pre-trade information (i.e., information such as the bid-ask quotes and order book information before the buy or sell orders are executed) and post-trade information (i.e. data such as prices, volumes, and the notional amount after the trade took place),

In March 2023, three small-to-mid-size US banks (i.e. Silicon Valley Bank, Silvergate Bank, and Signature Bank) ran into financial difficulties with spillovers to Europe where Credit Suisse needed to be taken over by USB. During this financial turmoil, the CDSs of EU banks rose considerably in terms of price and volume. For Deutsche Bank, there were even more than 270 CDS transactions for a total of US 1.1 billion in the week following UBS’s takeover of Credit Suisse. This represented a more than four-fold increase in trade count and a doubling in notional value compared with average volumes of the first ten weeks of the year. The CDS market is namely illiquid with only a few transactions a day for a particular reference entity, so this increase in trading volumes was exceptional. On 28 March 2023, the press reported that regulators had identified that a single CDS transaction referencing Deutsche Bank’s debt of roughly 5 million EUR conducted on 23 March 2023 could have fuelled the dramatic sell-off of equity on 24 March 2023 causing Deutsche Bank’s share price to drop by more than 14 percent.

One of the conclusions drawn by regulators, such as the European Securities and Markets Authority (ESMA), on the 24 March event was that the single-name CDS market is opaque (i.e., very limited pre-trade and post-trade market information), and consequently, subject to a high degree of uncertainty and speculation as to the actual trading activity and its drivers.

The Depository Trust and Clearing Corporation (DTCC) indeed provides post-trade CDS information, but the level of transparency is not very high, given that only aggregated weekly volumes are provided rather than individual prices. Furthermore, only information for the top active instruments are disclosed rather than for all traded instruments. Regarding pre-trade information, trading is conducted mostly through bilateral communication between dealers, who might directly contact a broker to trade or use a trading platform to enter anonymously non-firm quotes. However, even when screen prices are available, they are only indicative, and most dealers will not stand behind their
pre-trade indicated price because the actual price the dealer will transact with is entirely subject to bilateral negotiations conducted over the phone or via some electronic exchange. Dealers are free to change the price until the moment the trade is mutually closed. The end-users are thus dependent on their dealers and sometimes do not even have access to the pre-trade information because they have to rely on third-party vendors and services that aggregate data. End-users do not know before the trade which price offered by dealers is the best one and do not know which other parties are willing to pay or to sell at, nor do they have comparable real-time prices against which to compare the price of their particular trade.

New transparency requirements in the MiFIR Review

On 25 November 2021, the European Commission published a proposal to amend Regulation No 600/2014 on markets in financial instruments (MiFIR) as regards enhancing market data transparency, removing obstacles to the emergence of a consolidated tape, optimizing trading obligations, and prohibiting receiving payments for forwarding client orders. This initiative was one of a series of measures to implement the Capital Markets Union (CMU) in Europe to empower investors – in particular, smaller and retail investors – by enabling them to better access market data and by making EU market infrastructures more robust. To foster a true and efficient single market for trading, the Commission was of the view that the transparency and availability of market data had to be improved.

The proposal implemented the view of ESMA that the transparency regime that was in place earlier was too complicated and not always effective in ensuring transparency for market participants. For single-name CDSs, the large majority of CDSs are indeed traded over the counter where the level of pre-trade transparency is low. This is because pre-trade requirements only apply to market operators and investment firms operating trading venues. Even for CDSs traded on a trading venue, there is a possibility to obtain a waiver as they do not fall under the trading obligation and are considered illiquid financial instruments. Because of their illiquidity, the large majority of listed single-name CDSs can also benefit from post-trade deferrals where information could even be disclosed only after four weeks.

Regulation (EU) 2024/791 (”MiFIR Review”) was finally approved on 28 February 2024 and entered into force on 28 March 2024. Article 8(a) of the MiFIR Review now requires as pre-trade transparency requirement that when applying a central limit order book or a periodic auction trading system, market operators and investment firms operating a multilateral trading facility or organized trading facility have to make public the current bid and offer prices, and the depth of trading interest at those prices for single-name CDSs that
reference a G-SIB and that are centrally cleared. A similar requirement is now there for CDSs that reference an index comprising global systemically important banks and that are centrally cleared. Hence, under the new MiFIR Review, CDSs referencing G-SIBs are subject to transparency requirements only when they are centrally cleared. Such CDSs are, however, not subject to any clearing obligation provided for in the European Market Infrastructure Regulation (Regulation No 648/2012 “EMIR”). This means that data on single-name CDSs referencing G-SIBs that are not cleared or CDSs referencing other entities do not need to be made transparent.

Regarding post-trade transparency, Article 10 of the MiFIR Review requires that market operators and investment firms operating a trading venue have to make public the price, volume, and time of the transactions executed in respect of bonds, structured finance products, and emission allowances traded on a trading venue. For the transactions executed in respect of exchange-traded derivatives and the over-the-counter derivatives referred to in the pre-trade transparency requirements (see above), the information has to be made available as close to real-time as technically possible. The EU co-legislators are further of the view that the duration of deferrals has to be determined utilizing regulatory technical standards, based on the size of the transaction and liquidity of the class of derivatives. Article 11 of the MiFIR Review states that the arrangements for deferred publication will have to be organized by five categories of transactions related to a class of exchange-traded derivatives or of over-the-counter derivatives referred to in the pre-trade transparency requirements. ESMA will thus need to determine which classes are considered liquid or illiquid, and above which size of transaction and for which duration it should be possible to defer the publication of details of the transaction.

Besides the pre- and post-trade transparency requirements for market operators and investment firms operating a trading venue, the MiFIR Review also focuses on the design and implementation of a consolidated tape. This consolidated tape is a centralized database meant to provide a comprehensive overview of market data, namely on prices and volumes of securities traded throughout the Union across a multitude of trading venues. According to Article 22a, trade repositories and Approved Publication Arrangements (APAs) will need to provide data to the consolidated tape provider (CTP). The MiFIR Review is then also more specific on the information that has to be made public by an APA concerning over-the-counter derivatives, which will flow into the consolidated tapes. Where Articles 8, 10 and 11 of MiFIR before referred to ‘derivatives traded on a trading venue’, the MiFIR Review no longer uses this wording with respect to derivatives and refers to ‘OTC derivatives as referred to in Article 8a’, being those subject to the pre-trade transparency requirements. This incorporates again those single-name CDSs that reference a G-SIB and that are centrally cleared, or CDSs that reference an index comprising G-SIBs and that are centrally cleared. Similarly as for the pre-trade and post-
trade transparency, data on single-name CDSs referencing G-SIBS that are not cleared or CDSs referencing other reference entities do not need to be made transparent.

**Do we want even more transparency?**

The MiFIR Review’s revised transparency requirements for single-name CDSs are not very far-reaching, given that CDSs referencing to reference entities that are not a G-SIB are not majorly impacted. Given that CSDs referencing G-SIBS represent only a small fraction of the market (see introduction above), a substantial percentage of CDSs is not captured by the MiFIR Review. In addition, single-name CSDs referencing G-SIBS that are not centrally cleared are also not affected. As there is no clearing obligation on CDSs because they are not sufficiently liquid, a large fraction will not be impacted or can continue to benefit from pre-trade transparency waivers or post-trade deferrals. This entails that a large fraction of the entire CDS market will thus not be affected by the MiFIR Review.

Nevertheless, I argue that even more severe transparency requirements than those foreseen by the MiFIR Review might not necessarily be beneficial for financial markets. Too much transparency can be detrimental to financial markets as it might result in higher trade execution costs and volatility and could even discourage dealers from providing liquidity. In a market, in which there are few buyers and sellers ready and willing to trade continuously, asking for more transparency could lead to even less liquidity as the limited number of liquidity providers would be obliged to make their trading strategies available, giving incentives to trade even less. A total lack of transparency might thus be undesirable to avoid market manipulation or from an investor protection point of view, but full transparency on an illiquid CDS market might dissuade traders even more from trading. The EU’s newly adopted MiFIR Review thus seems to strike an appropriate balance between reducing the level of opaqueness while not harming liquidity.