

A Public Debt Management Perspective on Proposals for Restrictions on Short Selling of Sovereign Debt

by

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New restrictions on short-selling sovereign debt need to be supported by concrete evidence that links systematically unrestricted short-selling activities to fraud, abuse or market manipulation.

OECD debt managers noted that there is plenty of empirical evidence on the benefits of short selling, including more liquidity, pricing efficiency and better allocated risk.

However, solid evidence in the form of empirical data on market instability unambiguously caused by unrestricted short-selling activities (to be counted as 'costs') seems to be lacking. Debt managers also noted that the reporting requirements will be costly from a purely administrative point of view.

A ban on uncovered short selling transactions of sovereign debt would make risk management more difficult and expensive, with detrimental effects on market efficiency, liquidity and funding costs for sovereigns. Moreover, it is unlikely that such bans would have a stabilising effect in government securities markets during a crisis. Rather than containing the crisis, a ban on short selling of government debt is likely to worsen the situation.

The paper concludes that OECD debt managers have a range of tested tools at their disposal for dealing with temporary or chronic dysfunctional measures in sovereign debt markets, ranging from 'quantity measures', such as openings, to 'pricing measures' such as dynamic fails charges.

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I. Background

Some financial regulations might have possible unintended side-effects

Governments, international organisations and international or regional bodies have responded to the recent global crisis and its recessionary fall-out by suggesting or proposing the adoption of new financial regulations. Clearly, regulators expect that their implementation will have a beneficial effect on the stability and functioning of financial markets. However, several analysts, market participants and, indeed, several financial policy makers such as debt managers, have raised concerns that some financial regulations might have possible unintended side-effects. More specifically, it has been noted that some of these proposals might have a (potential) adverse impact on public debt management (PDM) operations and/or the functioning of government bond markets.

This non-paper focuses on the (potential) adverse impact of proposals for regulating the short selling of sovereign debt

During the annual meeting of the OECD Working Party on Government Debt Management (WPDM), held on 4-5 October 2010 in Paris, several debt managers expressed their unease about the (potentially) adverse impact of new financial market regulations for PDM and the functioning of government securities markets. Accordingly, this non-paper, representing these concerns, focuses on the (potential) adverse impact of proposals for regulating the short selling of sovereign debt from a public debt management perspective. The paper benefitted from comments on a previous draft by delegates to the OECD WPDM.

II. General framework: benefits and costs of new restrictions on short-selling sovereign debt

In the literature, *short selling* (also known as *shorting* or *going short*) is described as the practice of selling assets, usually securities, that have been borrowed from a third party (usually a broker) with the intention of buying identical assets back at a later date to return to the lender.

Short selling provides the market with important benefits

Short selling provides the market with important benefits, including supporting market liquidity, pricing efficiency and enabling more effective risk management. The latter benefit is quite crucial for the better functioning of both primary markets (such as auctions) and secondary markets (such as trading and market making in sovereign paper) by providing an important tool to hedge the risk of a long position in the same security or in a related security.

Proposals have been submitted or adopted by regulators in various jurisdictions to place restrictions on short-selling operations, in particular 'abusive' or 'illegitimate' forms of short-selling. For example, The US SEC adopted recently a so-called 'alternative uptick rule' ... "to address situations when a particular security is most vulnerable to manipulative short selling..."¹. Please note, though, that this new short sale rule (Regulation SHO) does *not* apply to Treasury securities.

New restrictions need to be subjected to cost-benefit analysis

All new restrictions, including possible short-selling restrictions on government securities, need to be subjected to the discipline of a rigorous cost-benefit analysis (CBA). The consistent use of CBAs would identify in principle the range of consequences of new regulations — both good and bad.

OECD jurisdictions already have general regulations in place that target abuse and manipulation

Benefits of new financial regulations are usually presented as possible actions that would eliminate existing or potential threats to the integrity of markets such as fraud or manipulation or abuse situations where selling pressures spurred by fear and uncertainty may, in turn, contribute to mispricing and destabilise markets. Unfortunately, by themselves, these considerations are of a general nature and cannot be used for singling out short selling as being ‘the’ cause of market abuse or manipulations; fraud and market manipulation are not concerns peculiar to short selling. Moreover, OECD jurisdictions already have general regulations in place that target abuse and manipulation.

Plenty of empirical evidence on the benefits of short selling

Working Party delegates noted that there is plenty of empirical evidence on the benefits of short selling. Short-selling can improve the functioning of markets by creating more liquidity, pricing efficiency and better allocated risk. Short selling can bolster buying by allowing investors that go long to hedge their positions, while it can also promote market participation by leading to improved price discovery. Moreover, short selling can foster investor confidence, as investors can be confident that securities prices reflect both optimistic and contrarian views. Indeed, short-selling can limit upward market manipulations.

Reporting, implementation and compliance will be costly

However, solid evidence in the form of empirical data on market instability unambiguously caused by unrestricted short-selling activities (to be counted as ‘costs’) seems to be lacking. Debt managers also noted that the reporting requirements will be costly from a purely administrative point of view. Implementation costs and compliance costs of primary dealers, other broker-dealers and trading centres are likely to be significant and need to be incorporated in a CBA.

Restrictions on uncovered short selling will be detrimental to market functioning, in particular market liquidity

Restrictions on uncovered short selling will be detrimental to market functioning, in particular market liquidity. The diversity and depth of liquidity would fall when (some) investors would start to withdraw from the sovereign debt market in the face of actual or potential restrictions or regulations, including public disclosure of short positions. They will also increase the costs of risk management by preventing investors and primary dealers from using modern and efficient hedging techniques in both primary and secondary markets. Short selling is important to maintain liquidity in secondary markets. In addition, the ability to short a security ahead of upcoming issuance of government bonds is important for the well-functioning of the auction process². Reducing access to these tools for risk management will make markets less stable, not more, while borrowing costs are likely to increase.

Ability to short a security is important for a smooth auction process

We are faced with a situation in which the tangible costs of new restrictions need be weighed against the uncertain and largely unsubstantiated benefits of their implementation and enforcement. In terms of the economic/financial criteria, many debt managers consider the case against

Tangible costs of new restrictions need be weighed against the uncertain benefits of their implementation and enforcement

short selling as not proven. Although proof may not be easy to obtain, it is indispensable as a reasonable basis for concluding that the claimed benefits of new legislation justify the costs of their introduction. The absence of hard evidence makes restrictions on short-selling sovereign debt unacceptable as a basis for new legislation because they may lead to higher borrowing costs for sovereigns.

In sum, these considerations support the notion that new restrictions on short-selling sovereign debt need to be supported by concrete evidence that links systematically unrestricted short-selling activities to fraud, abuse or market manipulation. Moreover, solid empirical evidence needs to be put on the table that these costs of short-selling outweigh the above, widely acknowledged, benefits of short-selling.

III. Are there compelling reasons for treating sovereign debt differently from equity instruments or fixed-income instruments issued by financial institutions?

Much discussion on short-selling restrictions has been focused on equity instruments

Much discussion on short-selling restrictions has been focused on equity instruments. Indeed, during the global financial crisis, restrictions on short selling focused on the shares of financial institutions. A widely expressed concern was that share prices are relatively easy to manipulate through short selling operations, in particular in the case of smaller companies with limited amounts of equity outstanding and where, as a consequence, turnover (liquidity) is low.

But governments bonds are very different from equities, making concerns about manipulative short selling of public debt appear to be much less relevant or compelling

It is difficult to see how a similar concern can be linked to the short-selling of sovereign debt. On the contrary, governments bonds are very different from equities in the sense that bonds³ do not represent a single instrument but a set of different instruments⁴. Given the sheer size and diversity of the sovereign bond markets, OECD debt managers are unlikely to face a situation where acute concerns over the possible adverse impact of short selling arise⁵. This implies that, as a *prima facie* conclusion, concerns about manipulative short selling of public debt appear to be much less relevant or compelling than in the case of shares. Concerns have also been expressed that short selling of sovereign debts can create systemic risks and that, therefore, restrictions are urgently called for. For the sake of argument, we will assume that this reasoning represents a legitimate concern and that, indeed, a short-selling ban is effective in addressing this concern. But in that case a similar type of argument is even more compelling for fixed-income instruments issued by financial institutions. After all, as noted, regulators imposed restrictions on the short selling of shares of financial institutions during the global financial crisis. Indeed, an important feature of the propagation of financial market pressures during the crisis was in the form of a *de facto* run on the market for funding instruments of financial institutions. Against this backdrop (and assuming, again for the sake of argument, that bans on short selling are effective in achieving their stated objectives), it would seem more compelling to focus on debt instruments issued by financial institutions, while the case for restrictions on short-selling sovereign debt is much less obvious.

IV. The adverse impact on the use of legitimate tools for risk management

Concerns about a negative impact of a ban on uncovered short selling on legitimate risk management

Concerns have been raised about the impact of a ban on uncovered short selling on legitimate risk management practices since routine hedging operations would become impossible or much less straightforward to execute. Clearly, this would have a detrimental impact on sovereign debt markets as it would reduce the ability to short bonds (or futures) for risk management purposes. For example, a short-selling ban would reduce the attractiveness (or perhaps make it impossible) of using bond futures to hedge long positions in sovereign bonds⁶.

In general, any restriction on the use of bond futures would impair the liquidity of bond markets and increase sovereign borrowing costs

A ban on uncovered short selling transactions would make risk management for the primary and trader community more difficult and expensive, with detrimental effects on market efficiency and funding costs for sovereigns. Similarly, it would constrain investors from using futures contracts to take a position on the basis of a particular view on the future development of interest rates. Eliminating such investors from the market will be harmful to the liquidity of the futures markets. Also this market impact will raise funding costs for borrowers as investors will require higher risk premiums. More in general, any restriction on the use of bond futures would impair the liquidity of bond markets and increase sovereign borrowing costs.

V. Are bans on short selling of government debt effective in exceptional situations?

Rather than containing a crisis, a ban on short selling of government debt is likely to worsen the situation

Regulators have at times also considered bans on short selling of government debt as a response to major threats to financial stability or market confidence. Debt managers have noted that it is unlikely that such measures would have a stabilising effect in government securities markets during a crisis. On the contrary, such a signal would trigger massive sell-offs (or similar hedging actions) from investors that initially have long positions in the instrument covered by the ban. Rather than containing the crisis, a ban on short selling of government debt is likely to worsen the situation.

A focus on short sellers as agents of financial market turmoil seems not appropriate

Bans on short selling seem to be based on the notion that short sellers are the primary agents moving market prices at a time of crisis. However, this is normally *not* the case. The key feature of crises is usually that investors that hold instruments have lost confidence and want out. To arrest downward price swings in such a highly volatile environment would necessitate halting trading altogether, analogous to the circuit breakers that are used in stock markets. A circuit breaker approach may be effective in the case of equity markets but it is often not feasible in fixed-income markets where trading typically is much more fragmented. In any case, a focus on short sellers as agents of financial market turmoil seems not appropriate, making it unlikely that short selling bans in government securities markets will be effective.

VI. The interest of DMOs in well-functioning public debt markets

Debt managers often play a key role in securing liquid markets

DMOs have a great interest in continuous, well-functioning public debt markets as this feature is an important contributing factor in minimising sovereign borrowing costs. Debt managers often play a key role in securing liquid markets, characterised by a high degree of market integrity and trust⁷. For example, a recent survey by the OECD WPDM shows that several DMOs were involved in addressing the malfunctioning (of some segments) of the government securities markets during the 2008-09 global financial crisis⁸.

DMOs have different, tested tools at their disposal for alleviating market stress or reducing market dysfunction

In this context, it is important to note that DMOs have different tools at their disposal for alleviating market stress or reducing market dysfunction. On various occasions the WPDM has discussed policy measures to address situations where the good-functioning and integrity of markets are being threatened. For example, in 2003 the WPDM discussed experiences with anti-squeeze⁹ measures¹⁰. Re-openings are the most frequently used tool to alleviate squeezes¹¹, followed by the use of a securities lending facility. Policies for lending securities to alleviate shortages were discussed in 2006¹². The major reasons for developing a lending securities facility are to provide liquidity (44 %) and to reduce/cover squeezes or prevent settlement failures (20 %). Other reasons are to smooth settlements, to enable Primary Dealers to meet their market-making commitments and to lend for reasons other than for the sake of addressing market liquidity.

A recent measure concerns the mitigation of the extraordinary volume of chronic settlement fails in the market for U.S. Treasury securities

A recent measure to deal with market dysfunctions concerns the mitigation of the extraordinary volume of chronic settlement fails in the market for U.S. Treasury securities. In order to deal with 'uncovered' short sales of US Treasuries, which presumably would result in fails to deliver, in May 2009 market participants (in co-operation with the U.S. authorities) adopted a 300 basis point "fails charge" which penalises delivery failures. This 'dynamic fails charge' has cleaned up the chronic fails situation that the U.S. Treasury was witnessing in 4Q08 (in the wake of the insolvency of Lehman¹³).

In sum, OECD debt managers (and other financial authorities) have a range of tested tools at their disposal for dealing with temporary or chronic dysfunctions in sovereign debt markets, ranging from 'quantity measures', such as re-openings, to 'pricing measures' such as dynamic fails charges.

Notes

1. Opening Remarks Regarding Short Sale Price Restrictions by Commissioner Elissa B. Walter of the U.S. Securities and Exchange Commission, 24 February 2010.
2. DMOs often observe dealers in a short position ahead of a security being auctioned.
3. Including corporate bonds.
4. Differentiated by maturity, coupon and indexation characteristics.
5. Moreover, DMOs have tools at their disposal for alleviating market stress or reducing market dysfunctions (see section VI).
6. For example, within the EU, the German Bund futures market is very popular for risk management operations because of its depth and liquidity. Its use in hedging operations is driven by the notion that its attractive transaction costs (and risks) more than offset the fact that rates from German and other markets are imperfectly correlated. However, a short-selling ban would make it harder (or impossible) to use this market for risk management purposes.
7. Integrity is an essential condition for market trust. Market integrity is a key feature of well-functioning sovereign debt markets and, therefore, the minimisation of borrowing costs.
8. See OECD Survey on Objectives of Government Debt (and Cash) Management, 2010.
9. Squeezes are market manipulation strategies implemented by traders to generate high profits. In essence, individuals and financial companies attempt to generate high returns from acquiring and exercising market power as part of trading strategies in government securities. Squeezes severely distort prices and hamper price discovery.
10. Anti-squeeze measures were discussed during the annual meeting of the OECD WPDM, held on 23-24 October 2003. The discussion was supported by a WPDM Survey among OECD countries. The responses showed that in the period 2000-2003, out of 24 countries, 3 had experienced more than five squeezes, 11 between one and five squeezes, while 8 had not experienced any squeeze. Two countries had to address market dislocations but it was unclear whether this was due to a squeeze.
11. The most widespread way to address illiquidity in the secondary market is by using re-openings. However, some DMOs are reluctant to institutionalise re-openings as these operations are uncertain by nature which would make them run counter to the objective of 'regular and predictable issuance'.
12. Responses to the WPDM Survey (discussed on 30-31 October 2006) showed that around 80% of the respondents have a securities lending facility. Ninety per cent of respondents limit participation to Primary Dealers.
13. In the wake of Lehman's insolvency, there was a rising tide of settlement fails, involving U.S. Treasury securities across the entire yield curve. The U.S. authorities' response was, first, to relax the terms of the Federal Reserve securities lending programme, followed by re-openings by the U.S. DMO. However, in spite of these measures, market participants noted that the Treasury market remained impaired and the repo market was not functioning. For these reasons, the Treasury Market Practices Group introduced a 'dynamic fails charge' for Treasury securities in May 2009.