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Additional Information

Level 1 Regulation
Short Selling Regulation (SSR) Regulation (EU) No 236/2012

Topic
Uncovered short sales

Subject Matter
Uncovered Credit Default Swap - Differences in durations of the sovereign CDS position and the hedged exposure

Question
Is it legitimate for an investor to hedge a risk through a CDS position which is either longer or shorter in duration than the term of the asset/liability being hedged? As examples, could a 12 year sovereign bond be hedged by 5 year sovereign CDS contract which was then rolled until the maturity date for the bond or a 2 year bond be hedged with a 5 year sovereign CDS

contract?

ESMA Answer

29-01-2013

Original language

[ESMA70-145-408 SSR Q&A, Q&A 11.3]

Article 19(3) of the DR states that the duration of the sovereign CDS position is aligned as closely as practicable given market conventions and liquidity with the duration of the exposures being hedged or the period during which the person intends to hold the exposure. ESMA recognises that the term of liquid sovereign CDS contracts may not be aligned with the term of the hedged exposure. Differences in duration (to be understood as meaning length of time) would therefore be permitted subject to the overriding condition that the person’s sovereign CDS position should never be uncovered as defined in the DR. Hence it would be legitimate to purchase a 5 year sovereign CDS to hedge a 12 year sovereign bond and 'roll' the contract every quarter while the position was held. It would also be legitimate to use a 5 year sovereign CDS position to hedge a holding of a 2 year sovereign bond provided that, on maturity of the bond, it was either replaced by an equivalent exposure or the CDS position was reduced or otherwise disposed of as required.