

## EU Sovereign Bonds: Borrow Costs and CDS Spreads

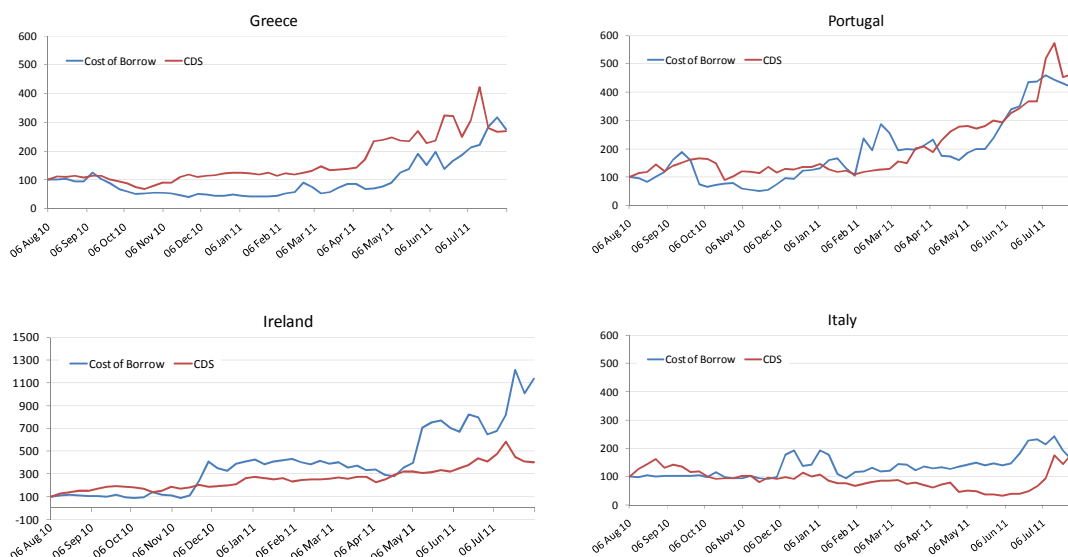
### Headlines:

- **The cost of borrowing EU Sovereign bonds has been rising across the member states.**
- **Bond borrowing costs show similar trends to CDS spreads – sometimes the CDS changes happen first, sometimes borrow costs take the lead.**
- **Both measures are subject to various distortions; in combination they provide a more robust measure of the pricing of default risk.**

The fixed interest securities lending market has more than \$6trn in lendable inventory. Government bonds from the major economies are widely used as collateral in repo transactions, which allows holders to borrow cash at the lowest possible rate<sup>1</sup>.

Bond loans which are not collateralized by cash are less common; they often form part of an arbitrage (between two similar bonds) or a hedge (for example, shorting the government curve component of a corporate bond to create a pure long exposure to credit spreads). The cost of such ‘non-cash’ bond borrowing is usually stable, and low. Where there are exceptions, they have typically been in High Yield bonds, or Government Bonds issued by smaller and fiscally vulnerable countries.

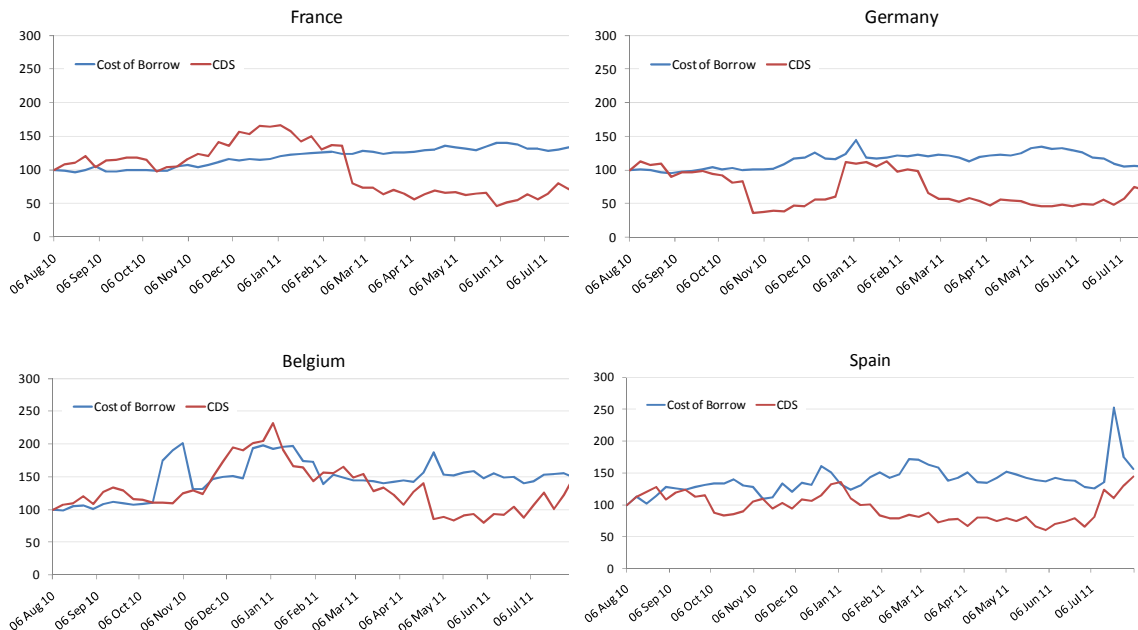
In recent months, however, the cost of non-cash borrowing of the bonds of a number of G20 member Government bonds has been rising. In particular, EU member states have seen a broad rising trend for a number of months. The following charts show the non-cash collateral borrow cost and the CDS spread\* (both indexed to 100) for Greece, Portugal, Ireland and Italy.



These show steep rises in Greece, Portugal and Ireland. Italy has also risen, but not on the same scale. Italian borrow costs began to drop in early July although the CDS spread continued to rise.

<sup>1</sup> Loans of bonds made in exchange for cash are usually reported as negative borrow costs – i.e. the lender is paying the borrower a repo rate in order to raise cash. This can be a useful data point in assessing the appetite for cash in individual country money markets.

The following charts show the same information for France, Germany, Belgium and Spain. These may look broadly flat, but France and Belgium have actually risen by around 40%, while Spain has shown a recent and short lived spike, which resulted in a 150% increase in bond borrowing costs. These charts show that the demand to borrow bonds for shorting has increased far less in the bond markets of the more solvent countries.



It is worth noting that the most recent moves in borrow costs in Spain and Italy have been lower; presaging the recent efforts of the ECB to manage a reduction in bond yields in these countries.

It is also noticeable that CDS spreads tend to be more volatile than bond borrow costs in the low CDS ('low risk') markets; while borrow costs tend to be more volatile in the high CDS ('high risk') markets; the relative volatility of the two series may itself be a risk indicator. For most of these markets, combined measures show lower volatility than the individual series.

More generally, these charts suggest that non-cash borrow costs are a useful data point in times of crisis, and are complementary to CDS spreads.<sup>2</sup>

**\*CDS Source: Factset**

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<sup>2</sup> Furthermore, it is a data point which is available even if there are no quoted CDS spreads for a particular name. They are also bond-specific, rather than issuer-specific; so unlike CDS they will explicitly capture the balance of supply and demand for borrowing specific bonds.