DISCUSSION: "Should Short Selling of Financial Firm Stocks be Restricted during a Financial Crisis?" by I. Hasan, N. Massoud, A. Saunders, and K. Song

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Summary

- Question investigated: Was short-selling activity during recent financial crisis abusive?
- Important analysis because short selling is seen as beneficial for price finding mechanism;
- Authors conduct three tests to investigate:
  1. short-selling activities prior to ban;
  2. if shortsellers differenciated between firms' riskiness using measures for subprime exposure;
  3. if shortsellers differenciated between firms' riskiness using CDS spreads.
- Authors find evidence that short-selling of financial firms' stocks during financial crisis was neither abusive nor manipulative.

Paper's Strengths

- Convinving paper investigating a controversial issue;
- Analysis highly relevant for regulators and supervisors;
- Wide range of models and time windows investigated provides for robust analysis;
- Convincing results, in line with theory and other research.

Short Selling

- Short selling is selling assets that are not currently owned with the aim to repurchase them later at a lower price;
- Argument for short selling bans: short sales can drive stock prices below fundamental values, potentially amplifying volatility and systemic risk during market turmoils;
- Argument for short selling: better price discovery mechanism because higher market liquidity, smaller spreads, prevention of bubbles and early detection of fraud (Enron), bans ineffective.

Potential Points to Address: CDS Implied Insolvency Risk

- Using CDS as alternative company risk measure potentially problematic;
- during period of market turmoil, in particular in face of government guarantees (implicit and explicit), CDS spreads might not provide good risk measure (cp. **Schweikhard and Tsesmelidakis, 2012**);
- if CDS underreport default risk of financial institutions which are too-big-to-fail, test results can be misleading.

Potential Points to Address: Interaction Effect

- Use explanatory interaction effect between bank dummy and tier 1 capital ratio to investigate effect of banks' (regulatory) riskiness measure on short selling,
- Use of dummy variables without including all constitutive terms usually leads to wrong inference (Brambor, Clark, Golder 2005),
- presumably authors use interaction effect because no equivalent ratios for non-banks available (but: e.g. solvency ratio for insurance companies),
- counterintuitively, when interaction term significant (e.g. Table V, Panels B and C) indicates higher capitalisation in banks leads to more short selling.

Potential Points to Address: Miscellaneous

- Non-negative dependent variable in OLS regressions==¿ use Tobit model
- Paper should be self-contained (e.g. upon first reading unclear what (-10, 10) window means

Conclusion

- Paper provides additional evidence that short sale bans are to be taken with care;
- Highly relevant for supervisors and regulators;
- CDS bans currently discussed in Europe.

Literature

- Brambor;
- Tsesmelidakis Schweikhard

Relative CDS Price Deviations[1]