Credit Default Swaps Explained

By Dirk van Dijk, CFA

At this point, it makes sense to explain just what a credit default swap, or CDS, is. They were the key reason for the demise of **AIG** (NYSE: AIG - News), and for the fear that if they were not bailed out that the whole ball of wax would come unglued. Essentially it is an insurance policy, but an unregulated one (the State of N.Y. just recently said that it would start to regulate part of the market -- can you say closing the barn door?).

If you buy a bond from, say, **General Motors** (NYSE: GM - News), you are lending them money for a set interest rate for a specified length of time. You face two sets of risks in doing so. The first is that they go bankrupt and don't pay you back. The second is that interest rates rise and the bond falls in value (think of bond prices and interest rates as being on opposite sides of a see-saw).

With a CDS, you could go out and find someone who will insure against the default risk. For a given premium, the seller of the CDS will pay off on the GM bond if GM goes belly up. Now, if it was from a real insurance company, the insurance company would be regulated and would have to hold enough money in reserve to pay you off in case GM actually did go belly up. This is just like how a Life Insurance company has to have enough cash on had to pay off on your policy in case you die.

However, since this is an unregulated market, someone can sell you a CDS and blow the money in Las Vegas. In that case, if GM did go belly up, you would just plain be out of luck.

In the case of life insurance, there are strict limits on who can take out a policy on you. You can take out a policy on your own life, and on close family members. In some circumstances you can take out a policy on your business partner, but beyond that there are not many people you can take out a policy on. You have to have what is called an insurable interest; you can't just wander the halls of the hospital looking for people who are unlikely to make it and take out life insurance policies on them.

This is not true for the CDS market. You are perfectly free to take out a 'life insurance policy' on GM, **GE** (NYSE: GE - News) or any other firm that issues a bond, and you do not have to be holding the bond. You can even take out a 'life insurance policy' on the synthetic garbage the Wall Street has been pumping out.

This ability to buy insurance on things that you have no insurable interest in transformed this market into a huge casino. It is totally unregulated, and even the new steps by the New York State Insurance Commissioner, Eric Dinnallo, only covers the least egregious part of the market, where people actually have an insurable interest (i.e. hold the underlying bond). Regulation of this market was specifically prohibited under the Commodity Futures Modernization Act of 2001. That provision was slipped into the bill in the dead of night by our old friend Senator Phil Gramm of Texas -- now Vice Chairman of **UBS** (NYSE: UBS - News).

People use this market to bet on the credit worthiness of companies, and often hedge funds will hold both long and short positions on the same underlying credit. For example (NOTE: figures are made up here, not a reflection of the actual creditworthiness of GE), the hedge fund might make a bet that it is worthwhile to get $200,000 up front and be on the hook for $10 million if GE defaults sometime in the next five years. Then after a few months, GE raises a bunch of capital which significantly strengthens its balance sheet and lowers the risk of default, so it can make a bet with someone else who would now be willing to take just $100,000 to bet that GE will not go belly up within then next five years. The hedge fund could have a perfectly matched book, so in theory they were totally indifferent if GE survives or not.

However, suppose that the person who they made the bet with goes bankrupt themselves and can't pay up. That hedge fund might then have a hard time paying its counter party. This is where the fear of 'cascading cross defaults' comes in.

All this is to say that the CDS market has seen more growth than practically any market in the history of mankind. It is currently at over $62 TRILLION, up from under $1 Trillion a decade ago. It would not take a very big percentage of that market to fail to leave a very big mark on the world financial system. When the dust settles from all the current mess, bringing this market under control has to be high on the agenda.

I would suggest that the contracts be standardized and that they be traded on an exchange, where the exchange itself acts as the counter-party for each trade (this is how the commodity exchanges work). It might also make sense to require that any party buying a CDS have an insurable interest in the underlying bond (i.e. that they are using it to hedge, not speculate).

This however, is work for the next Congress and Administration. First we have to put out the fire with a well crafted and responsible bailout bill to prevent these cascading cross defaults from occurring. The original Paulson proposal was not well crafted, yet Congress doesn't appear likely to make significant improvements to the bill.