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Bachelorthesis

Credit Default Swaps: A Review of Fundamentals and Systemic Risks

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Executive Summary

Credit derivatives - notably credit default swaps - played a significant role in the current credit and financial crisis affecting globally financial markets and real economies. The scope of this paper covers the key features of credit default swaps, how they work, examines their purpose, which default settlement possibilities the market uses, and what measures have been undertaken to enhance the stability of the credit derivatives market in order to assure a better functioning of financial markets.

Initially credit default swaps were created in response to a demand by financial institutions, mainly banks or insurance companies, for a means of hedging and diversifying credit risks. Over time CDS also became used for speculation and position taking on market views. Even though these speculative activities are often criticized for being too risky and creating the wrong incentives, they do have an economic value, namely they add liquidity to the market. An also often mentioned concern about the CDS market is that most of the swaps are traded on largely unregulated over-the-counter (OTC) markets in the form of bilateral agreements, facilitating speculation on a reference entity (even on an uncovered basis), which involves mainly counterparty and systemic risks. The reason is that the CDS market focuses on customized and tailor-made contracts for investors specific needs and this is why most of the contracts are still traded OTC. Even though measures of contract standardization can reduce the counterparty and systemic risk, indeed they might also take away liquidity from the market.

Another purpose of this paper is to explore how the development of the CDS market has influenced credit risk markets. The growth of the CDS market literally exploded during the years prior to the crash of the US real estate market which led to massive write-offs on balance sheets through different credit derivatives. In 2009, important changes took place with the implementation of the CDS Big Bang Protocol and the introduction of new trading conventions. This helped to achieve the elimination of offsetting trades (trade compression & netting), and introduced same day trade matching and centralized clearing.

After describing credit default swaps in detail, this paper will turn to the reasons of the current financial crisis and what went wrong to bring two of the largest US companies, AIG and Lehman Brothers, into financial distress, thus creating large uncertainties in financial markets.

Finally this paper concludes that CDS are not evil instruments as some people might believe, on the contrary they play a valuable part, because of the ability for credit risks to be transferred to investors better suited to bear a specified risk, and because of additional information about views and creditworthiness of reference entities to financial markets. However, to achieve this, the risks of trading CDS (mainly liquidity, counterparty & systemic risk) need to be minimized. In this regard, government regulations imposing stricter collateral requirements and higher equity capital for CDS traders need to be introduced along with the already implemented measures of same day trade matching, centralized clearing and trade compression.