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TRADING GROUP UBC

Market Concepts

CREDIT DEFAULT SWAPS

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Suppose an investor buys corporate bonds but fears that the company could default or suddenly refuse to make previously agreed-upon interest payments. In order to offset his risk of purchasing the bonds, he can engage in a contract with a third party by buying a credit default swap (CDS) from them.

In this type of agreement, the investor then has to make regular payments to the seller of the CDS until the termination date. In exchange, the seller of the CDS is obligated to pay him the principal, as well as all outstanding interest payments that the investor of the bond would have collected until the maturity date. It is called a credit default swap because the investor of a credit security, in this example the owner of corporate bonds, can "swap" their risk of default of the debt issuer with another party in exchange for paying a regular fee.

CDSs are the most well-known type of credit derivatives, meaning they derive their value from an underlying debt security, for example municipal bonds or mortgage backed securities. While their main purpose was to offset an investor's risk of default or credit events, their most common application has been as an instrument of speculation.

Sellers of CDSs assume that there will likely not be a credit event (such as bankruptcy or downgrade) and will profit from the fees paid to them. The buyer of a CDS makes a bet that the debt issuer will be subject to a credit event and hopes to collect the principal and overdue interest. In contrast to our previous example, the buyer does not actually have to own the underlying security, such as the corporate bond.

The speculative nature of credit default swaps was a central mechanism in the famous book and film "The Big Short: inside the doomsday machine".