CREDIT DEFAULT SWAPS

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A Credit Default Swap (CDS) is a contract in which a buyer pays a payment to a seller to take on the credit risk of a third party.

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In exchange, the buyer receives the right to a payoff from the seller if the third party goes into default or on the occurrence of a specific credit event named in the contract (such as bankruptcy or restructuring).

To give an example…

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- **Say there is a person A who lends Rs. 1000 to person B on Monday. Person B promises to pay him back on Friday. But there is a possibility that person B may default in paying back person A in the event of a bankruptcy etc.**
- **Therefore, person A gets into a contract with a person C to take over the credit risk of this transaction, *in case person B defaults*.**
- **According to the contract, person A pays a one-time premium of Rs. 100 to person C.**

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Now, imagine two situations…

- **Situation A: Person B pays back Rs. 1000 to person A. Since person B has not defaulted, the transaction ends between persons A & B, and also between persons A & C.**

- **Situation B: Person B defaults in his payment to person A. Now, according to the contract between persons A & C, It becomes the obligation of person C to pay back Rs. 1000 to person A.**

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Diagrammatically explaining…

Person B (Borrows Money from A)

Person A (lends money to B

& enters into a contract with C)

Person C

(takes on the credit risk of B)

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Therefore…

- **This contract, which:**

  - **Transfers the ‘credit’ risk from one person to another**
  - **Is exercised when one party ‘defaults’ in its payment**
  - **Consists of a ‘swap’ of a buyer and a seller (in our example,**
  - **person A is a seller to person B and a buyer to person C)**

is called a Credit Default Swap.

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Now…

- **One party of the CDS contract is called the protection buyer while the other party is called the protection seller.**
- **Protection Buyers are mostly banks and financial institutions but Protection Sellers could be anybody with an appetite for risk, such as hedge funds and insurers in the US.**
- **In all CDS contracts, a protection buyer transfers his Credit Risk of a third party transaction to a protection seller.**

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So what is Credit Risk?

- Credit risk is the risk involved in all transactions of borrowing and lending. If you lend money, what are the chances that the borrower will make the repayment?

- In case the borrower is likely to promptly return the money, then you have a low credit risk, and in case there is a high probability of default then you have a high credit risk.

- So each borrowing and lending has its own element of risk involved.

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So…

- **A credit default swap resembles an insurance policy. You pay the premium and the insurance company undertakes to make good your loss.**

- **So, everything depends on the happening of the credit event. If no default occurs then the protection seller would not make any payment.**

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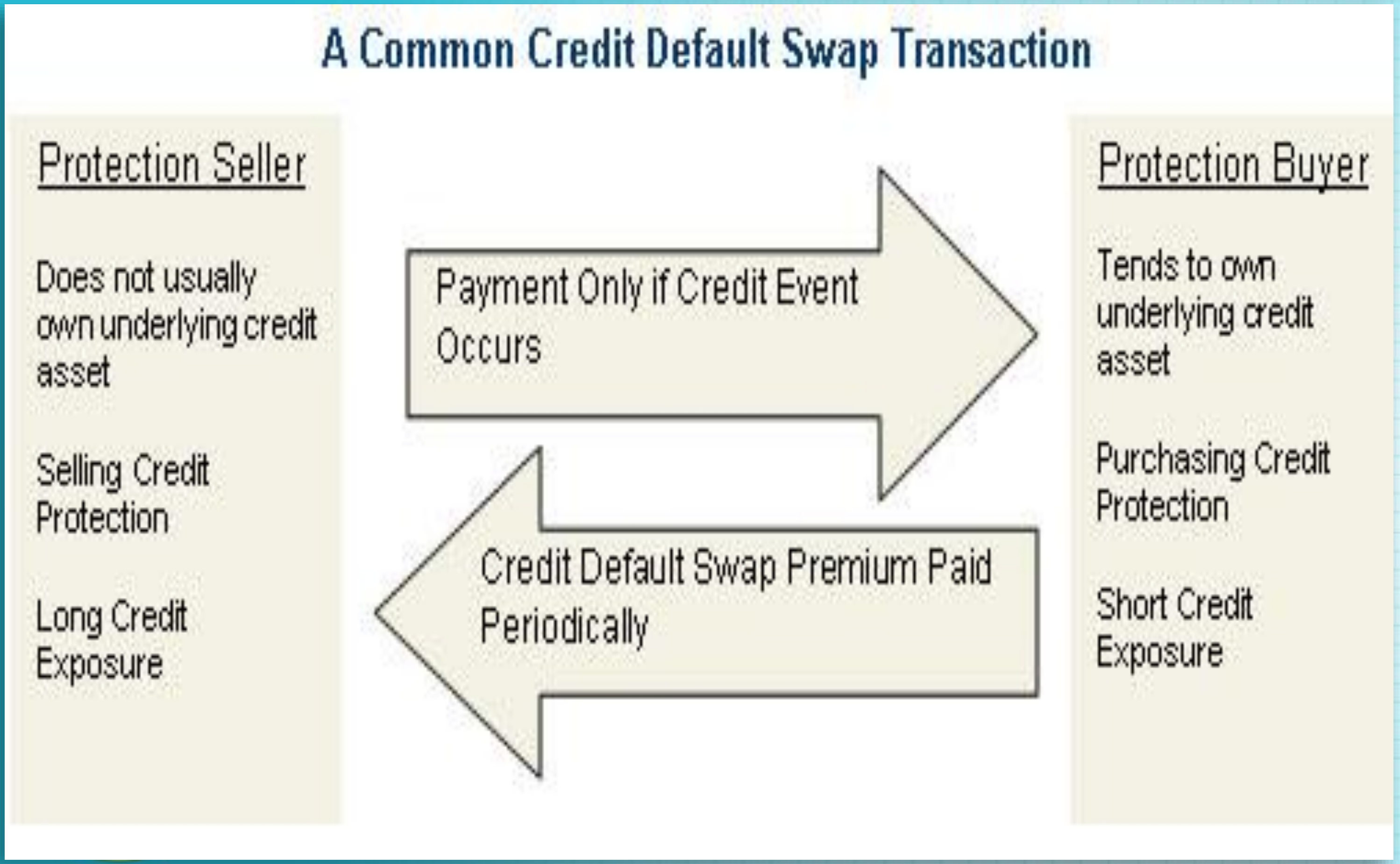
Here's another diagram…



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Also…

- **Like any other Over The Counter (OTC) derivatives contract, CDS contracts are negotiated directly between the two parties.**

- **But most of these contracts follow the standard terms and conditions of the International Swaps and Derivatives Association (Isda), which makes them look like a standardized product.**

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To Sum Up

- A Credit Default Swap (CDS) is a credit derivative contract between two counterparties, whereby the "buyer" pays periodic payments to the "seller" in exchange for the right to a payoff if there is a default or credit event in respect of a third party.
- They typically apply to municipal bonds, corporate debt and mortgage securities and are sold by banks, hedge funds and others.
- Like most financial derivatives, credit default swaps can be used to hedge existing exposures to credit risk, or to speculate on changes in credit spreads.

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Hope you have now understood the concept of Credit Default Swaps

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