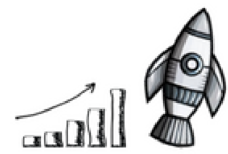

Credit Default Swap (CDS)

A Credit Default Swap (CDS) is a financial instrument that allows investors to protect themselves against the risk of default on a particular debt. CDSs were regularly discussed during the 2008 financial crisis, with many swaps hitting new highs amid uncertainty surrounding the banking and insurance industries. This article, written by Reuters in September of 2008, gives a glimpse into all the unfolding events and CDS's role in that.

CDSs can be used to hedge against default risk in a portfolio or to speculate on the creditworthiness of a specific debt issue. In a CDS, a buyer of the swap pays a premium to the seller. In exchange, the seller agrees to pay the buyer of the swap if a specific debt instrument falls into default. In essence, the buyer bets that the seller will go bankrupt and is purchasing insurance if that outcome transpires. As events unfold and the default outcome becomes more likely the CDS's premium (cost) will rise.

CDSs have been back in the news lately, with bank runs forcing a few banks like Signature Bank and Silicon Valley Bank to close altogether, and other banks sell themselves (Credit Suisse). As fears run through the markets, Credit Default Swaps have begun to spike for other banks that investors believe face default risk in the not-too-distant future. Below is a chart from Reuters that shows how much CDS have gone up in the last few months with contagion fears making their way through the financial sector. As with any investment, it is important to understand the risks and potential benefits of buying CDS and consult with a financial advisor before making any investment decisions.