SIFMA
Securities Industry and Financial Markets Association

Frequently Asked Questions About CDS

Did CDS cause the credit crisis?

No. While the origins of the financial crisis will be examined and discussed for years to come, it seems apparent that the principal causes of the crisis were a historic collapse in real estate prices combined with soaring rates of mortgage delinquency and default in the sub-prime real estate sector. These events were magnified by a number of factors, including, on the supply side, use of leverage, weak risk management practices and lax mortgage origination practices, and, on the demand side, by investor demand (in the prevailing low interest rate environment) for higher yielding, higher risk investment opportunities.

A small segment of the CDS market involves CDS written on asset-backed securities that were linked to the sub-prime real estate sector on a highly leveraged basis. These CDS magnified the effect and concentrated the risk of defaulting sub-prime housing loans, resulting in large losses among market participants in this sector, most notably AIG and monoline insurance companies, that had written protection on these asset-backed securities.

However, it is also clear that the widely publicized losses of these participants were attributable to weak risk management practices, ineffective or no oversight and, most significantly, the failure of these institutions to collateralize their commitments as sellers of CDS protection, as is standard practice in the corporate CDS market, rather than to any fundamental flaw with the CDS product or market itself.

How has the CDS market performed during the credit crisis?

While other credit markets (e.g., the bond market) have seized up, the corporate CDS market has continued to perform well and provide much needed liquidity for the transfer of credit risk throughout the current market turmoil, despite the defaults of several extremely significant reference entities (e.g., Lehman Brothers, Fannie Mae, Freddie Mac, Washington Mutual) and the failure of a significant market participant (Lehman Brothers). CDS have performed an important price discovery function in this environment, enabling market participants to impute market values for related credit products for which market prices have not been readily available.

CDS contracts on the many large companies that have defaulted during this recent period were settled in an orderly manner through a voluntary auction process that allowed for the settlement of such trades according to their terms and in keeping with participants' expectations. U.S. bankruptcy and bank insolvency laws designed to manage the fallout from large market participant failures also helped to ensure the orderly settlement of CDS contracts.

Isn't there a lack of transparency in the CDS market?

Regulatory transparency

Regulators currently have full access to information on the CDS positions and exposures of the institutions they regulate (e.g., the Federal Reserve has access to information on all of the activities of the banks and bank holding companies it regulates, including their CDS activities). The proposed central clearinghouse for CDS will further enhance regulatory transparency with respect to position and risk

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concentrations in the CDS market. The industry also supports measures to foster regulatory transparency with respect to all systemically significant participants in the CDS market.

Market transparency

The Depository Trust & Clearing Corporation currently publishes weekly on its website the outstanding gross and net notional values of CDS contracts on the 1,000 most commonly traded corporate reference entities.

In addition, all CDS market participants have access to the bids and offers of leading CDS dealers, both directly, through screens distributed by the major dealers, and indirectly through the several inter-dealer brokers that consolidate and distribute CDS quotation data.

What is the size of the CDS market?

Although The Depository Trust & Clearing Corporation has recently estimated the "notional" amount of outstanding CDS in its Information Warehouse at approximately [$33] trillion, for a variety of reasons that number vastly overstates the actual amount of risk and actual dollar payments that are associated with such positions.

By way of example, although the total "notional" amount of CDS on Lehman Brothers was roughly $400 billion, only about 1% of that total (a little over $5 billion) was actually exchanged between counterparties to settle the market-wide gains and losses associated with those positions.

What is "naked" CDS trading? Is it gambling? Should it be permitted?

Although many CDS are used to hedge credit exposure, like all capital markets products, including stocks, bonds, options and futures, CDS may also be used to obtain risk exposure (so-called "naked CDS"). The use of CDS to obtain risk exposure is no different than any other form of investment and trading activity in stocks, bonds, options or futures that is based on market analysis.

All capital markets have, and all efficient markets require, participation both by those hedging risks and those seeking exposure to risk. As in all capital markets, by facilitating the transfer of risk from those who don't want exposure to the risk, to those who do, CDS make efficient markets available to those market participants who need to hedge the credit risks arising from their commercial activities.

Limiting market participation to "hedgers" would create asymmetric trading interest (by those "long" credit risk), which would, in turn, cause the cost of hedging credit risk to increase. As a result, absent participation by non-hedgers, transactional costs for hedgers would be significantly higher. Significantly higher credit risk hedging costs would, in turn, directly impact the availability of, as well as the cost of, financing for companies throughout the U.S. economy, ultimately impacting economic growth and U.S. consumers.

The analysis of market and company fundamentals that is undertaken by participants in the CDS market, similar to that undertaken by investors in capital markets products generally, also enhances price discovery and leads to more efficient pricing of credit risk in the CDS market.

As a result, unlike gambling, which is an end in itself, participation in the CDS market by those seeking to obtain credit exposure produces important social and economic benefits, benefits that directly and positively impact the CDS market and that filter throughout the U.S. economy.

Retail investors may not directly participate in the OTC CDS market.

Are CDS insurance? If not, why?

No, CDS are not insurance. CDS differ from insurance in several ways:

<u>CDS are trading products</u>. Like stocks and bonds, CDS contracts are bought and sold by financial professionals every day to hedge and obtain credit exposures. Insurance contracts, on the other hand, are generally held for their stated terms. (For example, people don't buy hurricane insurance with the intention of selling it at a profit if the likelihood of a storm increases).

<u>CDS do not require an insurable interest</u>. Insurance policies require that the insured have an "insurable interest" in the risk that is covered by the policy. (For example, you can't buy insurance against your neighbor's house burning down.)

Unlike insurance, CDS do not require that buyers of protection have an insurable interest in the underlying debt obligations, or incur any loss as a result of credit events. (For example, you can buy CDS protection against the default of a company, even if you don't own its bonds.). In this respect, CDS are like all other derivatives (listed and unlisted) that do not require the incurrence of a loss as a condition to payment under the derivative instrument. As noted above, the absence of any requirement that a CDS holder incur a loss as a condition to payment is critical to the efficiency of, and the benefits afforded by, the CDS market.

Because CDS do not require an insurable interest, or the incurrence of a loss as a condition to payment, if treated as insurance, they would be prohibited as a result of the very feature that has contributed to the success of this product.

Would there be a conflict of interest if a CDS clearinghouse owned by swap dealers cleared those dealers' trades?

Conflicts of interest arise frequently and must be identified and managed properly. Any conflict of interest related to a central counterparty can be readily addressed through appropriate regulatory oversight and appropriate governance requirements. It is currently anticipated that the dealer participants in the ICE Trust clearinghouse will not have a controlling interest in the governance of the clearinghouse.