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When it Comes to Naming Wall Street's Worst Invention Ever, Credit Default Swaps Continue to Fill the Bill

By Martin Hutchinson
Contributing Editor
Money Morning

When it comes to naming a winner in the competition for "the worst product ever invented by Wall Street," there is quite a list of worthy candidates. With just the current financial crisis alone there are such "inventions" as subprime mortgages, auction rate preferred stock and asset-backed commercial paper, which all have a good claim to this title.

There's also the credit default swap (CDS).

While credit default swaps remain in second place to subprime mortgages in terms of total losses caused, there are plenty of reasons to crown these derivative securities as Wall Street's worst offenders ever.

It won't take me long to make my case. In fact, for "Exhibit A," let's just look at the collapse of U.S. insurance giant American International Group Inc. (AIG).

Misguided Missile

On Monday, the government announced that the already-hard-pressed U.S. taxpayer is being forced to put another $30 billion into AIG, bringing the total rescue package, thus far, to $180 billion.

For those with short memories, by far the largest portion of AIG's losses has come in the $50 trillion credit default swap market, which was instituted only in 1995. Other Wall Street products have caused huge losses, but have spent decades growing before they did so, producing sober profits for many years before blowing up.

[Just yesterday (Tuesday), in fact, U.S. Federal Reserve Chairman Ben S. Bernanke verbally ripped AIG - saying the insurer operated like a hedge fund, while stating that having to rescue the insurer made him "more angry" than any other episode during the financial crisis - because of how its mishandling of credit default swaps led to the company's implosion.]

It is increasingly clear that CDS's have produced profits only for the dealing community, and only for a few years. Even by Wall Street's abominable standards, they thus have a rightful claim to be considered the worst financial "product" ever invented.

Under a credit default swap, if Institutional Investor "A" has a $10 million loan to Megacorp, Institutional Investor "B" can agree to cover the credit in that loan. In other words, if Megacorp defaults, "B" has to cover the debt. But "B" collects a small insurance premium for agreeing to cover the loan - a premium it gets to pocket as income.

Typically, payments under a Megacorp CDS are triggered either by a bankruptcy or by Megacorp failing to pay interest or principal on its debts. Because hedge funds and others gamble with these financial instruments, the problem arises in that the volume of credit default swaps currently outstanding is far greater than the volume of the loans themselves.

The bottom line: The credit risk spawned by the CDS market is much larger than the credit risk of loans on which CDS are written.

It's no longer a question of hedging. It's casino capitalism.

Inside View From an Insider

Back in the early days of the derivatives market, I spent five years running my employer's derivatives desk: It was very simple stuff - mostly small transactions - and while we made money, the trades didn't make either us or our employers rich.

However, we were always on the lookout for something new, because you can make good money on new types of transactions - without taking big risks. Needless to say, we looked at the possibilities of credit derivatives, for which there was an obvious need among the major international banks.

But there were two problems:

- First, there was no obvious way of settling the things - each bankruptcy is unique, and the generally happen gradually, so it was difficult to determine how much to pay and when to pay it.

- And second, the cash flows involved were totally skewed - a small annual payment versus the possibility of a huge payout on bankruptcy - so the amount of credit risk you'd build up between the two sides made the whole business uneconomic if you allocated risk correctly.

By the middle 1990s, the capital markets were so exuberant that dealers didn't bother to solve those problems - they just ignored them. A $50 trillion credit derivatives market means there is $50 trillion of credit exposure on the dealer community, and no amount of collateral arrangements and fancy accounting can eliminate that fact. As for settlement, the dealers came up with an ingenious, but very un-foolproof scheme, whereby a mini-auction of the bankrupt credit would take place, so by buying a million or two in dodgy bonds you could corrupt the pricing of billions in credit default swaps that you held.

There are two other problems with credit default swaps CDS we didn't think of in the 1980s.

First, AIG stayed almost entirely on one side of the CDS market - selling credit protection - because it believed it could do so, book the premiums up-front as income, collect bonuses based on the total premiums each year and never account for the risks on the actual derivative contracts themselves. After all, the swaps were being AAA-rated mortgage backed bonds.

(It would never have occurred to us in the 1980s that we could do this - we weren't sufficiently in control of our auditors!).

From the point of view of AIG, the company, this was extremely stupid, though it had its advantages from the traders' point of view. In the end, of course, it was all of us - the U.S. taxpayers - who were stuck paying the tab for a meal that others got to eat.

However, the second - and most serious - problem with credit default swaps is their potential use by short-sellers to cause bankruptcies.

Short-Sighted, Short-Selling

In the so-called "rational markets" that are so beloved by the textbooks, this should theoretically be impossible. In the real world, however, it would be fairly easy to engineer - especially in a period of uncertainty, such as we have had since 2007 - for a large operator to spread rumors, push down share prices, and thus cause the market to panic.

Richard S. "Dick" Fuld Jr., the former chief executive officer of Lehman Brothers Holdings Inc. (OTC: LEHMQ), the former CEO of Lehman, is convinced this is what happened in Lehman's case, and it has undoubtedly been tried in several others.

Short-selling of shares was banned for several weeks after the Lehman bankruptcy, the reality is that neither short share sales nor share put options offer anything like the potential of credit default swaps to profit from a bankruptcy - particularly the bankruptcy of a financial institution whose debt is several times its share capital. Citigroup Inc. (C) and JPMorgan Chase & Co. (JPM), for example, each have around $1 billion in short positions outstanding in their shares. In the traded options market, Citigroup has a nominal $1.4 billion worth of put options outstanding while JP Morgan Chase has $2.1 billion - the cash value of those contracts will be a fraction of those figures.

What's more, there are undisclosed amounts of over-the-counter equity options written between dealers. However, the volumes of credit default swaps were recently $65.7 billion on Citigroup and $62.4 billion on JPMorgan.

Now think about the arithmetic. To sell a share short, you risk all your capital - there's no limit on how high a share of stock can rise. To buy puts, you deal only in a small market, and most puts are short-dated, so you would have to act quickly. With a CDS, however, you pay only an annual premium that is a small fraction of the principal amount involved, you acquire an asset that typically lasts several years, and you can deal in a market of over $60 billion - enough potential profit for even the greediest hedge fund.

Thus, credit default swaps make causing a "run" on a bank or investment bank enticingly profitable, with a profit potential that far outweighs the cost of undertaking the operation. Because the CDS market is much larger than the market for stock options - or even the share markets themselves - the product is a standing temptation to bad guys, and a danger to the banking system.

By now, it's easy to see why credit default swaps are Wall Street's worst invention.

Granted, these particular derivative securities are so far only second in total losses, behind subprime mortgages, but they lack the social purpose of the home loans for borrowers with poor credit, since those mortgages at least had the somewhat redeeming benefit of putting some folks in houses.

While there are a few CDS securities that genuinely hedge credit risk, almost all of them have no such benefit: They are gambling contracts, pure and simple.

For the taxpayer to bail out the victims with self-inflicted CDS wounds is as ludicrous as asking us to bail out the Las Vegas casinos.

But don't laugh - that may well happen, yet.

[Editor's Note: When it comes to either banking or the international financial markets, there's no one better to hear it from than ***Money Morning*** Contributing Editor Martin Hutchinson, for he brings to the table the kind of high-level expertise that our readers have come to expect. In February 2000, for instance, when he was working as an advisor to the Republic of Macedonia, Hutchinson figured out how to restore the life savings of 800,000 Macedonians who had been stripped of nearly $1 billion by the breakup of Yugoslavia and the Kosovo War.

Credit default swaps entered the public lexicon last September, with the collapse of insurer American International Group Inc. But in an article featuring the headline, "Credit Default Swaps: A $50 Trillion Problem," Hutchinson warned ***Money Morning*** readers back in April 2008 that these derivative securities were poised to cause big problems for investors.

Just last month, Hutchinson published an analysis on the "Top 12 U.S. banks" report. If you missed story, which enjoyed a big response when it was published last Wednesday, please click here to access it and check it out. The report is free of charge. The follow-up story on that story was his analysis of Fifth Third Bancorp (FITB). The report on Fifth Third appeared last Friday. Both reports may be well worth your time to read.

Hutchinson also writes regularly for our monthly newsletter, ***The Money Map Report***, in which he and other ***Money Morning*** colleagues also make investment recommendations for subscribers. To find out more about ***The Money Map Report*** - including a special offer that includes ***The New York Times*** best seller, "Crash Proof" - please click here.]

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March 4th, 2009

This entry was posted on Wednesday, March 4th, 2009 at 12:00 pm and is filed under Main Essay. You can follow any responses to this entry through the RSS 2.0 feed. Due to the amount of comments we receive Money Morning will not be able to respond to all questions. If you have not already registered to leave a comment, once doing so you will receive Money Morning's Daily Email.

There Are 18 Responses So Far. »

1. *Comment by CDS Trader* on 4 March 2009:

   What a rubbish article.

   CDS's are zero-sum - one person's gain is another's loss, so it's wrong to say they have caused the '2nd biggest amount of losses'.

   Given this is essentially the only reason the article gives for being a bad product (ignores the fact that hedging might be a sensible idea for a bank…) the author's thesis collapses.

   The author is ill-informed.

2. *Comment by John Lounsbury* on 4 March 2009:

   Recommend you submit this article to Seeking Alpha

3. *Comment by John Lounsbury* on 4 March 2009:

   The problem with CDS Trader's position is that he does not recognize why CDS's are NOT a zero sum game.

   Too many CDS's were sold by those that made no provision (or insufficient provision) for payment should their contract obligation be called. Therefore, some CDS buyers have made payment for "insurance protection" that is not there.

   Even if all CDS's were properly backed by resources in case of claims, I still have not seen an analysis that would prove a zero sum to the participants. There is some slippage due to fees and commissions received by the transaction agents. Until I see how much these transaction costs have been and how they were accounted for in the CDS contracts, I can not accept that this was a zero sum process, even in theory.

4. *Comment by CDS Trader* on 4 March 2009:

   True, should have included "ignoring the premium".

   Any payment in the event of default is zero-sum (minus very small transaction fees if you're going to be pedantic).

   CDS in general *are* provisioned through margin calls. However since AIG was AAA-rated it didn't have to post margin calls. Once they got downgraded then the sh*t hit the fan.

5. *Comment by robertsgt40* on 4 March 2009:

   Sounds like sour grapes for "CDS trader". He may have to work for a living now. Good luck. There are plenty of predators just like you…looking for work.

6. *Comment by John Lounsbury* on 4 March 2009:

CDS Trader - - -

Much better job of qualifying your position in the second comment. Thanks.

7. *Comment by CDS Trader* on 4 March 2009:

   I'm not actually a CDS trader.

8. *Comment by Searcher* on 4 March 2009:

   Would the net net net… upon closure of comprehensive clearing significantly reduce the 'sand reckoner' nominal values?

9. *Comment by Zacman* on 4 March 2009:

   when we first designed a system to manage the derivatives , interest rate swaps and other I as internal audit forced the board to set strick limits and audit reviewed monthly. we cleared them through our back office operations and they checked the offset however in a situation like now i dont know how they faired i have since retired but heard nothing from those i still keep in touch with.

   but it is just a stupid unnessary way to conduct business. Greenspan also now accepts regulation was needed or the use just prohibited.

10. *Comment by Adam Smith* on 5 March 2009:

    Great article and right on point. If CDSs are a zero sum game, then why is Lehman gone? Bear Stearns is gone too because of CDSs and AIG is a great example of how they are NOT a zero sum game. If they were, the U.S. Government would not be "bailing" them out. There are several German Banks that have had to write down Billions due to CDSs. Several Municipalities owe billions due to Swaps and several pension plans have lost billions due to CDS. If P.T. Barnum were alive today, he would be selling credit default swaps and so would Ponzi.

11. *Comment by former hedge fund trader* on 5 March 2009:

    rubbish article

    The sellers of CDS, are the equivalent of buyers of debt in that credit exposure. If they thought it was ok to take on this credit risk based on the premium they were receiving, so be it - these are the true criminals: individuals, who were happy to receive above-average renumeration for playing with credit risk they (1) did not try to understand, (2) did not due their due diligence on (3) and never owned up to the fact they were getting paid hugely for this unsustainable trading strategy

    whats more - if one takes out a huge short credit position by buying CDS, this does not create a self-perpetuation market sell-off process which brings the underlying credit closer to bankruptcy

    sorry - but it is wrong to print such a damning article without consultation with established market participants

    I would expect a retraction of this article with commentary from those that truly understand this market from a respected journalist. Anything less would be tantamount to sensationalist, superficial media manipulation for political means

    good luck

12. *Comment by CDS Trader* on 5 March 2009:

    LB and BS did *not* go down solely because of CDS - show some evidence before chucking around these random assertions, please! Thye collapsed because they couldnt raise any short-term funding because the market had lost confidence that they were solvent thanks to massive amounts of illiquid/difficult to value assets on their balance sheet.

How do you think people lose money when selling CDS? They *pay* someone else; ergo the settlement leg is zero-sum.

It's true that lots of people have lost lots of money on CDS, but others have made massive amounts as well…

Furthermore, the bulk of CDS trades that brought down AIG were protection on senior tranches of asset-backed CDOs etc. The big investment banks bought a lot of this protection. If AIG defaults on these payouts the remaining banks are screwed, since the MTM is in their favour. So good call those who think AIG should just be left to die.

13. *Comment by Bob Sandridge* on 5 March 2009:

The problem is 'making money'. If the day traders, thoughs that roll the stocks for daily, weekly and other short term gains, abusing the work of Wall Street, go some place else, the true investors could build retirement equity and watch for value and company (new and old) growth. The government is so self serving that anything goes and investor be ware. Why can't they be honest and admit "it's not 'public servant' but self serving". It takes drive to get a head and Bill is King. If Obama succeeds 'praise the Lord', if not, thanks to the politicians and the Wall Street crowd. I'll die, thanking God for a great life as an American and looking foward to seeing the day traders, politicians, lawyers and bankers in the 'tribulation'. Gods mercy, forgiveness and grace on all. Bob S.

14. *Comment by Adam Smith* on 6 March 2009:

You can check out how credit default swaps became the accelerant for the current financial crisis at several financial news networks, Bloomberg, Financial times and Seeking Alpha. CDS was supossed to be a financial instrument to transfer risk. The problem is that the CDSs were sold (and bought) with very complicated mathematical models that were not perfect. So instead of selling the exposures to credit just once, it was sold 10 to 20 times (of the underlying asset) by investment bankers. The SEC did a probe of the CDS market in late 2008 and found the cost of default insurance for Bear Stearns and Lehman spiked in the days before these wall street firms collapsed. Frank Partnoy(a former derivatives broker) stated,when asked about what part the CDSs played in the financial crisis, "they were the centerpiece, really". "That's why the banks lost all the money"(60 miniutes). The CDS market is unregulated and not trasnparent so few people in the CDS chain knew the financial stability of everyone else in the chain. Read Professor Greenberger's article on regulatory reform. He estimates that the CDS market is $35 to $65 TRILLION and its unregulated. Check out the article by GH bank on "Credit Default Swaps Almost Bring Down Global Financil System". Do not even think about asking any European bank what they think of CDSs, as they have lost billions on these instruments. When the real world has lost billions on CDSs, they are financial weapons of mass destruction and have been toxic investments for many banks.

15. *Comment by CDS Trader* on 6 March 2009:

"The problem is that the CDSs were sold (and bought) with very complicated mathematical models that were not perfect. So instead of selling the exposures to credit just once, it was sold 10 to 20 times (of the underlying asset) by investment bankers."

You have not explained why this is a problem. It's called *hedging*.

"The SEC did a probe of the CDS market in late 2008 and found the cost of default insurance for Bear Stearns and Lehman spiked in the days before these wall street firms collapsed."

Well obviously the CDS spiked. The market saw that the two companies were in trouble so people rushed to buy protection to cover their losses! I think it's an interesting discussion to be had regarding whether this creates positive feedback loops, but for Fuld/Cayne to complain about short-selling/CDS is pretty hypocritical given they are the two most important risk management tools in a bank's armoury.

"He estimates that the CDS market is $35 to $65 TRILLION and its unregulated."

See my post above. DTCC releases weekly data on the size of the CDS market (http://www.dtcc.com/products /derivserv/data/index.php?lpos=home_splash_promo&lid=index.php) and it is currently around $28 trillion. However, as per my post above, this is a *notional* value. If you don't appreciate what this means then frankly you have no place discussing the pros and cons of derivatives.

"Do not even think about asking any European bank what they think of CDSs, as they have lost billions on these instruments."

Erm, this is just complete crap. European banks such as Deutsche, Credit Suisse are two of the world's biggest CDS dealers and have *made* billions from them.

"they are financial weapons of mass destruction and have been toxic investments for many banks."

In my opinion, just because you *can* lose lots of money on investments doesn't mean they should just be banned outright.

CDS are a vital hedging tool and help the easy flow of credit in the economy. It's true that a massive speculation market has grown up around them, but this is an inevitable consequence of any market. Do you own stocks? I'm guessing you don't buy majority stakes to control the company, so all you're doing is speculating!

16. *Comment by c joe* on 8 March 2009:

Dear CDS Critic:

It appears we Citizens are obsessed with the Blame Game, when we get the perpitrator properly identified, we can then go about perfecting the "Cure.!"
Well guess what? Will that bring back ENRON? Bear Sterns? Bernie Maloof's lost fortunes? AIG's Missteps? GM/Chryslers financial crisis? The banking Crisis? The Housing Crisis?
It appears to me, that Government's Cures for the ills that face us, are proving to be more impotent, than the very ills that face us?
When this crisis is all over, we will be left with monutains of ill conceived debt, that we plunged into, because our leadership said we must. Our leadership in Washington, is
IMPOTENT, TOO!
The Resolution Trust Company, successfully dealt with the last mortgage crisis, as did other, "Focused Approaches," in earlier times. Why do we not emply "Tried & True Remedies?"
We cannot, "Spend our way out of a poorly constructed Economy Built upon Foolish, Out of Control SPENDING?
CHANGE CHANGE CHANGE INDEED! It all apperars to be much the same to me!
c joe

17. *Comment by MediaMac* on 8 March 2009:

Before the first bailout, I chastised Congress and 'talking heads' alike that all of the focus was on the 'spilt milk' and not on the root cause. The government subsidy went to banks that were suffering under "mark to market", a well-intended but ill-conceived accounting philosophy that has no roll in a true "market economy".

At the most, banks should have been bailed out exclusively on the non-performance aspect of the underlying debt. Specifically, the lost interest income over a preset period of time (3-5 years). In the absence of "mark to market", the banks could have sustained the infusion as loans secured by low interest convertible debentures. All for less than half the amount being dispersed, and largely recoverable for the taxpayers.

Win-Win-Win!

Stay tuned for my take on a Recovery Plan.

18. *Comment by ben* on 9 March 2009:

It seems from this article that AIG et al. were not really the one's bailed out, but the contra parties on CDS. Who were these contra parties, and why would the government step in to protect them? The buyers of CDS should have done their own due diligence on AIG and the writers of the CDS, and if the CDS writers defaulted, too bad.

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