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How Credit Default Swaps Spread Financial Rot  
by Alex Blumberg

All Things Considered, October 30, 2008 · If bad mortgages got the financial system sick, credit default swaps helped spread the illness worldwide.

Like many parts of the financial system these days, credit default swaps are so complicated, simple bankers couldn't have created them. They were invented by people like Gregg Berman.

"My formal training is in physics," he says. "I studied experimental physics and nuclear physics before joining finance in 1993."

Now just to be clear, Berman didn't invent these things, but he works for Risk Metrics Group, which helps people manage risk, and so he thinks about them a lot and he's good at explaining what they are.

Imagine, he says, you buy a bond from Ford for \$100.

"You're holding your bond and you are worried about Ford's credit. So you enter into an agreement with another party where you say to other party, 'I will pay you some money – 2 percent a year, 3 percent, 4 percent – and what you need to do is give me protection.'

"If Ford should go bankrupt, then I'm going to give you this perhaps worthless bond and you're going to give me my \$100 back. In the big context, it looks like insurance."

So is insurance what we are talking about? People with bonds, which are already considered safe, trying to make them safer? Well, it didn't stay that way.

### Insurance On A Home You Don't Own

"I think Mae West said it very, very well when she said, 'I used to be Snow White, but I drifted,'" says Satyajit Das, a risk consultant who was around when credit default swaps first appeared.

For 30 years, he has worked with hedge funds and bankers all over the world as a sort of a financial hired gun. He saw first hand how what started as insurance morphed into something else entirely. In the 1990s, he says, he was a fan of credit default swaps.

"But by about 2003-2004, I was starting to get nervous," Das says. "I could see the market had gone from a very legitimate purpose to something which was much more racy and interesting but also much more dangerous."

He says along the way, it stopped being insurance.

"The line between investing and speculation or gambling in financial markets is always a pretty gray one," he says. "And speculation is always a motive."

So, how did we get from one of the safest activities on the planet – insurance – to one of the riskiest – gambling? There's one key difference between an insurance policy and a credit default swap.

"The way that I first described the credit default swap is, you own the bond and you want to transfer the risk to someone else. But what if I want to buy protection but I don't own the bond?" Berman says.

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But isn't buying protection on a bond you don't own like buying fire insurance on a house that's not yours?

"It is exactly like buying insurance for a house you don't own," Berman says. "So it's like you took out fire insurance on your home, and I also took out fire insurance on your home, and a thousand other people took out fire insurance on your home."

"And when that happens, what you're doing is, you're betting on the house."

So, a CDS allows people to get paid off by insuring something they don't own – not a house in this case, but a bond.

### How Credit Default Swaps Work

A credit default swap is what they call an over-the-counter instrument. It's not something that's traded publicly on an exchange, like a stock. Instead, it's a private deal between any two people with more than \$5 million – so that means, effectively, someone at an investment bank, or a hedge fund, or at a big commercial bank like Citibank and Credit Suisse. They all have credit default swap desks.

Now, every day, the guy at this desk is getting thousands of e-mails and calls from people who want to enter into credit default swap contracts with him. Sometimes those people want it for insurance. They have a bond from say, the ABC Co., but they're a little worried about ABC Co.'s financial health. They call the guy at the desk up and say, "Will you sell me credit default swap protection?" In other words, "Will you guarantee that if ABC Co. goes down, you'll guarantee the full value of the bond?"

But sometimes, Das says, they often don't have the bond; they just have a hunch about ABC Co.

"So they want to, essentially, bet that say, ABC Co. will default," he says. "So he and I agree that if ABC defaults, I'll pay him a certain amount and in return he pays me some fees."

Das says that during his time in the industry, the amount of credit default swaps that were speculative grew to dwarf the amount that were used for insurance. The numbers are staggering. There are \$5 trillion worth of bonds issued in the world, but the total amount that people have bet on those bonds is \$60 trillion. For every one person insuring a bond with a credit default swap, there are more than 10 people betting on it.

"All of this is unregulated partly because they wanted it to be unregulated," says Andrew Ang, a professor at Columbia University Business School who studies the credit default swap market.

### The Upside And Downside Of Leverage

One of the reasons the industry wanted credit default swaps to be unregulated has to do with a word you hear a lot when you talk to finance people: leverage.

Here's what they mean by leverage and how it can both give and take away.

Imagine someone with a hedge fund worth \$100 million who wants to make a killing in the credit default swap market. He starts calling and e-mailing all those credit default swap desks and hedge funds out there, saying, "I'm selling protection, who wants to buy?"

Someone calls back and says, "I have a billion-dollar bond from Lehman Brothers, I want to insure." He says, great, "I'll insure your bond if you agree to pay me 2 percent of its value every year." The caller says, "All right." They are in

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business.

Now, let's review those numbers: 2 percent of \$1 billion is \$20 million, which the person with the \$100 million hedge fund gets every year. So, by signing one piece of paper, he has doubled his money in five years – psyching him and his investors.

That's the upside of leverage: You make profits on a billion dollars even though you only have \$100 million.

The downside of leverage is that he is on the hook for up to \$1 billion if the bond defaults and he doesn't have a billion.

In 2005, this particular bet – on a Lehman Brothers bond – seemed like a sure thing. The idea that Lehman Brothers, one of the oldest and largest investment banks in the world, could possibly default seemed crazy. In 2008, it became scarily, unbelievably real.

In Part 2, Alex Blumberg tells us the role credit default swaps played in destabilizing the global financial system. This story was produced in collaboration with Chicago Public Radio's This American Life.