

Derivatives, Credit Default Swaps Risky Investments that Impact our Stock Markets

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The collapse of the banking system has been blamed for the current recession, and that has also breed the current credit crunch that many businesses and consumers are experiencing. But one area that seems to have many investors still worried about our financial stability is centered on derivatives. But just like investors didn't really understand the sub-prime mortgage crisis, it's also difficult to understand what derivatives are and how they might impact our economy in the future.

Derivatives are financial contracts whose value is derived from the value of something else. They can be used to reduce risk, or they can be used as a speculative financial instrument. Derivatives can be based on different types of assets such as commodities, stocks, residential mortgages, commercial real estate, and even loans and bonds.

Derivatives are not new. In fact, the ancient philosopher Aristotle writes about a certain “financial instrument” we would now refer to as an option, one type of derivative. Agricultural commodities futures, another form of derivative, date back to the founding of the Chicago Board of Trade in the 1800s. While all derivatives can be used to reduce risk (hedging) they can and often are used as speculative vehicles. Derivatives are continually evolving, though, from the plain vanilla options and futures contracts listed above, to the more financially engineered such as Credit Default Swaps, which today are getting the greatest attention.

Credit Default Swaps, or CDS, are credit derivatives whose value is derived from the credit risk of a bond or loan. CDS are private contracts between two parties, referred to as counterparties, where the buyer of protection agrees to pay premiums to the seller of protection. The seller, then, agrees to pay the buyer in the event of a loss, normally a “credit event” such as default, on the underlying asset. In this way, a CDS does not seem much different than an insurance policy. If you pay an insurance premium on your house, and a “covered event” occurs, the insurer agrees to pay for your loss.

On the surface, CDS can appear as an insurance product, helping holders of large quantities of corporate debt, for example, minimize risk of default. For example, if the City of Detroit pension fund holds \$3 million of GM bonds, it can buy protection, by way of a CDS on these GM bonds, so that if GM defaults, the seller of this protection covers the amount of loss the pension fund incurs. It is important to understand however that the counterparties of a CDS do not have to have an interest in the underlying financial instrument. By way of illustration, then, our pension fund above would not have to hold GM bonds in order to buy protection against a GM default. In this manner, CDS are more of an investment vehicle, a bet, if you will, between two parties that a credit event (bankruptcy, default, etc.) will or will not take place.

To further complicate the issue, there is very little requirement on the part of the seller of this protection to actually have the financial backing to cover such losses. Why? First, there is very little, if any, government regulation on the CDS market, so there is no requirement on the part of sellers of protection to set aside any reserves for losses. Add to that the fact that all CDS transactions are private between buyer and seller leading to very little market transparency. In the earlier days of CDS buyers and sellers knew each other and arguably better understood the risks, including the risk that the selling party could cover any losses. But as the market became more complicated, including the increasing use of Credit Default Swaps as a speculative investment, it wasn't uncommon for the CDS to be resold a number of times. It is estimated that many of the holders of CDS' do not fully understand what is covered by their contract. With little market transparency, however, the ultimate value of a contract is less clear. And without a requirement for capital reserves to be held back by sellers in case of defaults, Credit Default Swaps can quickly unhinge the financial markets.

This is where mortgages, and especially the sub-prime mortgages, fit in. By now, most people understand the games investment bankers were playing by packaging up good mortgages with the subprime mortgages and calling the resulting investment an *investment grade bond*. Before the housing collapse, these bonds were paying much better interest than those bonds holding just high quality mortgages. Of course, the theory was that any risk could easily be spread out among the speculators in the derivatives markets using Credit Default Swaps. Hedge funds were more than happy selling this protection, and were estimated to have written over 30% of CDS protection. The losses incurred by rising bond defaults, a direct result of a rise in mortgage delinquencies by subprime, and even prime borrowers, have not been covered by the sellers of this protection, many of whom are the same hedge funds more that willing to take the premium payments for this protection. It would be like having insurance on your home, but if it burns down, you find out that your insurance company is insolvent and not backed by anyone.

So what is the future of derivatives and credit default swaps? Obviously, these investment options will continue to be a part of our market, regardless of the risks involved to both investors and the financial markets. Fortunately, government regulators like the SEC are paying attention to this risky area of investing and are calling for more regulation of credit default swaps. We can also hope that many of the investors who deal in this risky area of finance have also learned a valuable lesson, and will be less likely to enter into contracts that have such a high level of risk regardless of the potential profits that can be earned.

Individual investors need to make sure they also protect themselves from getting involved in risky investments like these. And the best way to do that is to make sure you due a lot of research about a fund before investing, so that you know what its investment philosophy, holdings and fees are. One place to do that is at the independent investment information website, www.morningstar.com. You should also review the funds prospectus annually to make sure it hasn't changed direction and begun investing in companies or holdings that don't fit the original philosophy.

And lastly, use common sense when it comes to investing. If an investment is too hard to understand or poorly regulated, it probably isn't the kind of investment you want to be involved with regardless of its claim or past return.