

Crucially, it's not the CDS that is the problem, it's that it's not used as a derivative, but rather as a capital adequacy reduction tool, and that it's used in the inappropriate manner in "conglomerated" banking system.

7.6 Auto Insurance and Default Swaps (the basics are easier than you think)

Many swaps, including CDS's, are conceptually fairly simple, though the valuation process is "incredibly fiddly" and requires much technical knowledge. A swap is simply an agreement to exchange cash flows.

This Section provides a "building block-like" explanation of swaps at a qualitative level. The basic framework is: loans can be swapped, swaps incorporate default risk "fees", the default risk fee/protection element of a swap can be "stripped out", and when repackaged in a particular way, it becomes a default swap. A CDS that results from this type of "structuring" represents an "insurance policy" against loan default, almost exactly in the way auto insurance represents insurance against crashes.

CDS's themselves are nothing "evil". However, they were invented and often used in a way that is "inconsistent" with the purpose of derivatives: that of capital adequacy reduction", rather than default insurance/hedging.

That sort of "inconsistent usage" contributed to the speed and scale of the financial collapse of 2008, but certainly did not cause it. Moreover, the manner in which agents of the US Government "managed/implied" default protection "fees" further contributed to the impact made by CDS's. Clearly that is not the fault of the CDS's, but rather illustrates the culpability of the US Congress and its GSE's., and to a lesser extent, bankers.

7.6.1 Vanilla Swaps

Suppose you had a floating rate mortgage with a bank and interest rates dropped dramatically. Since a floating rate mortgage means that your periodic mortgage payments "float" with prevailing rates, now your interest payments are much lower compared to earlier. You may reasonably consider that there is the risk that interest rates may rise again, and then your payments would increase. What can be done about this risk?

One solution is to enter into a derivative contract called a fixed/floating swap. This is by far the most common type of swap (or indeed any derivative), and is generally considered the standard/vanilla swap structure. This agreement would arrange the following: you now pay the derivatives dealer (or whomever is assigned as the counterparty) a fixed rate as specified in the swap contract, and which reflects the current low rates (instead of