



Credit Default Swaps - CDS's

A Credit Default Swap is a derivative contract through which two parties transfer the credit exposure to bonds between them

Key terms	
Buyer	The buyer of credit protection
Seller	The seller of credit protection
Notional	Face value of the unrestricted credit bet between the two counterparties
Reference obligation	The underlying bond
Premium	The premium payable in basis points of the Notional amount
Settlement	Usually in cash
Term	Duration of contract

CDS Trade Example

Terms

Buyer: Birkdale

Seller: Augusta

Notional: USD10mn

Reference: Muirfield Plc 5 year bond

Premium: 55bps

Settlement: Cash

Term: 1 year

Birkdale buys a 1-year CDS from Augusta on a notional amount of USD10 million on the 5-year bonds issued by Muirfield Plc.

The CDS has an annual premium of 55 basis points and cash settlement.

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CDS - No Credit Event

Muirfield Plc does not default and no 'credit event' or 'trigger' occurs.

Buyer: Birkdale Capital

Seller: Augusta Inc.

Notional: USD10mn

Reference: Muirfield Plc bond

Premium: 55bps

Settlement: Cash

Term: 1 year

	Birkdale	Augusta
$0.0055 \times \text{USD10 million}$	(55,000)	+55,000
CDS pay out	Nil	Nil
Net	(55,000)	+55,000

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CDS - Credit Event

Muirfield Plc defaults on day 2. Consequently the bonds are now trading at 0 cents on the dollar and Augusta Inc. pays out on the CDS protection they sold.

Buyer: Birkdale Capital		Birkdale	Augusta
Seller: Augusta Inc.	0.0055 x \$10 million	(55,000)	+55,000
Notional: USD10mn	CDS payout (1-0.0) x \$10 million	+10,000,000	(10,000,000)
Reference: Muirfield Plc bond			
Premium: 55bps	Net	+9,945,000	(9,945,000)
Settlement: Cash			
Term: 1 year			

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CDS – Credit Deterioration

Two days into the trade no credit event has occurred but Muirfield is experiencing difficult trading conditions. The CDS spread goes up by +40 basis points to reflect this and Birkdale unwinds the trade.

Buyer: Birkdale Capital		Birkdale	Augusta
Seller: Augusta Inc.	0.0055 x \$10 million	(55,000)	+55,000
Notional: USD10mn	Close out the CDS position by selling the CDS (+0.0040 + 0.0055) x \$10 million	+95,000	-95,000
Reference: Muirfield Plc bond			
Premium: 55bps	Net	+40,000	(40,000)
Settlement: Cash			
Term: 1 year			

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CDS – Credit Improvement

Two days into the trade no credit event has occurred. Muirfield is experiencing better trading conditions and the CDS spread goes down by (30) basis points to reflect this. Birkdale unwinds the trade.

Buyer: Birkdale Capital

Seller: Augusta Inc.

Notional: US\$10mn

Reference: Muirfield Plc bond

Premium: 55bps

Settlement: Cash

Term: 1 year

	Birkdale	Augusta
0.0055 x \$10 million	(55,000)	+55,000
Close out the CDS position by going short the CDS (-0.0030 + 0.0055) x \$10 million	+25,000	-25,000
Net	(30,000)	+30,000

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CDS – Credit Event and Counterparty Default

Muirfield Plc defaults before the end of the year and the bonds are trading at 0 cents on the dollar but Augusta Inc. fails to pay out on the CDS

Buyer: Birkdale Capital

Seller: Augusta Inc.

Notional: US\$10mn

Reference: Muirfield Plc bond

Premium: 55bps

Settlement: Cash

Term: 1 year

	Birkdale	Augusta
0.0055 x \$10 million	(55,000)	+55,000
CDS pay out	Nil	Nil
Net	(55,000)	+55,000

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Who Trades CDS's?

Commercial banks
Risk management

Hedge funds
Credit speculation

Investment banks
Dealing & risk management

Insurance firms
Ongoing business

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Types of CDS Credit Events

A ratings downgrade
e.g. (AAA→AA)

Non-payment or delayed payment of a
fixed income obligation

Going concern issues
e.g. receivership, liquidation, capital
restructuring or a Creditors Agreement

A regulatory compliance breach or
penalty

Any **other variable** as defined by the
OTC contract

Collectively
known as
'credit
events'

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CDS - Indices

Allows for buying or selling credit protection on an Index using Standardised contracts

Examples:

iTraxx Europe ("The Main")	HiVol	Xover
125 most liquid European credits	30 high spread credits	75 sub-investment grade credits

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Swaptions – Options on Swaps

Swaptions

- The right but not the obligation to enter into a Swap
- The underlying Swap will have pre determined dates, rates and term
- Can be agreed on any type of Swap
- An option on entering into a Swap contract!

Receiver swaption

gives buyer the right to sell a CDS in the future
(i.e. go **long** in underlying bond)

Payer swaption

gives buyer the right to buy a CDS in the future
(i.e. go **short** in underlying bond)

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