

## Credit Default Swaps Ain't That Bad

A credit default swap provides de-facto insurance against default losses on loans, bonds, or other forms of debt. While contracts to insure against other disaster losses (e.g. wildfire in the foothills, hurricanes in Haiti, volcanos in Venice) are generally thought to be both privately useful and socially responsible, the credit default swap's reputation has been much maligned of late. While some criticisms may be justified, at least one isn't, as noted below.

The New York Times ([Banks Bet Greece Defaults on Debt They Helped Hide](#), February 25, 2010) printed a story raising the possibility of debtor death spirals induced by credit default swaps on their debts, quoting some pundits who believe this is unambiguously bad, including the current French finance minister.<sup>1</sup>

To understand this, we must recall the first principle of insurance: the greater the risk, the higher the cost. If something occurs that increases the perceived probability of default, the insurance cost goes up. When potential creditors notice this, they either become more reluctant to extend additional credit to the problematic debtor, or only willing to do so at higher interest rates. But this may exacerbate the debtor's woes, and thus further raise the perceived probability of default, the attendant cost of insuring against it, and the willingness of creditors to extend more credit as cheaply as before. As the Times put it:

*"A result, some traders say, is a vicious circle. As banks and others rush into these swaps, the cost of insuring Greece's debt rises. Alarmed by that bearish signal, bond investors then shun Greek bonds, making it harder for the country to borrow. That, in turn, adds to the anxiety — and the whole thing starts over again."*

This cycle is a type of "positive feedback" loop akin to some of the mechanisms described by scientists concerned about global warming.

But there is an important distinction between the positive feedback loops of global warming and the potential debtor death spiral described above. It is presumed that policies enacted to curb global warming will not cause additional effects that negate them. Physics and chemistry will not change just because government enacts policies to curb greenhouse gas emissions. Unfortunately, the behavior of creditors and debtors cannot be assumed to be as invariant to government policies. The market for credit default swaps makes it easier for potential creditors to see the default probability embodied in the estimates of the other default swap market participants. But this does not imply that potential creditors will necessarily make lower default probability estimates in the absence of that market information; in fact, risk-averse creditors might

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<sup>1</sup> Anyone wondering whether we should have world government should consider the possibility that the fate of our economy could be placed in the hands of the French finance minister.

wind up acting as-if the default probability were higher than that implied by would-have-been credit default swap prices.

Even if this doesn't happen, we should also consider the possibility of behavioral changes by the debtors. The ready availability of marketplace assessments of creditworthiness may help discipline debtors who would otherwise continue to take risky actions. In default, creditors often have more say in how the debtor is run, including who gets to run it. A perceived increase in the default probability may induce a debtors' executives (e.g. a corporation's CEO or a governmental entity's ruling executives) to run operations more conservatively, for fear of losing their jobs. In fact, we are now seeing this in the case of the Greek Government's response to those higher default estimates. Greek politicians are running for cover; their Deputy Prime Minister Pangalos argued that the wartime Nazi occupation is to blame for their current woes, rather than post-war leftist socialists like himself ! The banning of credit default swaps will make negative assessments about debtors harder to find, and is no more socially responsible than banning government grants to those who may make negative assessments about society's ability to cope with future climate changes.