Overexposure to credit default swaps contributed to financial meltdown, study finds

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a market-traded form of investment insurance - are believed to have contributed to last year's financial meltdown.

Trying to understand how CDS prices are determined, a team of researchers concludes that earnings have a major impact and in turn, CDS prices can seriously affect the economy. When earnings drop, CDS spreads rise.

"Credit default swaps represent a huge market for trading credit risk and it's not going to disappear at all despite what people think," says study co-author Jeffrey Callen, the Joseph L. Rotman Professor of accounting at the University of Toronto's Rotman School of Management. "If you don't understand pricing then of course you're in trouble if you don't know what's affecting the market."

In a CDS, the protection buyer pays a premium to the protection seller for a fixed period of time. The parties agree that if a certain event happens affecting the buyer - a bankruptcy of another company whose debt the buyer has invested in for example - the seller will compensate the buyer. If the event does not happen, the buyer continues to pay premiums until the term ends.

The paper has found that when earnings of the company presenting the risk -- the "reference entity" -- go up, the cost of the CDS goes down. A

1% increase in the return on assets leads up to a 9% drop in the cost of a CDS. But the paper also found that the cost of a CDS rises disproportionately when the return on assets drop.

The CDS market is estimated to be in the trillions of dollars in notional value and had grown exponentially up to the crisis, up to the crisis. A sharp increase in CDS rates is believed to have affected last year's collapse of Lehman Brothers as well as the dire financial straits of insurer AIG.

More information: The complete study, which was recently published in the Accounting Review, is available at: www.rotman.utoronto.ca/newthinking/cds.pdf

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