CREDIT DEFAULT SWAPS (CDS)

are fine, but without regulation, they are crazy!

CAN'T Lend unless AA

Ratings Agency

Moody's

Ratings

AAA
AA
A
BBB
BB
A
. . . . .

Good → less good

Pension Fund

needs to invest to make $
Requires AA Rating

10% interest

Lend 1B $

ABC Corp

Rating BB
needs to Borrow 1 B $

Insurance

10% fee

Insurance Company

AIG Rating AA

① sell insurance to pension fund & BB rating of ABC corp becomes AA.

② if ~~corp~~ ABC corp defaults AIG will pay pension fund 1 B $

But AIG does not have to set aside money in case ABC corp Defaults. "capital Requirements"

Hedge Fund

① Loans no money to ABC Corp.

② Buys CDS (Gambling) on ABC corp for $10 B.

fee for CDS

pays $10 B if ABC corp Defaults

pension funds

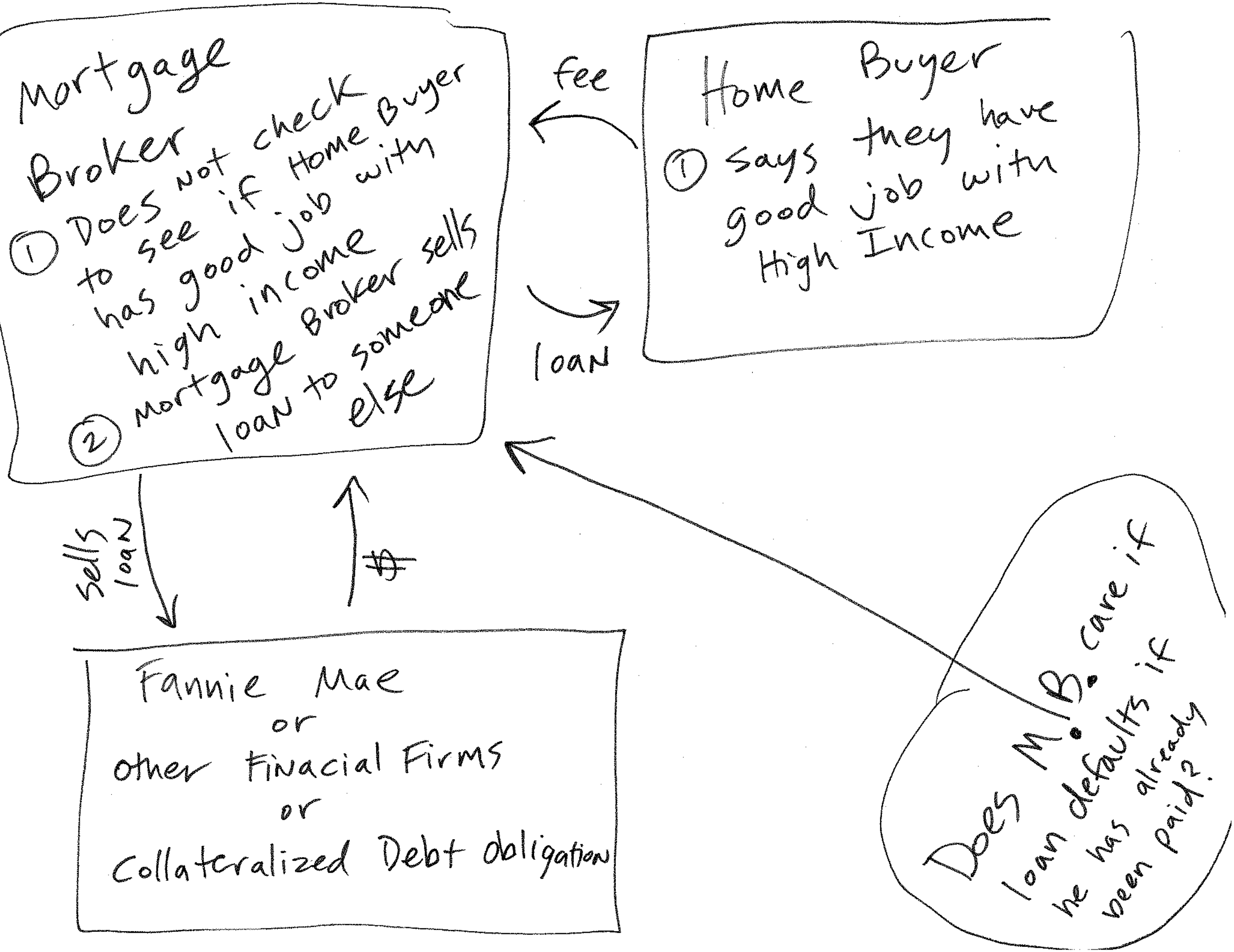
1. we give money to pension fund
2. they hold our money untill we retire
3. pension fund invests money & earns return
4. they keep some of return
5. they give us some of return
6. when we retire we get our money back plus extra.

Default

company can't pay money back

Interest

Rent on money



Mortgage Broker
1 Does not check Home Buyer to see if has good job with high income
2 Mortgage Broker sells loan to someone else
fee
loan
Home Buyer
1 says they have good job with High Income
sells loan
$
Fannie Mae
or
other Finacial Firms
or
Collateralized Debt obligation
Does M.B. care if loan defaults if he has already been paid?