

Understanding Credit Default Swaps

(CDS)

What is Credit Risk?

Credit risk is the probability of a financial loss resulting from a borrower's failure to repay a debt. Essentially, credit risk refers to the risk that a lender may not receive the owed principal and interest, which results in an interruption of cash flows and increased costs for collection. Lenders can mitigate credit risk by analysing factors about a borrower's creditworthiness, such as their current debt load and income.

Although it's impossible to know exactly who will default on obligations, properly assessing and managing credit risk can lessen the severity of a loss. Interest payments from the borrower or issuer of a debt obligation are a lender's or investor's reward for assuming credit risk.

What is a Credit Default Swap (CDS)?

A CDS is a financial derivative that allows an investor to swap or offset their credit risk with that of another investor. To swap the risk of default, the lender buys a CDS from another investor who agrees to reimburse them if the borrower defaults.

Most CDS contracts are maintained via an ongoing premium payment similar to the regular premiums due on an insurance policy. A lender who is worried about a borrower defaulting on a loan often uses a CDS to offset or swap that risk.

Applications of CDS

CDS rates (spreads) are quoted in basis points, normally on a specific bond issued by a bank for example. A basis point is one hundredth (1/100) of one percent, so 50bp is equivalent to 0.50%.

For example, If a 5-year CDS is quoted at 200 basis points, this means the buyer of the CDS must pay the seller 200 basis points (2%) per annum on top of the notional amount (the size) of the bond for 5 years to receive credit protection. So, if the notional amount of the bond is £1m, then the buyer must pay the seller £20k per annum ($= £1m \times 2\%$) to receive credit protection.

CDS spreads are widely considered as a proxy for creditworthiness. In theory, if the market is operating efficiently, the lower the spread, the better the credit quality of the bank. CDS provides an approximation of funding costs for banks, other organisations and even countries.

Structured products are usually a direct source of funding for banks. This means that any increase or decrease in funding costs is likely to be reflected in structured product pricing. As a rule of thumb, every 10 basis point increase in CDS level will cheapen the cost of a 5-year structured product by 50 basis points. By the same logic, if Bank A has a CDS level which is 100 basis points higher than Bank B's CDS level, then Bank A will have around 500 basis points (5%) more to spend on the product and should be able to offer better terms.

Sources: Credit Default Swap: What it is and how it works', Adam Hayes, Investopedia (2025)
'The structure and dynamics of the UK credit default swap market', Bank of England, Financial Stability Paper No. 25 (2013)

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