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CDS

Credit Check

The amount an investor must pay annually for protection against a default on $10 million in debt over five years.

Merrill Lynch | Lehman Brothers | American Int'l Group

$1.00 million

0.75

0.50

0.25

0

2006 '07 '08

Note: Data as of Sept. 12

Source: Markit Group

A summary of credit default swaps and how they play into Lehman's woes

What they are: Credit default swaps are contracts between two parties that act like insurance against debt defaults. They are also used by hedge funds, investment banks and others to bet on a company's fortunes. or hedge

How they work: CDS buyers make regular payments to sellers, who in turn promise to make big payouts if a company's bonds default or it files for bankruptcy. Buyers and sellers don't need to hold the underlying debt when they enter into the contracts, which can be for periods such as one year or five years.

Size of the market: CDS have been written on over $62 trillion worth of bonds and loans

How they trade: CDS trade 'over the counter,' or directly between buyers and sellers.

The problem with Lehman: Lehman is a large buyer and seller of CDS and entered into many contracts with different firms. In addition, other banks and investors have bought CDS tied to Lehman's own debt. A bankruptcy filing could trigger large payouts from institutions that have sold swaps on Lehman debt. Lehman's own counterparties, meanwhile, may have to re-hedge their positions with other firms.