DOI: 10.20472/IAC.2015.015.163

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SECURITIZATION AND CREDIT DEFAULT SWAPS (CDSS): TOWARDS DIAGNOSTIC OF THE FUNDAMENTAL PROBLEM AND SUGGESTED SOLUTIONS

Abstract:

Most of the blame for the present Global Financial Crisis (GFC) has been attributed to securitization and CDSs in the years preceding growth of the crisis. On reflection, most of the blame must be "sheeted home" to the former U.S government's mandate to banks and other financial institutions to mitigate their normal lending criteria on U.S home loans. The fundamental problem with these securitization contracts was not the securitization of good loans, but the securitization of "lemons". The loans should have never been entered into in the first place. The "failure" of securitization contracts was therefore a failure of well-intended (but poor) government policy makers in foreseeing the unintended consequences. In order to "insure" against expected defaults, the lenders and the investors entered CDS contracts in the shadow banking sector. The fundamental problem with the CDS contracts which are much touted in the regulated and shadow banking sectors as being "desirable" as a profitable form of "insurance", was that they were (and are) able to be used for wagering or betting purposes. In contrast to the conventional insurance, CDS contracts do not require an insurable interest; do not require compliance with the indemnity principle; and are not uberrima fides.

Keywords:

Credit Default Swaps, Securitization, Global Financial Crisis

JEL Classification: G01