Introduction:

This is an exercise on writing parenthetical, sentence, and expanded definitions. The goal is to provide precise yet easy to understand wording to help non-technical readers to understand a non-trivial definition.

Parenthetical definition:

A CDS (credit default swap) is a financial instrument used by financial institutions to hedge credit (default) risks.

Sentence definition:

A credit default swap is a financial instrument that the buyer (usually also the buyer of a referencing loan) of the CDS instrument pays the seller a fix premium periodically (i.e. monthly, quarterly, and semi-annually) in exchange for a compensation in the event of default (the seller of the loan is unable to repay the principle of the loan).

Expanded definition:

A credit default swap is usually traded with a reference to an underlying asset, such as a bond, a loan, or a mortgage. The buyer of the credit default swap is protected by the seller in the event of default of the underlying asset. A default is when the debtor of the underlying asset is not able to repay the full amount or any amount of the underlying asset.

A credit default swap is structured as follows:

* A premium leg (a leg is a stream of cash flow) that the buyer of the CDS pays a periodic premium to the seller.
* A protection leg such that in the event of default, the buyer of the CDS stops paying for the premiums, and the seller of the CDS pays the buyer an recovery amount to the buyer. The recovery amount is specified in the CDS contract as a percentage of the notional amount (notional principle amount or notional value) of the underlying asset.

A graphical representation of the cash flows is as follows:



A little history:

Credit default swap played a key role in the 2008 financial crisis. In the 2000s, mortgage approval rate sky rocketed that American people can get mortgages without any credit checks. Everybody was buying houses, some of them have multiple mortgages on multiple properties. However, the economy was not strong enough to provide average American people with sufficient income to fund the mortgages. The sales volume of CDS on subprime mortgages increased significantly because investment banks failed to recognize the default risks on the housing market. The bubble burst in 2008 because of huge default rate on mortgage payments and investment banks didn't have enough capital for the CDS protection payments. Over 22 Trillion dollars evaporated and large banks went bankrupt such as Bear Sterns, Goldman Sachs, and Morgen Stanley. Eventually, tax payers were the ones had to pay for the bail out of some of these investment banks.

Work cited:

[1] Gandi79, CC BY-SA 3.0, <https://commons.wikimedia.org/w/index.php?curid=5085575>

[2] Simkovic, Michael, ["Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias, and the Credit Default Swap Solution"](http://ssrn.com/abstract%3D1632084), Columbia Business Law Review (Vol. 2011, No. 1, pp. 118), 2011

[3] [O'Sullivan, Arthur](https://en.wikipedia.org/wiki/Arthur_O%27Sullivan_%28economist%29); Sheffrin, Steven M. (2003). Economics: Principles in Action. Upper Saddle River, New Jersey 07458: Pearson Prentice Hall. p. 261. [ISBN](https://en.wikipedia.org/wiki/International_Standard_Book_Number) [0-13-063085-3](https://en.wikipedia.org/wiki/Special%3ABookSources/0-13-063085-3).