MASSIVE AMOUNT OF "BOND INSURANCE" CONTRACTS POSE AN UNKNOWABLE LEVEL OF EXPOSURE TO GLOBAL FINANCIAL DISORDER

(Before you decide this topic is esoteric, please read on)

What's a Credit Default Swap Contract? Simple Example:
Charitable Foundation buys $10 million (face value) of bonds issued by General Company (GenCo). The bonds have interest coupons that pay 7%.
The Foundation purchases the bonds in the market for $10 million and it wants to avoid any exposure to a default by GenCo on the bonds.

The Foundation enters into a Credit Default Swap (CDS) contract with XBank. The contract provides that the Foundation will pay the bank 0.1% per quarter and, for that fee, the Bank agrees to make ABC financially whole if GenCo defaults on the bonds during the next 5 years.

Possible Outcome 1: If GenCo defaults, the Foundation will simply deliver the bonds to XBank and the Bank will pay the Foundation $10 million. (Note that GenCo would have no knowledge of, or involvement in the contract between the Foundation and XBank.) The Bank will wind up holding $10 million of bonds that are either worthless, or worth a fraction of $10 million (if the Bank can find a buyer).

Possible Outcome 2: If there is no default during the 5 years of the contract, the Foundation will have collected 7% interest per year and paid the Bank 0.4%; so the Foundation nets a 6.6% yield per year.

The net exposure of all CDS contracts is about $43 trillion.
The natural buyers of default protection are hedgers: banks, bond portfolio managers and Wall Street, while the natural sellers are speculators: hedge funds, etc. Because buyers and sellers of this derivative form of "bond principal insurance" usually create multiple insurance arrangements as they attempt to control risk, the gross amount of CDS includes a lot of duplication. But the net exposure, says the Bank for International Settlements, is still massive: about $43 trillion…no one knows for sure. ***That puts the volume of net outstanding CDS contracts close to 3 times the size of the entire U.S. economy.***

The BIG Questions:

(1) If bond defaults ramp up to, say, a several-times-normal level, perhaps triggered by the currently unwinding "sub-prime" mortgage securities crisis, and then by other sectors that may cave in on top of the mortgage pile, can major providers of default protection (i.e., the XBanks of this world) survive?
(2) If not, what would likely happen to the public stock and bond markets?

Answer: Major default protection-providers might survive….IF they have hedged their own risk in some manner. But, their cost of hedging may be too unattractive for them to actually do it, to the degree needed for dealing with a catastrophic scenario; so, their un-hedged exposure could be huge, though in nearly all circumstances not a threat to their solvency.
Un-regulated "market": Despite the fact that CDS volume is massive, these are unregulated private contracts. This factor makes them eerily similar to the most common of the "sub-prime" mortgage securities that have forced Merrill Lynch, Citigroup and others to search the globe for added capital.
Conclusion: While buyers and sellers of bond default protection have confidence that their contracts represent prudent risk-management, nobody knows the answers to these important questions.