Credit Default Swap Spreads and Systemic Financial Risk

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Abstract

This paper measures joint default risk of financial institutions exploiting information about counterparty risk in credit default swaps (CDS). A CDS contract written by a bank to insure against the default of another bank is exposed to the risk that both default together. From CDS spreads we can then directly learn about the default risk of pairs of banks. Since information about pairwise default risk does not fully characterize multiple default risk, I derive the tightest bounds on the probability that many banks fail simultaneously.