

Credit Default Swaps and the synthetic CDO

Bloomberg Seminar 20March 2003

Moorad Choudhry

Journal of Bond Trading and Management

www.YieldCurve.com



Agenda

- /// Credit derivatives and securitisation
- /// Synthetic CDOs
- /// Managed synthetic CDOs
- /// Case study



Credit Derivatives and Securitisation: the CDO

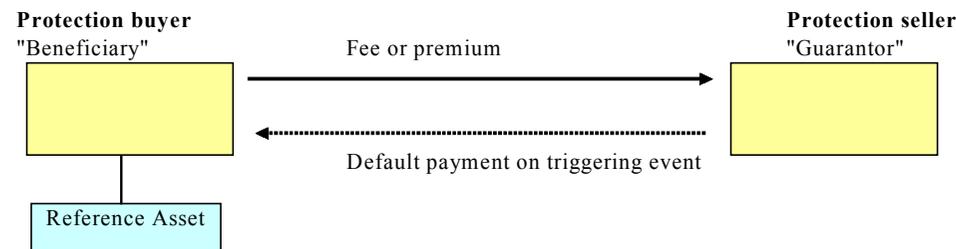
- /// **Collateralised Debt Obligations** (CDOs) are a major asset class in the securitisation and credit derivatives markets.
- /// CDOs provide **banks** and **portfolio managers** with a mechanism to outsource risk and optimise economic and regulatory capital management. For **investors** they are a tool by which to diversify portfolios without recourse to the underlying assets.
- /// CDOs split into two main types: **balance sheet** and **arbitrage**. Within these categories they may be either **cashflow** or **synthetic**.
- /// In a cashflow CDO the physical assets are sold to a special purpose vehicle (SPV) and the underlying cash flows used to back the principal and interest liabilities of the issued overlying notes.
- /// In a synthetic securitisation, **credit derivatives** are employed in the structure and assets usually retained on the balance sheet.



Credit derivative instruments

- /// With a credit derivative one is transferring credit risk of specified asset(s) to a 3rd party while keeping the asset(s) on the balance sheet – so not a “true sale” but use of loss definitions for risk transfer.
- /// In a credit derivative contract the buyer of protection pays a premium to the seller of protection, who is obliged to pay out on occurrence of a credit event

/// Credit default swap

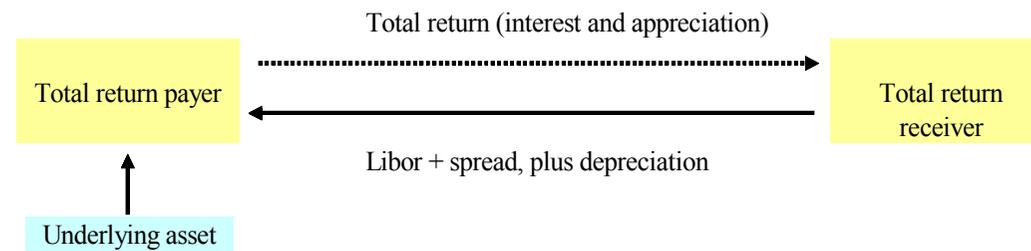


- /// The “trigger event” is the credit event as defined in the legal documentation for the contract
- /// A credit default swap is deemed to be an unfunded credit derivative, because the protection buyer is exposed to counterparty risk from bankruptcy of protection seller



Credit derivatives

- /// **Total return swap:** Like a credit default swap, a bilateral contract, but where the protection buyer exchanges the economic performance (“total return”) achieved by the reference asset in return for periodic payment that is usually a spread over Libor. Similar to asset swaps, allowing the total return receiver to create a synthetic leveraged position in the reference asset



- /// **Credit-linked note:** A bond containing an embedded credit derivative, linked to the credit quality of the issuer *and* of the underlying reference credit. The investor – the protection seller – receives an increased coupon payment, as well as par value of the note on maturity assuming no credit event occurs. CLNs are funded credit derivatives since the issuer (protection buyer) receives payment upfront for the note and so has no counterparty risk exposure.



Synthetic securitisation

- /// **True sale versus synthetics: a true sale via SPV**
 - has higher costs
 - less flexibility
 - takes longer to bring to market
 - is more difficult across multiple legal and regulatory regimes
- /// **Unified documentation (ISDA)**
- /// **Flexibility to create customised exposure**
- /// **Enables separation of funding and credit risk management**
- /// **Synthetic CDOs**
 - “Second generation” CDO use CDS and/or CLN or SPV; unfunded, partially funded / fully funded
 - Third and fourth generation CDOs: Hybrid CDO mixing elements of synthetic CDO with cash assets (eg., Deutsche Bank “Jazz”)
 - Managed synthetic or “CSO” (Robeco III)

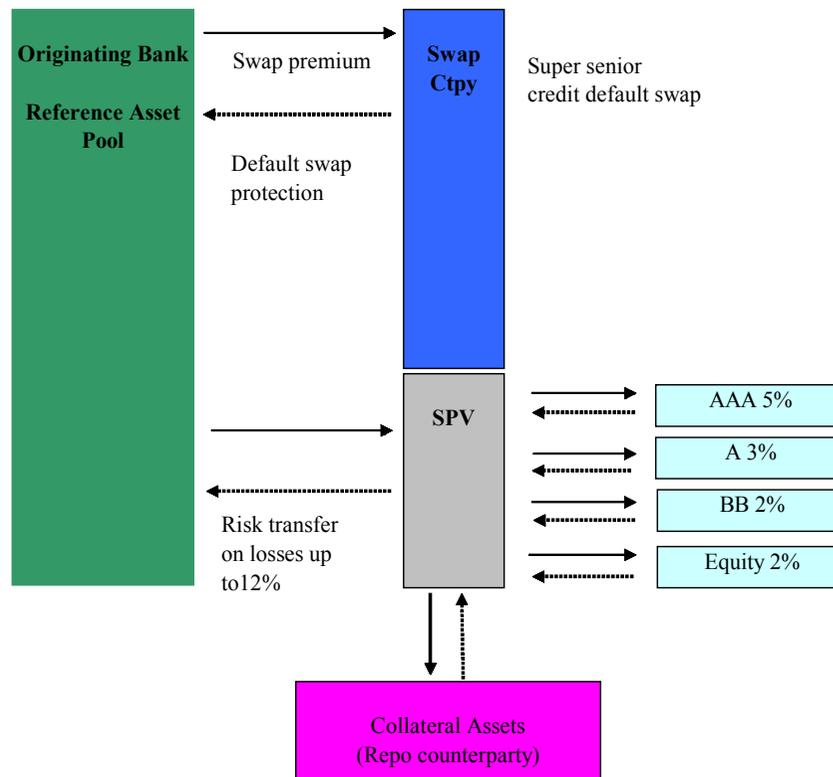


Synthetic CDOs...

- /// Synthetic CDOs combine securitisation techniques with credit derivatives and were introduced in Europe in 1998.
- /// A vehicle used to transfer credit risk via credit derivatives, rather than via a “true sale” of receivables to an SPV. The variations include:
 - /// Funded synthetic, where liabilities are solely credit-linked notes
 - /// Unfunded, where liabilities are solely credit default swaps
 - /// Partially funded: both credit-linked notes and credit default swaps
- /// The originator transfers the credit risk of a pool of reference assets via **credit default swaps**, or transfers the total return profile of the assets via a **total return swap**.
- /// Typically an SPV issues one or more tranches of securities which are the **credit-linked notes**, whose return is linked to the performance of the reference assets.
- /// Proceeds of note issuance form the first-loss protection reserve and are usually invested in liquid AAA-rated collateral.
- /// Synthetic CDOs have evolved into a number of forms (**static, dynamic, managed**)



Generalised partially funded synthetic CDO



- The majority of the credit risk is transferred by the “super senior” credit default swap, usually sold on to a monoline insurer...

- **current issues?!**

- The riskier element is transferred via the SPV which issues default swaps (unfunded) or credit-linked notes (funded)

- The first-loss piece is the unrated equity note.

- Each note has a different risk/return profile



Motivation behind synthetic CDOs

- /// The primary motivation for entering into an arbitrage CDO is to exploit the yield mismatch between a pool of assets and the CDO liabilities.
- /// Motivation behind a balance sheet CDO is to manage regulatory risk capital and engineer more efficient capital usage

- /// **Advantages of a synthetic structure**

Typically the reference assets are not actually removed from the sponsoring firm's balance sheet. For this reason:

- /// **synthetic CDOs are easier to execute than cash structures:** the legal documentation and other administrative requirements are less burdensome
- /// **there is better ability to transfer credit risk:** especially partial claims on a specific credit reference asset
- /// **risk transfer achieved at lower cost:** the amount of issuance is small relative to the reference portfolio. In a "partially funded" structure, funding is mainly provided by the sponsoring financial institution at lower cost than fully funded structures.
- /// **Lower risk weightings:** eg., 100% corporate loan vs 0% on funded portion



Managed synthetic CDOs or “CSO”

- /// Essentially a managed synthetic CDO or CSO is an arrangement designed to provide investors with high return on a portfolio of investment grade credits
- /// Structured to have a higher average rating quality and shorter maturity than traditional high yield cashflow CDOs
- /// The portfolio manager actively trades in and out of credits according to its view,
 - Buying protection with swap counterparties, entering into offsetting swap
 - Selling protection
 - Each new default swap traded must meet portfolio tests (“covenants”) established by rating agency and confirmed by Trustee
- /// The structure is designed to generate higher zero-default expected return than cashflow CDO, typically 7-9% higher, with risk-adjusted return (historical default statistics) around 5-6% higher



///CASE STUDY: ROBEKO CSO III B.V.

- Issuer: Robeco CSO III B.V.
- Originator: Robeco International Asset Management
- Arrangers: JPMorgan Securities Ltd and Robeco Alternative Investments
- Trustee: JPMorgan Chase Bank
- Portfolio Administrator: JPMorgan Chase Bank
- GIC account: Rabobank

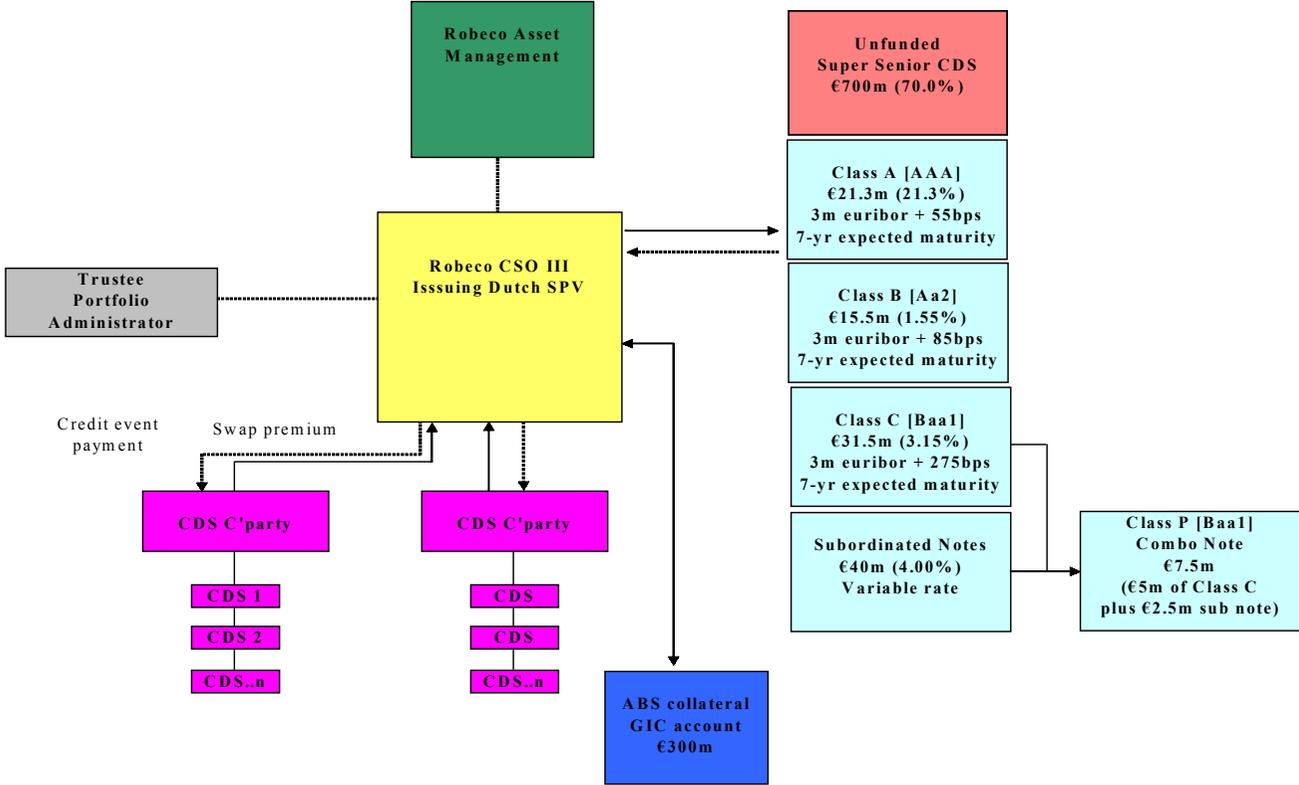


Robeco CSO III B.V.

- /// Originator is Robeco Institutional Asset Management, issuer is Robeco CSO III B.V., bankruptcy-remote vehicle incorporated in Netherlands.
- /// Structure is €1bn of reference pool assets, partially funded managed synthetic CDO, with €300m issued in five classes of notes, collateralised by ABS bond (MBNA credit card issue, AAA rated) and GIC account
- /// The issuer enters into credit default swaps with specified list of counterparties. The portfolio of CDS is dynamic, as the portfolio manager can enter into new CDS or offset existing CDS by purchasing protection on the same entity.
- /// Trading CDS means that differences in spread levels at time of trade will lead to trading gains and losses.
- /// With Robeco CSO, manager can purchase protection **only** to close out an existing sale of protection



Robeco III structure diagram





Note tranche summary

Class	Amount €m	Percent	Rating	Type	Coupon
Class A	213	21.30%	AAA	Floating	3meuribor + 0.55%
Class B	15.5	1.55%	Aa2	Floating	3meuribor + 0.85%
Class C	31.5	3.15%	Baa1	Floating	3meuribor + 2.75%
Subordinated	40	4.00%	NR	Variable	
Class P	7.5		Baa1	Variable	

(Source: MbodyS)



Credit Default Swaps

- /// The Issuer takes a view on particular reference assets and sells protection via credit default swaps
- /// The terms of the CDS are:
 - Regular premium paid by counterparty to Robeco CSO III B.V.
 - On occurrence of pre-defined credit event on any of the reference assets in the reference pool, the calculation agent will determine the difference between the nominal value of the reference asset and its market value. This amount paid by Robeco CSO III B.V. to the counterparty (cash-settled CDS)
 - During life of transaction the Issuer may buy protection on any asset to close out an existing (sold protection) CDS
- /// Credit events are defined as: failure to pay, restructuring, bankruptcy, repudiation and moratorium, and obligation acceleration
- /// Structure rated by Moody's



Innovative structure

- /// Robeco III is the first managed synthetic deal in Europe, a multiple-dealer stand-alone structure
- /// The transaction is 70% unfunded and 30% funded. The unfunded part comprises 100-130 reference assets, of which 95% are investment grade, with Baa2 maximum weighted average rating.
- /// This rating is above average compared to most CDOs due to the liquidity of the CDS market – more names can be traded in this market compared to the cash market
- /// The portfolio manager is able to undertake credit trading on European corporate and other credits in the more liquid credit derivatives market, where they may be liquidity problems in the cash market
- /// There is therefore a dynamic, active pool of assets (compared to previous static pool) whose credit can be traded with up to seven CDS counterparties

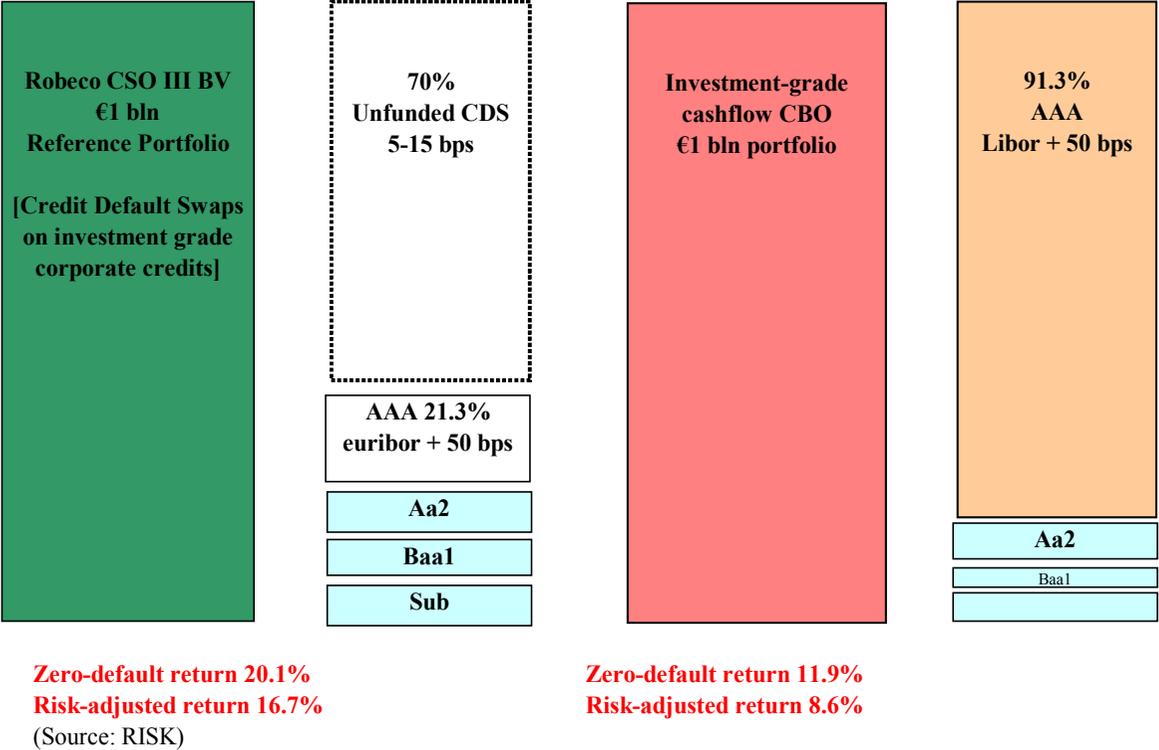


Investor return

- /// The note issue will be of interest to investors who wish to hold credits but where opportunities are limited because of liquidity issues, or lack of market intelligence / expertise in analysis of high yield debt.
- /// The class A, B and C notes pay from 55 bps to 275 bps over 3m euribor, (2008 expected maturity, so 7-year paper). The sub notes pay a variable return reflecting trading activity, as credit-linked notes.
- /// The structure design is similar in concept to an entity with 30% capitalisation. As this is collateralised with AAA security, this is effectively Tier 1 capital with 0% risk weighting.
- /// The zero-default expected return is 20.1%, while expected return based on historical default rates of the reference assets is 16.7% (source: RISK). This is higher than expected returns on equivalent investment-grade cashflow CDO



Return comparison





www.YieldCurve.com

- ✓ Fixed income market research
- ✓ Publications
- ✓ Market intelligence
- ✓ Up-to-date terminology

DISCLAIMER

The material in this presentation is based on information that we consider reliable, but we do not warrant that it is accurate or complete, and should not be relied on as such. Opinions expressed are current opinions only. We are not soliciting any action based upon this material. YieldCurve.com or any other affiliated body mentioned or not mentioned in this presentation cannot be held liable or responsible for any outcomes resulting from actions arising as a result of delivering this presentation. Moorad Choudhry or any of his associates may or may not have a position in any instrument described in this presentation. This presentation does not constitute investment advice and should not be construed as such.

Contact

info@yieldcurve.com