

CDSs, CLOs, CLNs... : Credit Derivatives are Leaving “iTraxx”

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CDSs, CLOs, CLNs...

- Introduction
- Credit derivatives – an overview
 - Key structures and concepts
 - Participants
 - Main applications
- Linguistic challenges
 - The concept of “credit”
 - Some examples
- Q&A

Credit derivatives – introduction

- Some figures to start with...
 - “Notional amount of credit default swaps grew by 52% in the first six months of the year to \$26.0 trillion from \$17.1 trillion. The annual growth rate for credit derivatives is 109% from \$12.4 trillion at mid-year 2005. 88 firms provided credit default swap data.”

*Source: ISDA – www.isda.org
(2006 Mid-year Market Survey)*

Credit derivatives – introduction

- ...and some quotes:
 - “CDSs of CDOs spice up the alphabet soup”
 - “As one senior banker recently admitted, ‘Almost every other week a new word pops up that I have to ask [my juniors] to explain.’”
 - “As the derivatives market democratises, more firms are using assets they don’t adequately understand, and they collectively represent a much bigger risk.”

Credit derivatives – introduction

- ...and that's what we're up against:
“Essentially DEF is transferring the major part of the credit risk on the loans in the pool by purchasing credit protection via a Credit Default Swap from XYZ, who then in turn purchases credit protection on the reference pool from a number of banks and institutional investors: the £355.7 m non-funded Super-Senior Tranche (rated AAA/Aaa by S&P and Moody's respectively) has been insured by ABC, the leading US monoline insurer.”

Credit derivatives – an overview

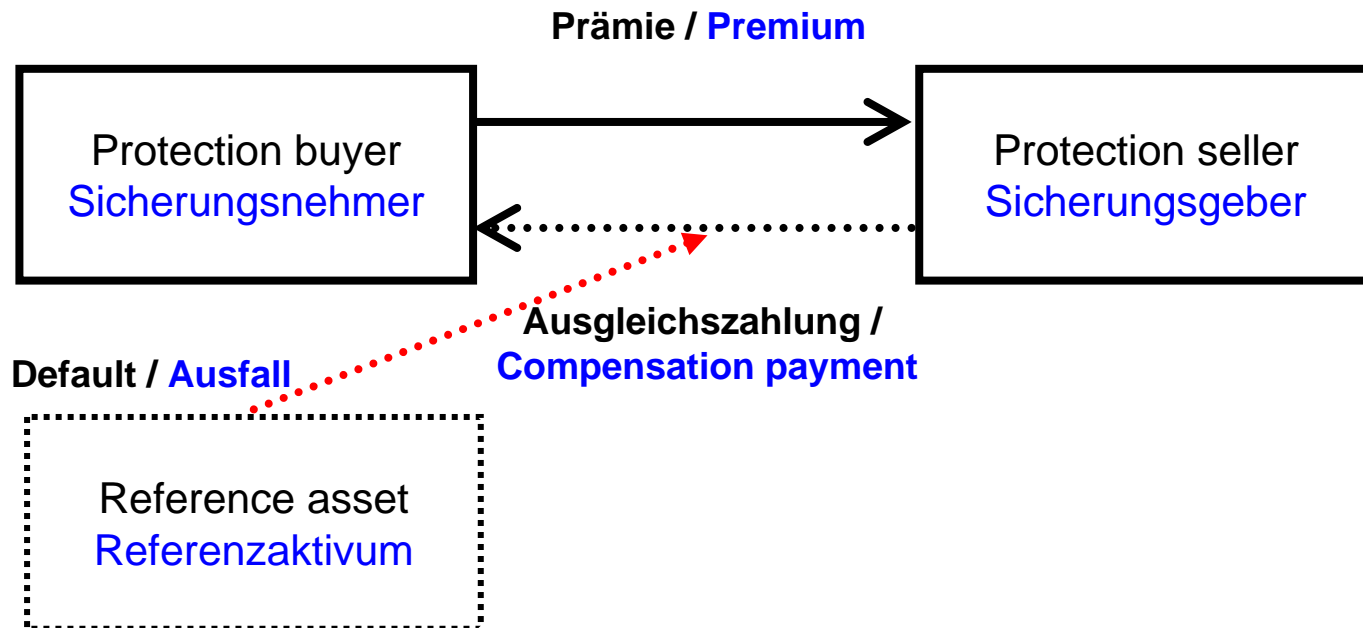
- Key structures and concepts
 - **CDS**: Credit Default Swap
 - **TRS**: Total Return Swap
 - **CLN**: Credit Linked Note
 - **CDO**: Collateralised Debt Obligation
 - **SCDO**: Synthetic Collateralised Debt Obligation

Key structures and concepts

- Protection buyer
- Protection seller
- Premium
- Credit spread
- Reference asset/
reference entity
- Default
- Sicherungsnehmer
- Sicherungsgeber
- Prämie
- Spread
- Referenzaktivum/
Referenzschuldner
- Ausfall

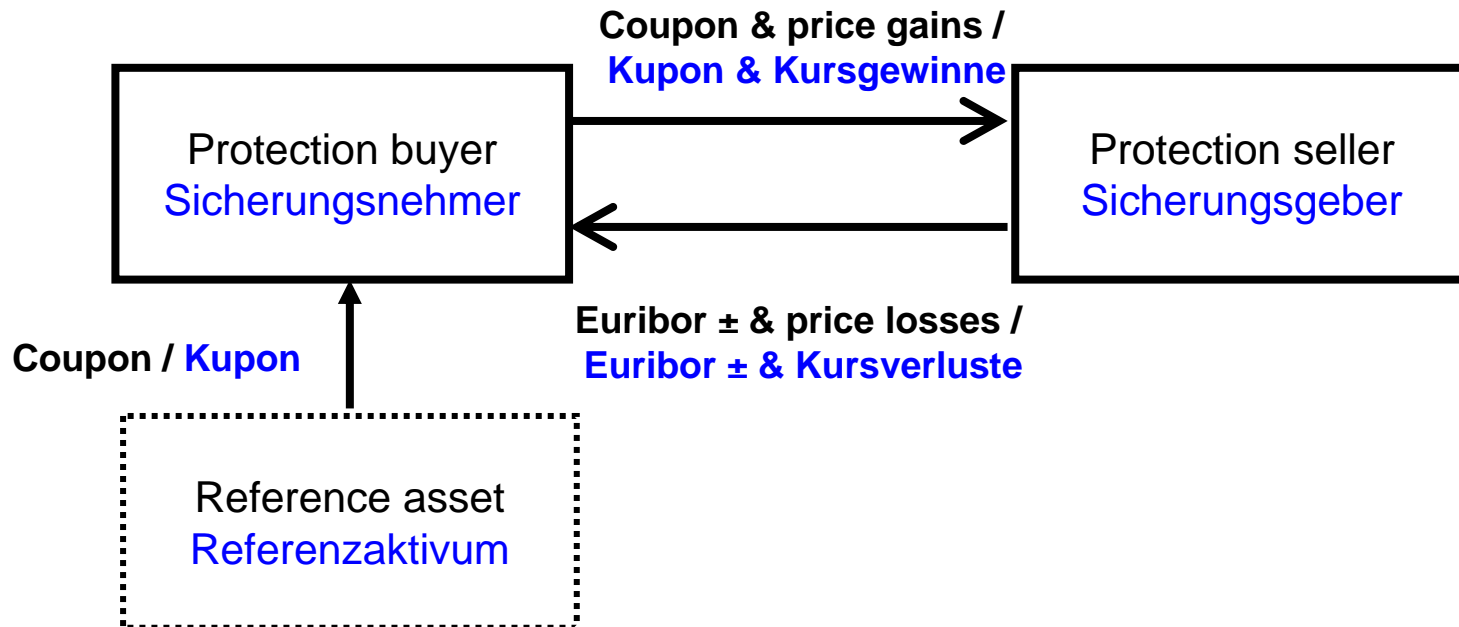
Key structures and concepts

- Credit Default Swap



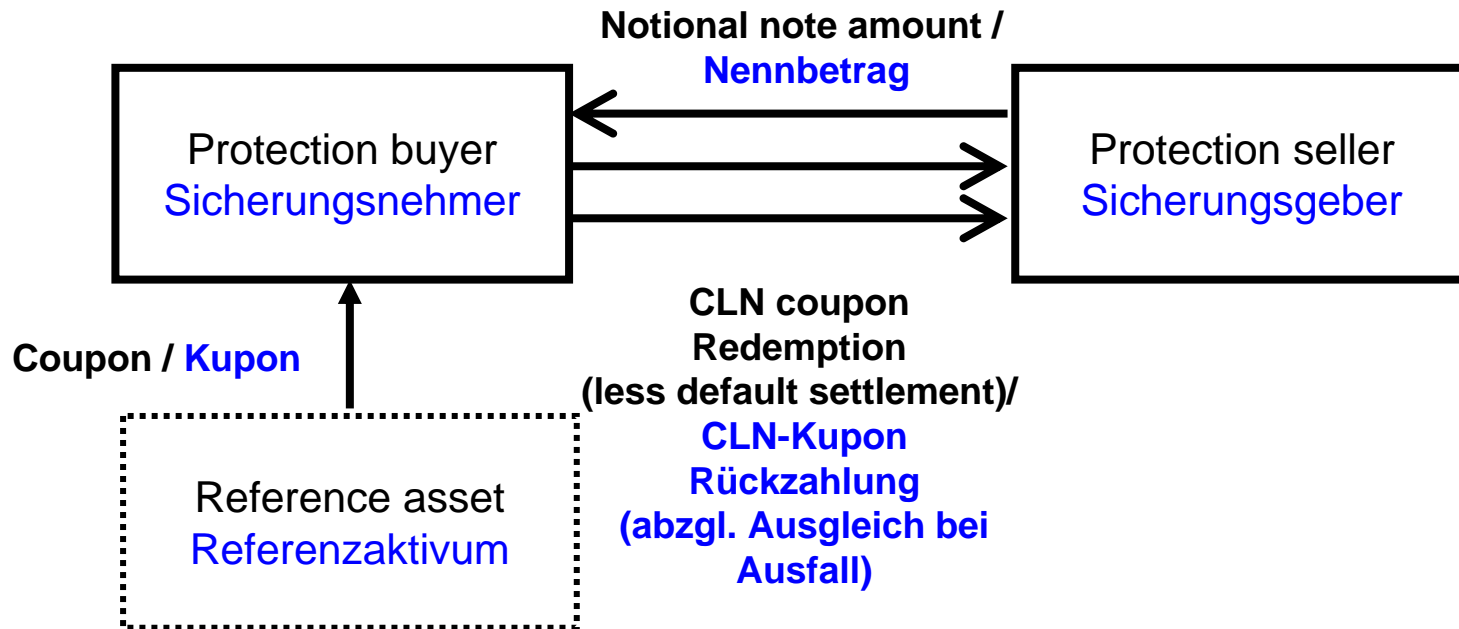
Key structures and concepts

- Total Return Swap



Key structures and concepts

- Credit Linked Note



Key structures and concepts

- Single-name credit derivatives
 - based on single reference asset
- Basket credit derivatives
 - based on basket of reference assets
- Credit index derivatives
 - e.g. on iTraxx index (125 most liquid single-name credits)
 - Index tranches (super senior, senior, mezzanine, junior/equity, first-loss piece)

Participants / Main applications

- Banks (banking book/credit portfolio)
 - Segregation of credit risk and liquidity
 - Active management of credit risks
 - “Credit volume under management”
 - Credit spreads and statistical data as a basis for credit pricing
 - Basel II

Participants / Main applications

- Proprietary traders (banks, hedge funds, etc.)
 - Active assumption of credit risk
 - Trading portfolio
 - Arbitrage across different asset classes
 - Structured products

Participants / Main applications

- Investors
 - Credit risk exposure as a separate asset class
 - Active portfolio diversification
 - Return enhancement

Linguistic challenges

- The concept of “credit”
 - Credit spreads
 - Credit investments
 - Credit instruments
 - Credit trading
 - ...



Linguistic challenges - examples

“Unfunded” vs. “funded”

In an unfunded contract, the protection buyer is exposed to counterparty risk, whereas in a funded transaction the protection buyer is exposed to the risk of credit deterioration in the collateral pool (but not to counterparty risk).

Linguistic challenges - examples

In an unfunded contract, the protection buyer is exposed to counterparty risk, whereas in a funded transaction the protection buyer is exposed to the risk of credit deterioration in the collateral pool (but not to counterparty risk).

Bei einem reinen Derivativkontrakt ist der Sicherungsnehmer somit dem Kontrahentenrisiko ausgesetzt. Dies ist bei der strukturierten Transaktion nicht der Fall – hier besteht jedoch das Risiko der Bonitätsverschlechterung im Pool der als Sicherheit dienenden Wertpapiere.

Linguistic challenges - examples

Super-Senior Tranche

Essentially DEF is transferring the major part of the credit risk on the loans in the pool by purchasing credit protection via a Credit Default Swap from XYZ, who then in turn purchases credit protection on the reference pool from a number of banks and institutional investors: the £355.7 m non-funded Super-Senior Tranche (rated AAA/Aaa by S&P and Moody's respectively) has been insured by ABC, the leading US monoline insurer.

Linguistic challenges - examples

Essentially DEF is transferring the major part of the credit risk on the loans in the pool by purchasing credit protection via a Credit Default Swap from XYZ, who then in turn purchases credit protection on the reference pool from a number of banks and institutional investors:

Wirtschaftlich überträgt die DEF den Großteil des Kreditrisikos der im Forderungspool enthaltenen Kredite durch Abschluss einer Kreditabsicherungsvereinbarung (Credit Default Swap) mit der XYZ, die sich wiederum durch entsprechende Vereinbarungen mit einer Reihe von Banken und institutionellen Investoren im Markt absichert.

Linguistic challenges - examples

...the £355.7 m non-funded Super-Senior Tranche (rated AAA/Aaa by S&P and Moody's respectively) has been insured by ABC, the leading US monoline insurer.

Die Absicherung für die erstrangige, ausschließlich über Derivate dargestellte „Non-Funded Super-Senior“-Tranche über 355,7 Mio. GBP mit einem Rating von AAA (S&P) bzw. Aaa (Moody's) wurde durch den führenden US-„Monoline“-Versicherer ABC übernommen.

Linguistic challenges - examples

Komponenten von CDS-Spreads:

Zum Zeitpunkt des Kontraktabschlusses (t) entspricht der erwartete Barwert der Prämienseite der Summe der abgezinsten Prämienzahlungen; dabei ist der effektive Abzinsungssatz ($r + h$) der um die Ausfallwahrscheinlichkeit adjustierte risikofreie Zinssatz.

Linguistic challenges - examples

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At origination of a contract at time t , the expected present value of the premium leg is equal to the expected sum of discounted premium payments, where the effective discount rate, $r + h$, is the risk-free rate adjusted for the possibility of default.

Q&A

Do you have questions?



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