# Credit Derivatives and Synthetic Securitisation

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# Agenda

- Credit derivatives
- Traditional securitisation
- Synthetic securitisation (CSOs)
- Synthetic ABCP conduits
- Repacks

# Credit Derivatives

## Credit derivatives

Traditional definition: bilateral OTC contracts designed to reduce or eliminate credit risk exposure and enable credit risk to be taken on or reduced synthetically

The modern definition: a means of investing in assets (not “credit-risky assets” – what about sovereign CDS) using derivatives

Forget the insurance premium idea: credit derivatives are doing to the corporate markets what interest-rate derivatives did for interest rates in the early 1980s

Single-name and basket (or “portfolio”) credit derivatives

## Benefits of the synthetic market

Meets specific requirements of issuer and investor; flexiblity of OTC and OBS instruments

Enables long- and short-position taking with ease and liquidity

More flexible risk management (the original use – bank risk management, asset portfolios, client relationships, etc)

Isolates credit as an asset class in its own right, making possible a credit term structure and more transparent markets

# Credit derivatives...

## Instrument types

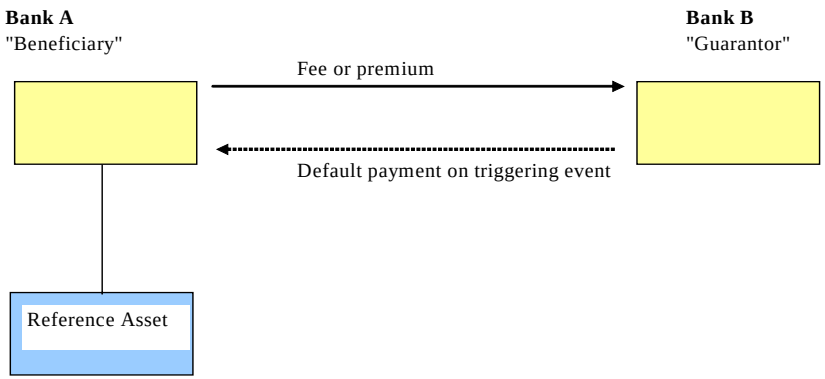
Asset swap

Credit default swap (below)

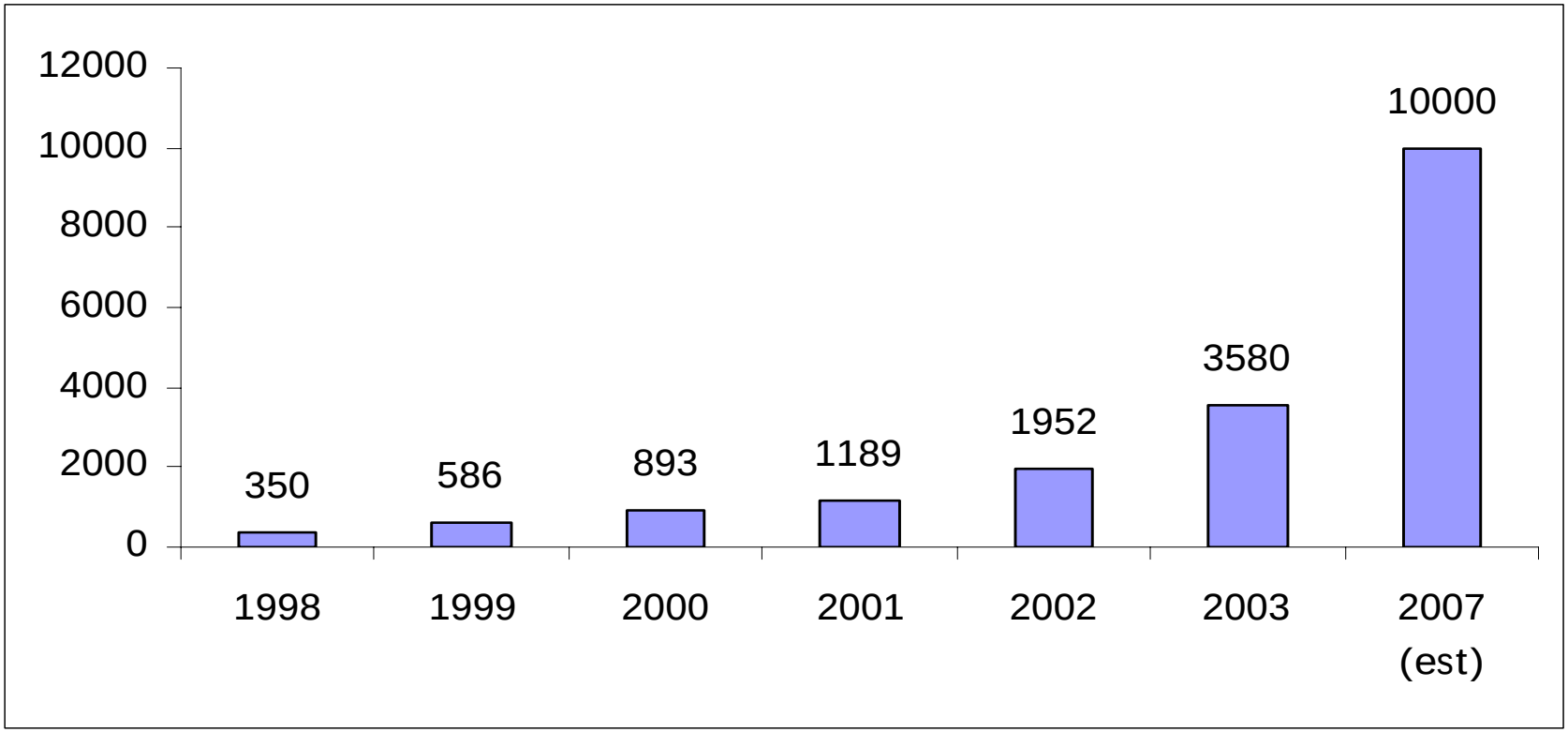
Total return swap (synthetic repo)

Credit-linked note

Portfolio products (basket CDS, FtD, nth-to-default, etc)



# Credit derivatives volumes, $bln notional plus estimate




Source: BBA, ISDA

## First – securitisation

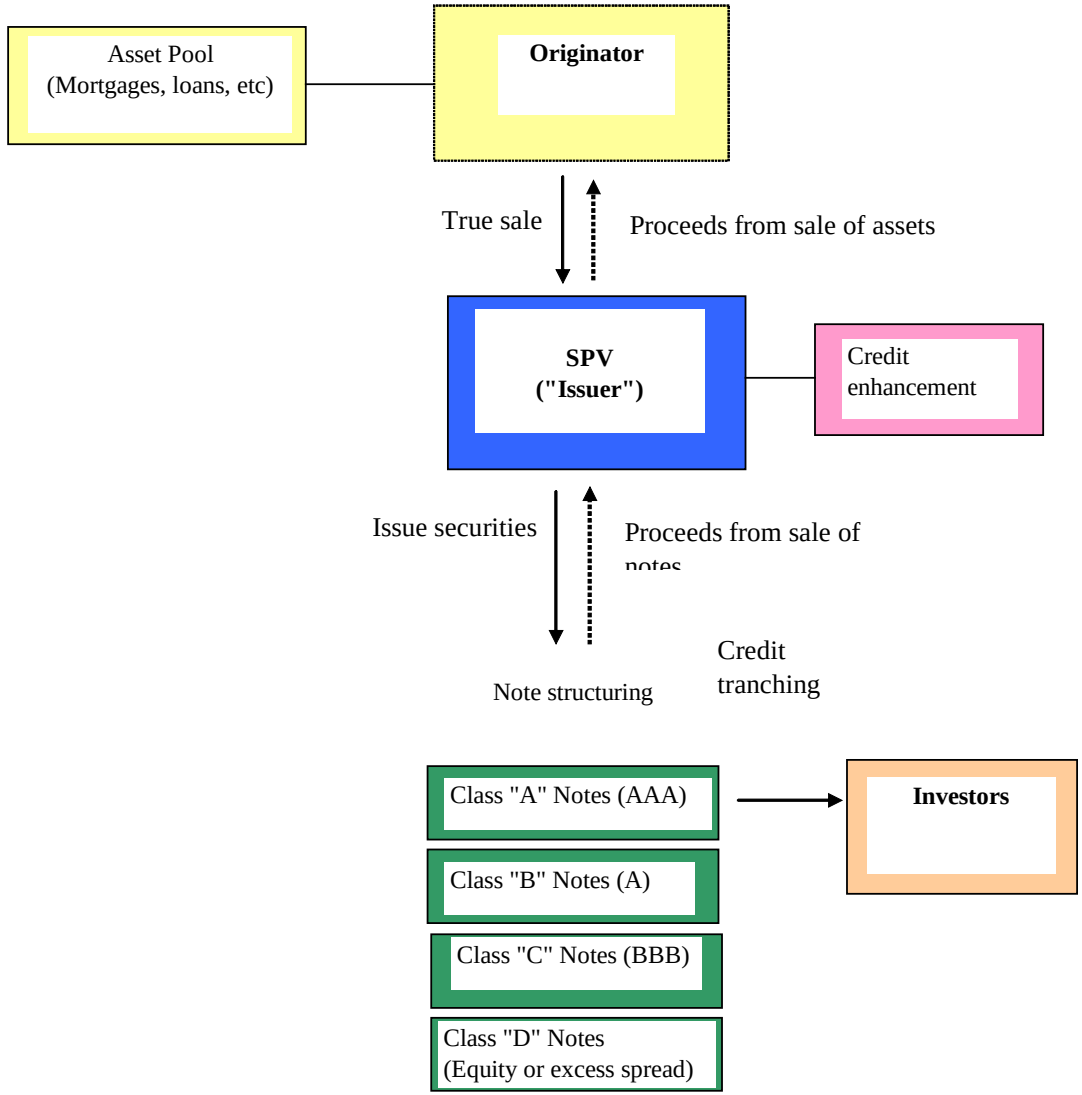
One of the great contributions of investment banking to global economic developments

Realising value from asset portfolios, diversifying investment opportunities, greater intermedation, cheaper funding, the list of advantages is very long…

ABS, MBS, CDO…

A picture is worth, if not a thousand words, at least a slide of text or two…

# Traditional securitisation



## Synthetic securitisation

Traditional securitisation is "true sale" securitisation

We can use credit derivatives – usually CDS but sometimes also TRS and CLN – to replicate the effect of a true sale without actually doing so

Advantages:

- more tailored structures
- quicker to market
- easier across multiple legal jurisdictions
- unified ISDA documentation
- enables separation of funding and credit risk management

## Synthetic CDOs

Combine securitisation with credit derivs

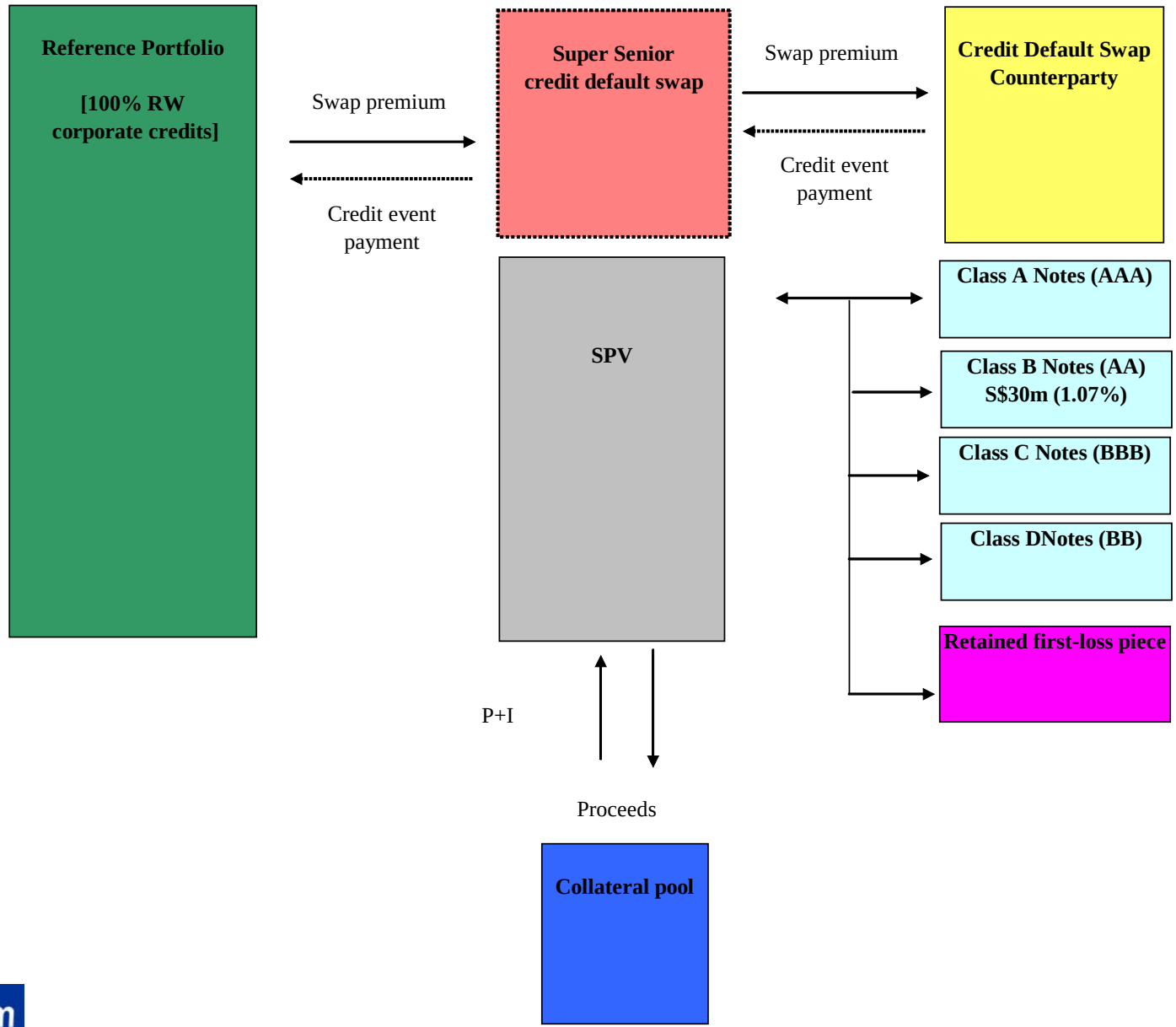
An SPV used to transfer credit risk via credit derivatives, not by actually selling/purchasing any cash assets

Variations included funded (CLN), unfunded and partially funded

Various forms: static, managed, single-tranche, hybrid

They DO use tranching to obtain the range of credit ratings traditional in cash securitisation: super-senior swap, swap, CLNs, equity piece, etc

# Generic partially funded synthetic CDO



## Motivation for issuance

"Arbitrage" CDOs: exploiting yield mismatch between asstes and liabilities

Balance sheet CDOs: regulatory capital and ALM management

Synthetic CDOs are sometimes easier to execute than cash structures

Better ability to transfer credit risk, especially partial claims on a specific reference asset

Risk transfer at lower cost

Lower risk weightings on OECD bank CDS counterparties

## Jazz CDO

A structure from 2002 so not exactly new! But innovative nevertheless…

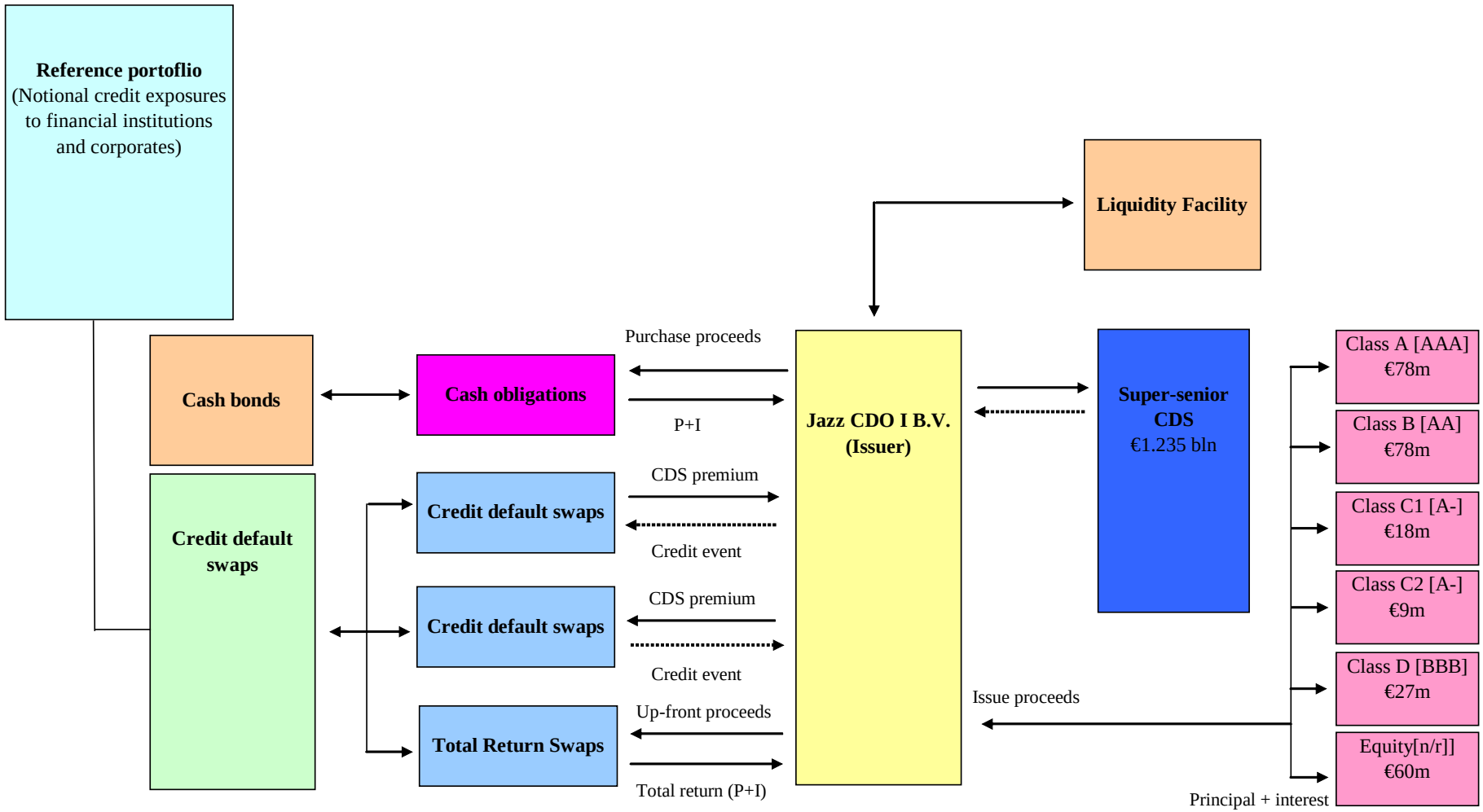
This is in effect a fund management vehicle for its sponsor, AXA IM, that combines both a cash and synthetic CDO

Combines super-senior swap and note issue. Note proceeds can be used to purchase cash bonds, or placed in collateral account.

Swap and notes assume credit risk of the reference portfolio. Cash assets can be bonds, HY, ABS, etc

In effect, an SIV-type [??] structure that combines securitisation, portfolio management expertise and cash and synthetic credits in one vehicle

# Structure diagram Jazz CDO BV

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## Synthetic ABCP conduits

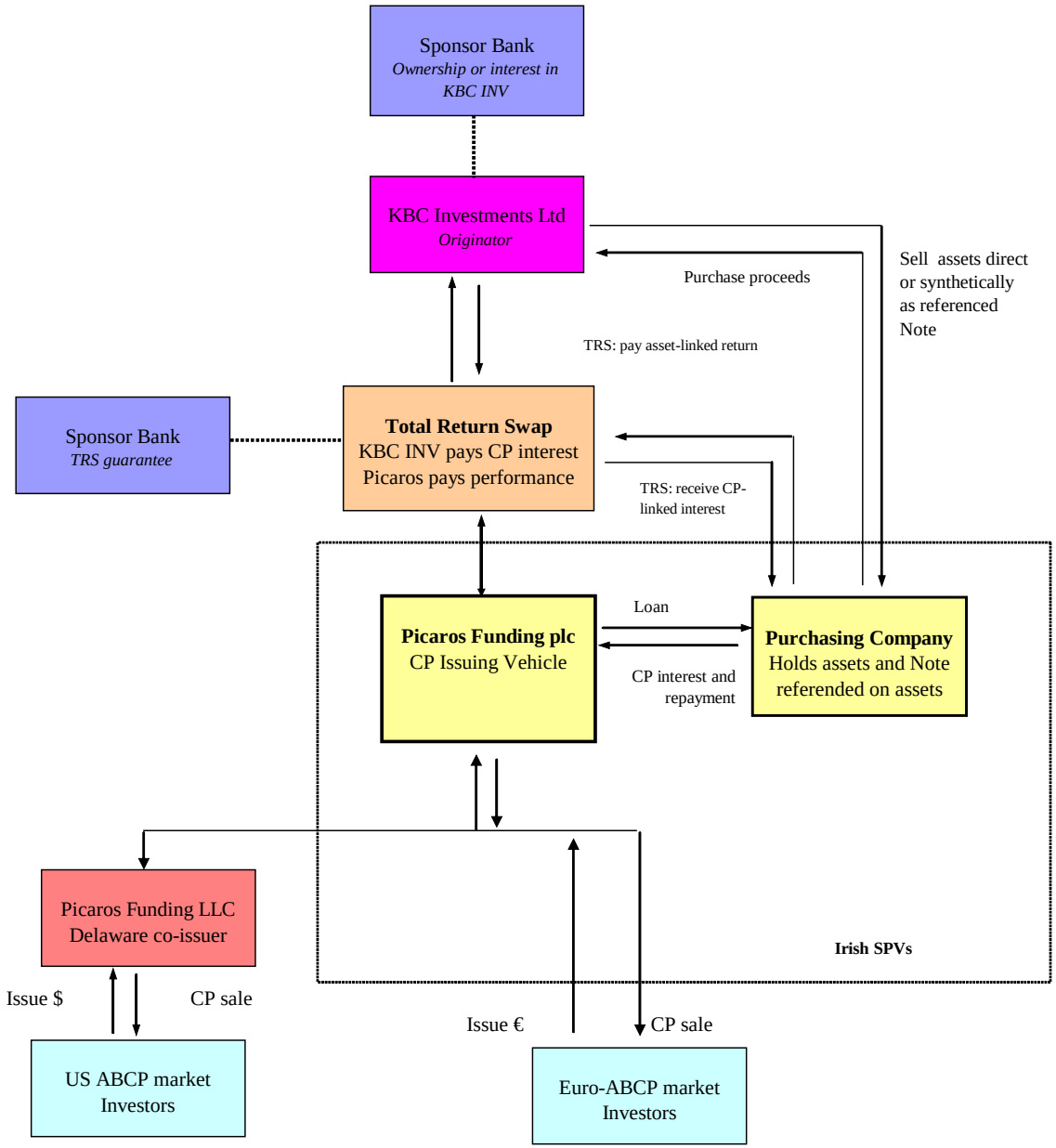
Conduit is just another name for SPV but for some reason this term is used in the money markets

Asset-backed conduits employ securitisation techniques to raise funds at shorter-term liabilities, hence they are used in the money markets. In the same way as an ABS, the conduit purchases assets (receivables, etc) and uses these to back an issuance of CP

A synthetic ABCP conduit does not purchase cash assets, rather it uses TRS instruments to reference assets synthetically

The conduit credit rating is in effect a rating of the guarantee or backing behind the TRS

# Picaros Funding plc…the world's first synthetic ABCP deal

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# Synthetic Repacks

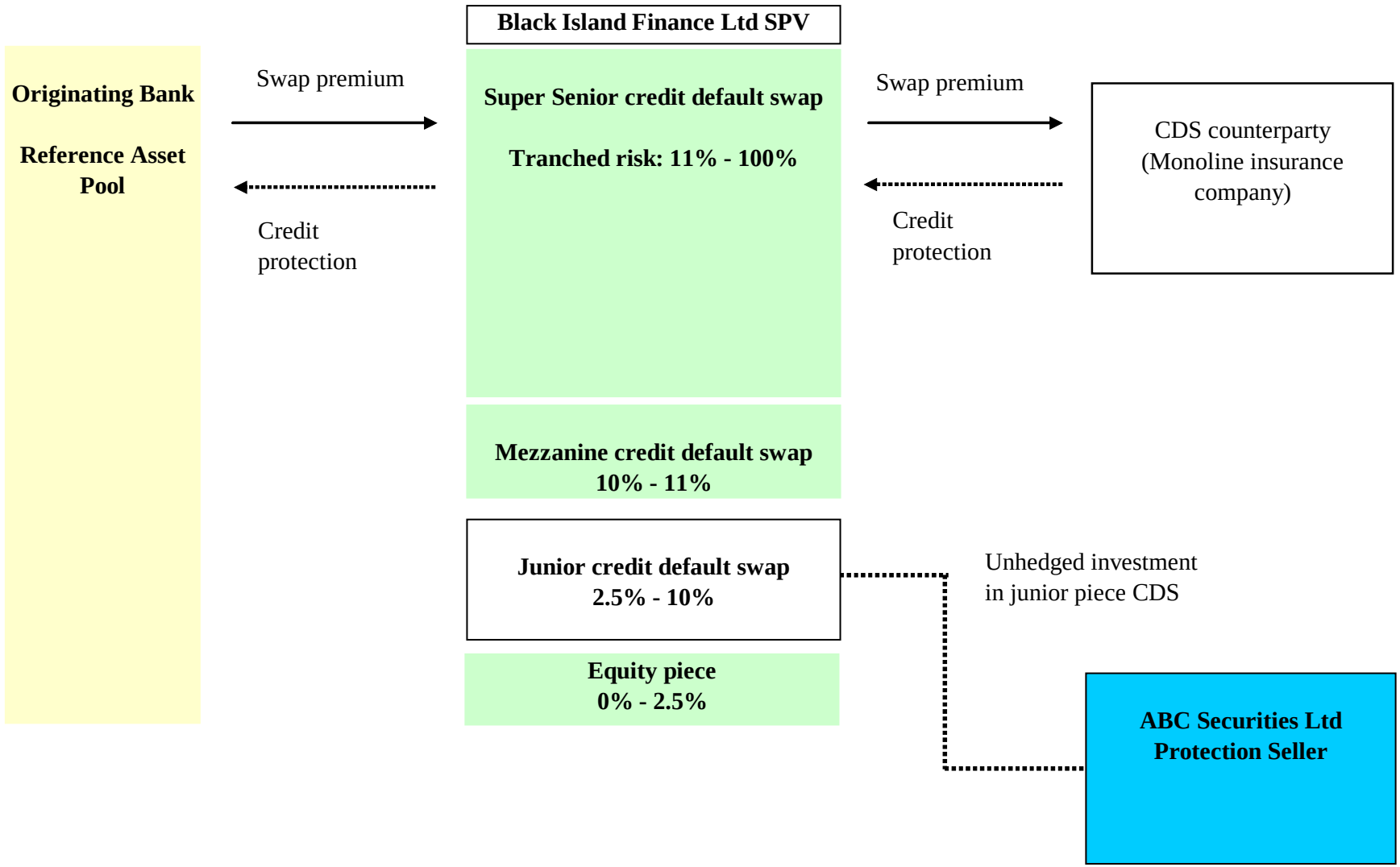
"Repacks" is short for "repackaging" or "repackaged security" and is the art of using an SPV to repackage an existing security into something with added features and enhancements so it can be sold on to new investors

An early form of securitisation – the first repacks were of illiquid Japanese convertible bonds

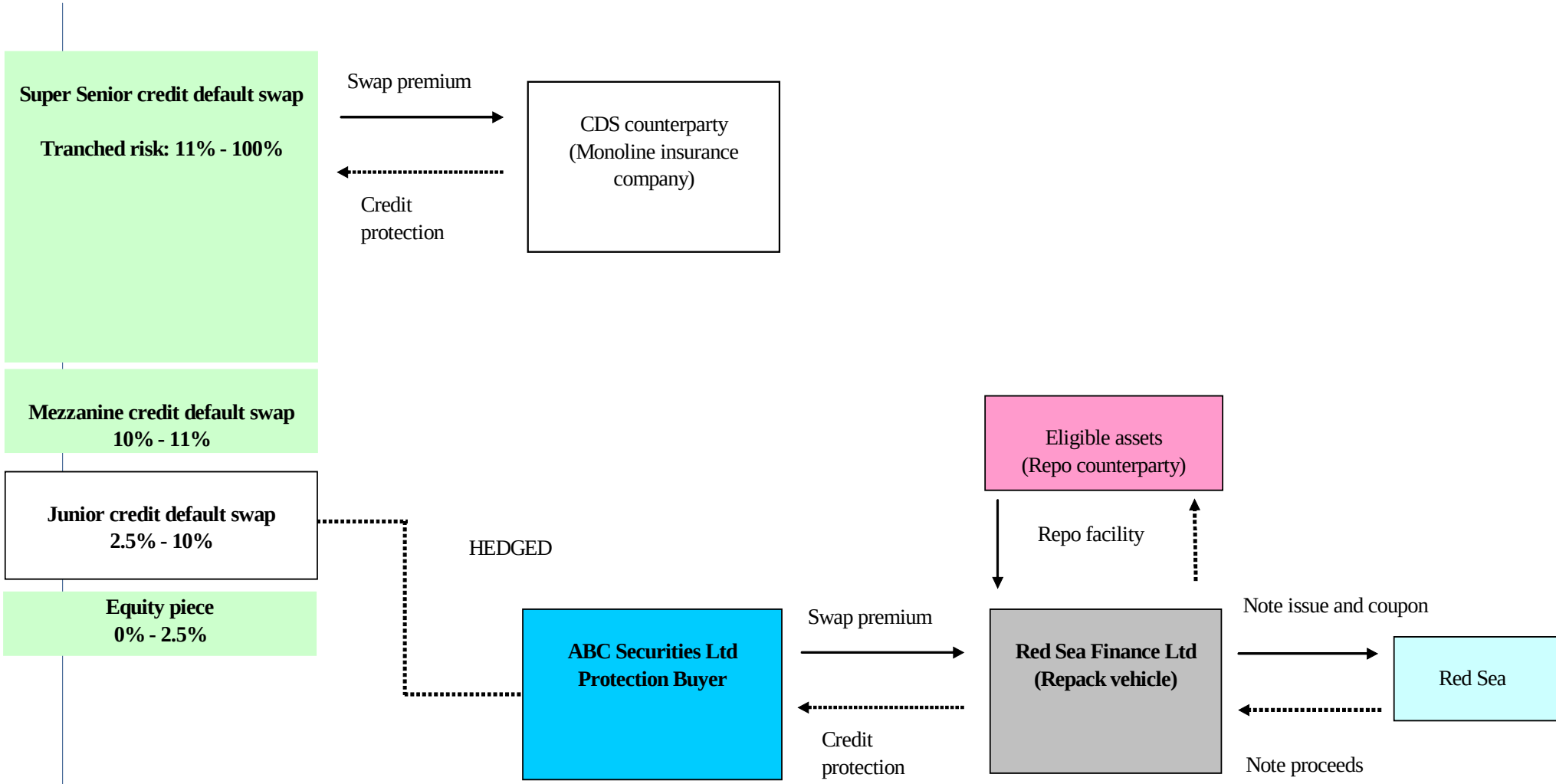
The example overleaf is an existing issue – a note from a CDO [??] – that has been repackaged using a CLN

The structure was employed when the existing noteholder wanted to hedge out its holding so repackaged it to a client (another investor)

# Repackaged CDO investment



# Repackaged CDO investment...

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