ABCDS - Marrying ABS with CDS

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The latest evolution in the credit derivatives market is the International Swaps & Derivatives Association's standard form documentation for credit default swaps written on ABS, otherwise known as ABCDS. Derivatives market participants have long desired to acquire ABS exposure. In the current tight credit spread environment, the higher yields from ABS as compared to the yield from investing in a corporate bond of equivalent rating makes it an attractive asset. Moreover, the shortage of cash ABS in the primary market has encouraged the growth of financial derivatives that transfer the risks of such securities without the need to acquire the assets. A synthetic credit derivative such as a synthetic CDO can free up valuable regulatory capital. By combining credit derivative technology with well-established ABS structures, a new and expanded credit investment market has developed.

Until recently, the major stumbling block for growth in this market has been the lack of standardized documentation. Variations across individually crafted documents result in a lack of transparency in the risks associated with each trade and create unquantifiable risks. When the ISDA published its first set of Credit Derivative Definitions in 1999 - which it republished in an improved form in 2003 - it relieved much of the market angst over the lack of standardized documentation. However, innovations in the CDS market to encompass ABS, made the ISDA definitions that were focused on corporate credits, less than useful. Two new ISDA templates for ABCDS on CMBS and RMBS attempt to address this issue in these two asset classes, reduce the hidden risks and enhance liquidity.

From its early days of customized swaps tailored principally for bank clients, the volume of credit derivatives has grown exponentially. The ISDA reported in its 2004 mid-year survey that the notional outstanding amount for credit derivatives in the first six months of the year alone, grew by 44% to $5.4 trillion. Some of this growth can be attributed to the increase in the number of participants expanding beyond banks and insurance companies to encompass hedge funds and asset managers and the fact that credit derivatives have become a more acceptable financial hedging and risk transference tool. In the continuing search for higher yield, the credit derivative, in particular in the synthetic form, has provided some reprieve for market participants. Standardization of documentation and structural innovations that permit this product to be applied across a range of asset classes have also added to this unprecedented growth.

Probably the most important document in a credit derivative transaction is the credit default swap agreement. In a typical credit default swap agreement, a counterparty with risk concentration in a particular credit (the protection buyer) enters into a contract to sell some of that risk to another party (the protection seller) by paying a premium. Upon the occurrence of a credit trigger event, such as the bankruptcy of the reference entity, the protection buyer may put the underlying obligations of the corporate entity, bonds or loans, to the protection seller.

Although a significant portion of the credit derivatives market still involves single name corporate default swaps, an increasing number of credit default swaps now reference market standard credit indices such as iTRAXX and Dow Jones CDX. In recent years, synthetic credit derivatives have become increasingly popular as a way to transfer tranched credit risks in a portfolio. Instead of issuing a credit derivative across the entire spectrum of the capital structure, synthetic credit derivatives allow the separate allocation of credit risks to specific tranches. Other innovations in transaction structure and reference asset include CDOs on a basket of CDOs, repo CDOs, CDOs of emerging market sovereigns and recently, ABCDS. Unlike corporate bonds, which are directly impacted by the credit worthiness of its corporate issuer, the ABSDS is structurally insulated from the corporate risk of the seller of the asset. Therefore, the credit default swap of such an asset class needs to be tailored to address the unique nature of ABS.

The 2003 ISDA Credit Derivatives definition was drafted with corporate and sovereign entities in mind. Hence the use of traditional indicators of corporate financial health: bankruptcy, failure to pay, restructuring. In an ABS transaction, however, the issuer is a SPV or the reference obligation is a pool of asset-backed securities. The bankruptcy remoteness of the SPV means that the traditional bankruptcy credit event is not a useful basis upon which to measure the credit standing of the reference entity and hence a less than useful determinant of whether a payment should be made under the credit default swap. This is also true of restructuring as a credit event since ABS transactions do not permit an SPV to restructure.

The notion of failure to pay with respect to a corporate entity typically refers to the failure by such entity to pay a scheduled principal or interest amount. This credit event however does not take into account the fact that in some ABS transactions a default is not necessarily triggered by a failure to pay interest for certain periods. Shortfalls can be made up in some transactions by payments at a later date.

The types of obligations that may be delivered by a protection buyer upon the occurrence of a credit event in a corporate reference entity is much broader than assets that are available for delivery in ABCDS. Corporate referenced default swaps may permit the delivery of bonds, loans or other specified obligations of the corporate entity as acceptable deliverable obligations. In ABCDS, however, the deliverables are the securities themselves that are referenced. This is a significantly smaller pool of deliverable assets than corporate bonds or loan obligations.

This year, the ISDA published two forms of confirmations for ABS: a cash or physical settlement form and a pay-as-you-go, or PAYG, form. These forms are designed for the CMBS and RMBS market. The physical cash form is similar to a CDS on a single name corporate reference entity. The credit events that it references are bankruptcy, failure to pay, loss event (or write-down) and ratings downgrade. Should a credit event occur, the buyer may require compensation in cash or may deliver the underlying reference obligation to the seller.

The pay-as-you-go form attempts to more closely replicate the actual cash-flow of an underlying ABS. It is a far more customized form that would be more useful in the context of hedging. In this structure, should a credit event occur - in addition to giving the buyer an option to settle by requiring physical delivery of the reference obligation - the trade may also be settled by the protection seller making payments equal to the shortfall in amounts due on a scheduled payment date. The seller may also pay the amount of any principal write-downs in the ABS. The various options provided with respect to credit events are failure to pay principal, writedown, maturity extension and downgrades below investment grade - all terms familiar to ABS participants but with their inherent risks once referenced in a credit default swap.

The importance of standardization in credit derivatives contracts cannot be overestimated. It has expedited the speed in which these transactions are negotiated and, in using standardized industry-wide concepts and language, it has enhanced liquidity in the credit default swap market by synthesizing the risks of each trade.

One word of caution, however, in relation to the standardized forms: much of the documentation is still in its infancy and is being analyzed extensively by market participants and their legal counsels. Currently, various amendments are already being made to the standard forms as market participants are beginning to fully understand their implications. The pitfalls still lie in the details and the fact that a structured credit default swap is not an easy instrument to navigate.

True standardization can only be achieved when the template forms survive the test of time. The current ISDA forms are also limited to just the CMBS and RMBS markets. It is still true that risk mitigation associated with each transaction and, in particular, asset classes that are not CMBS and RMBS, must be viewed as a team effort between the business groups and legal counsels. With continuing innovation in the market, it is unlikely that any kind of standardized form would be able to accommodate the most creative of structures.