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CREDIT DERIVATIVES

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Multitudes of Credit Derivatives

- Single name CDS
- Index swaps
- Credit linked notes
- Synthetics
- Basket trades
- Credit spread options
- Recovery swaps
- Swaptions
- Constant maturity swaps
- CDS on ABS

Single Name CDS

- Important Provisions
  - Reference obligation
  - Reference price
  - Fixed-rate payment
  - Floating-rate payment
  - Physical or cash settlement
  - Credit event

Credit Events

- Bankruptcy
- Obligation acceleration
- Obligation default
- Failure to pay
- Repudiation / moratorium
- Restructuring

Cash Settlement

- Cash settlement date
- Settlement amount
- Final price
- Valuation method
- Valuation time
- Full quotation / weighted average quotation

Index Swaps

- Credit derivative index measured by reference to a group of reference entities
- Composition of group determined by: creditworthiness; industry; geography; trading volume
- Some licensed indices
  - iTraxx – Europe/Asia
  - CDX – U.S. investment grade, high yield, emerging market sovereign/corporate
  - ABX – asset backed

Recovery Swaps

- Swap allows parties to express views on the recovery rate of a reference entity
  - recovery swap (lock)
  - CDS with fixed recovery (digital CDS)

Swaps on Asset Backed Securities

- Differences from standard CDS
  - Buyer can elect physical settlement or PAYGO
  - Additional credit events:
    - distressed ratings downgrade mandatory;
    - failure to pay interest;
    - option of implied writedown and distressed ratings downgrade
  - PAYGO payments after soft credit events – can go both ways

Tax Characterization of Credit Derivatives

- Character
- Timing
- Withholding
- U.S. trade or business
- Other issues, e.g., UBTI

Some Possible Characterizations for Various Credit Derivatives

- Insurance
- Guarantee
- Notional Principal Contract
- Option
- Unidentified Financial Instrument (UFI)

CDS – Notional Principal Contract?

- A financial instrument
- That provides for the payment of amounts
- By one party to another
- At specified intervals
- Calculated by reference to a specified index
- Upon a notional principal amount
- In exchange for specified consideration
- Or a promise to pay similar amounts
- Futures, forward, option contracts not NPCs

CDS – Option?

- Freddie Mac definition: Contract is an option contract when it provides:
  - The option to buy or sell
  - Certain property
  - At a stipulated price
  - On or before a specific future date or within a specified time period
  - For consideration

Other issues

1. Tax consequences of counterparty bankruptcy
2. UBTI
3. New CDS clearinghouse

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