

# CDS on ABS: Credit default swaps on asset-backed securities

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## 1. **Introduction**

Credit default swaps on asset-backed securities (CDS on ABS) have been much talked about over the last few years and the nascent market that started in 2002 has much future potential. CDS on ABS are the natural step on from standard credit default swaps, and their emergence and development has been fuelled by growth in the ABS market itself. A marriage of credit derivatives specialists and asset-backed securities specialists have been spearheading a template documentation drive through the ISDA Working Group on Credit Derivatives – Asset Backed Securities and we now have suite of templates, with future developments already in the pipeline. The complexity of these templates and the likelihood that this product area will continue to grow means that CDS on ABS merit their own chapter in this book. This chapter expands upon the overview Sections on CDS on ABS provided in Part I and explains in detail each of ISDA's CDS on ABS templates.

Credit default swaps referencing asset-backed securities have several monikers. Sometimes they are known as CDS on ABS but they can also be known as: asset-backed credit default swaps, ABCDS or synthetic ABS. We shall stick to CDS on ABS here. In addition, CDS on ABS most commonly cover three types of asset-backed product: pure asset-backed securities; mortgage-backed securities and collateralised debt obligations. This means that the acronyms CDS on MBS and CDS on CDOs are also in common parlance.

## 2. **Reasons for buying and selling credit protection on asset-backed securities**

The principal reasons for buying and selling protection on the credit risk of asset-backed securities are similar to the reasons that market participants are active in the sovereign and corporate credit default swap market: regulatory capital treatment, portfolio management, hedging credit risk, alternative investments and trading and market making. Additionally, due to the lack of liquidity and the small issue size of particular tranches in the ABS market, many securities may be difficult to obtain. CDS on ABS can allow investors to access the credit risk of securities that they could not otherwise purchase. Due to the 'soft' nature of CDS on ABS credit events, the ability to short the market by taking a view on the overall direction of particular securities is also a market driver.

The residual risks of CDS on ABS are also the same as traditional CDS: basis/mismatch risk, market risk, liquidity risk, regulatory risk, collateral risk, counterparty risk and documentation risk. The less settled nature of CDS on ABS template

documentation probably means that documentation risk is greater than in other credit derivatives products.

### **3. Key ingredients**

The reasons for having specific CDS on ABS template documentation arise from the inherent characteristics of ABS. Comparing any of the current CDS on ABS templates to the original single-name CDS confirmation set out in Exhibit A to the 2003 Definitions, the family resemblance is evident, with certain 'genetic' differences in the nature of ABS accounting for the substantial differences from standard CDS. The principal reasons for the differences are as follows.

#### **3.1 ABS issuer as reference entity versus corporate or sovereign reference entity**

Asset-backed securities are structured so that a bankruptcy-remote special purpose vehicle (SPV) issues securities linked to underlying assets. Barring execution risk, the SPV will not become bankrupt or fail to pay any due amount of interest or principal, because of its own creditworthiness. Notwithstanding this structure, an investor in the securities of the SPV may lose all of its principal and/or projected interest if the relevant underlying assets fail to perform. This means that the traditional credit events in the 2003 Definitions are unsuitable in relation to the obligations of the ABS issuer.

#### **3.2 ABS versus standard debt obligations**

In a standard CDS transaction, a reference entity will have many relevant debt obligations outstanding and credit protection will generally be sold on a wide selection of obligations. Not so with a CDS on ABS. Either an issuer of ABS will be used once to issue a specific transaction or, in a multi-issuance structure, investors will have limited recourse to only the assets of their issue, making general credit protection meaningless. In addition, the variable credit quality created by tranching securities means that each tranche of securities would have a significantly different credit quality, with losses occurring at different times to different tranches. This means that CDS on ABS are designed to reference a specific tranche of a particular issue of asset-backed securities and rather than the credit quality of a particular reference entity.

In addition, most corporate and sovereign bonds and loans repay the full principal on the maturity date, making any payment default most likely to occur on a single date. In contrast, ABS often amortise over time, meaning that the notional amount of a CDS on ABS should alter in line with the reference obligation's outstanding principal amount.

Losses to ABS can occur over time, meaning that the parties may wish only to partially settle a CDS as soon as a loss on the underlying asset occurs.

#### **3.3 Liquidity**

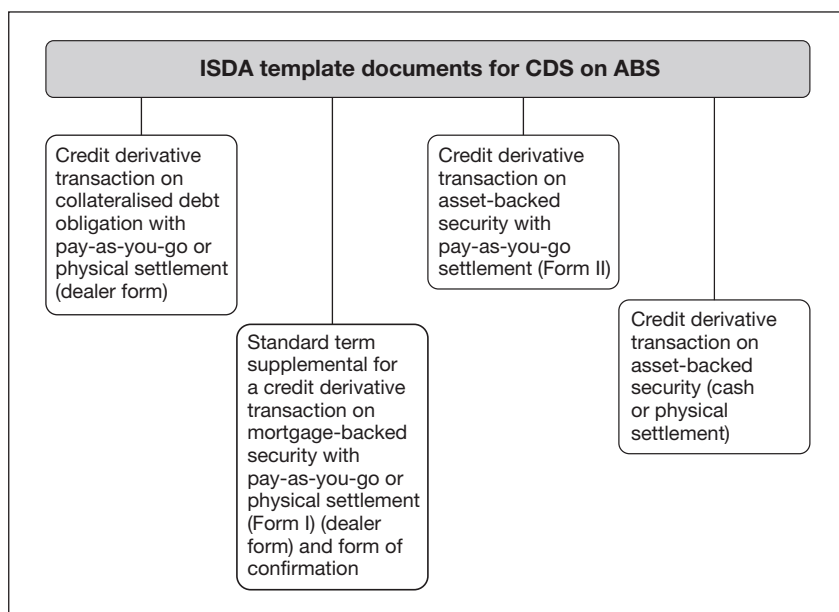
The ABS market is not as liquid as the corporate bond or loan market. Particular tranches of ABS may be even less liquid, due to their specialised nature and small size. Therefore, a CDS on ABS post-credit event settlement needs to be more flexible than in standard CDS.

The unique characteristics of ABS therefore make the original single-name CDS confirmation set out in Exhibit A to the 2003 Definitions (designed for referencing corporate and sovereign creditworthiness) unsuitable for documenting CDS on ABS.

#### 4. Development of template documentation

When market participants began to document CDS on ABS, any documentation was necessarily highly bespoke and also highly complex. Initially, this lack of standardised documentation prevented the market from developing: highly complex and bespoke documentation meant high costs and risks.

The ever-increasing size of the ABS market, which already exceeded \$800 billion by 2004, created a strong need among market participants for standard templates to allow them to hedge and trade the risk of ABS defaults. Individual market participants on both sides of the Atlantic developed their own templates and, once market standards had begun to form, ISDA published the first CDS on ABS template in June 2005. This provided the impetus that the market needed and further developments (including differing views from European and American market participants) resulted in three more standard CDS on ABS forms.



The four templates, most of which have been amended a few times already since they were initially published (see table below), not only reflect the differences between different underlying types of ABS, but also are tailored to reflect the different expectations of the European and American markets

##### 4.1 History of ISDA CDS on ABS templates

Although the first CDS on ABS transaction were made in 2002, the market took a

stride forward when ISDA published the first CDS on ABS template on June 13 2005. The accompanying press release stated: “The International Swaps and Derivatives Association (ISDA) has announced publication of a template for documenting trades of credit default swaps (CDS) on asset-backed securities (CDS on ABS) intended for cash or physical settlement. A second template for use with CDS on ABS with a pay-as-you-go (PAUG) settlement approach will be published later this month”.

The first form’s full description is “credit derivative transaction on asset-backed securities (cash or physical settlement)”. It is also known as the “non-PAUG form”. It is intended for use with reference obligations that are any type of ABS with either cash or physical settlement and it is mainly used in the European market. It is the simplest of the four forms and most closely resembles the standard CDS template. The non-PAUG form has been revised and its current version was issued on June 7 2006.

### **History of ISDA templates (opposite)**

Shortly after issuing the non-PAUG form, ISDA published the “Credit derivative transaction in asset-backed security with pay-as-you-go or physical settlement (dealer form)” on June 21 2005. The form has been amended four times since then and its current version was published on April 5 2007 under a changed name: “Standard terms supplement for a credit derivative transaction on mortgage-backed security with pay-as-you-go or physical settlement (Form I) (dealer form)”. It is also now known as “Form I”. Whereas the non-PAUG form was designed for any type of ABS, Form I is intended to be used to reference obligations which are portfolios of mortgages. Its first four versions were especially designed for the US market, where securitisations of mortgages are very common. However, at the request of European traders, the current version was made compliant with the Basel II framework for capital requirements and it is hoped that it will facilitate trade on the old continent. Since the new Form I was issued only very recently, it is difficult to tell whether it will actually gain popularity in the European market.

The next form to be published was “Credit derivatives transaction on asset-backed security with pay-as-you-go settlement (Form II)” on December 19 2005. It is known as “Form II”. This template is primarily used in the US market. A key difference to the other templates is that it does not have any credit events. It only provides for a pay-as-you-go settlement, which means that the protection seller pays the protection buyer a defined amount whenever a specified event happens. This form was created at the request of monoline insurers which wanted to avoid the liquidity risk of having to make one large lump-sum payment to settle CDS on ABS transactions. Instead, the settlement is based on making up payment shortfalls on a particular reference obligation and reflects the gradual decline in creditworthiness of ABS transactions as opposed to the catastrophic declines which can occur when a credit event impacts on a corporate or sovereign reference entity.

The last template “Credit derivative transaction on collateralised debt with pay-as-you-go or physical settlement (dealer form)” was first published on June 7 2006 and was later updated on June 6 2007; it is known as the “CDO Form”. It closely