Documenting credit default swaps on asset backed securities

by Edmund Parker and Jamila Piracci, Mayer, Brown, Rowe & Maw LLP

Four different ISDA CDS on ABS templates published since June 2005, one which has been updated three times and another once already, means that with more changes in the pipeline, an explanation of the existing template documentation and CDS on ABS's characteristics is welcome.

Introduction

ISDA press release, 13 June 2005: "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".

A lack of standardised documentation had hindered the nascent CDS on ABS market's advancement and the new forms ISDA announced in the June 2005 press release helped provide the needed kick-start. Further market development has resulted in four templates: a CDS on ABS template with cash or physical settlement (since updated once) designed for CDS referencing asset-backed securities generally and three templates incorporating a PAUG mechanism. One PAUG template (Form I) is designed for trades referencing US mortgage-backed securities and includes physical settlement as an option; another (Form II) is intended for asset-backed securities (ABS) generally and does not include a physical settlement option; and a third is for CDS referencing underlying collateralised debt obligation (CDO) issuances.

Key ingredients of CDS on ABS

The reasons for having four templates arise from the inherent characteristics of ABS. Comparing any of the templates to the original single-name CDS confirmation set out in Exhibit 1 to the 2003 ISDA credit derivatives definitions (2003 definitions),



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the family resemblance is evident, with certain 'genetic' differences in the nature of ABS accounting for the substantial differences from standard CDS.

(i) 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, due to 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.

(ii) 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. An issuer of ABS will either 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 will have a significantly different credit quality with losses occurring at different times to different tranches. This means that CDS on ABS can only reference a specific tranche of a particular issue of asset-backed securities and not the credit quality of a particular reference entity.

In addition to the above, 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. By 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 and not fully settle a CDS as soon as a loss on the underlying asset occurs.

(iii) 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 CDS on ABS post-credit event settlement, needs to be more flexible than in standard CDS.

Overview of ISDA's four CDS on ABS templates

(i) Credit derivative transaction on asset-backed security (cash or physical settlement) template: the 'non-PAUG form'

Also known as the 'non-PAUG' form, this is the European market's preferred template. It was published by ISDA on 13 June 2005, and later updated on 7 June 2006. It was developed with all asset-backed securities in mind.

Whereas the credit events for a standard CDS are bankruptcy, failure to pay and sometimes restructuring, the non-PAUG template provides three principal credit events: failure to pay, loss event, and restructuring. Bankruptcy and ratings downgrade are included in the form as optional credit events as well. Although bankruptcy and restructuring do not seem to be particularly relevant to bankruptcy remote vehicles and asset-backed securities, regulatory capital requirements may compel a seller to insist on their inclusion.

The 'failure to pay' credit event in the non-PAUG template modifies the 2003 definitions standard by defining the event as a non-payment on a scheduled distribution date of an amount due pursuant to the reference obligation's terms. A loss event occurs when the principal amount of the underlying ABS's is irrevocably reduced, without its resulting in the issuer breaching its obligations. A ratings downgrade credit event occurs when the reference obligation is downgraded below a level pre-agreed at the transaction's outset.

The non-PAUG form provides a hybrid cash and physical settlement method. Cash settlement is the default option unless the seller receives a notice of physical settlement prior to an agreed cut-off date after the conditions to settlement have been met. If the buyer opts for physical settlement, the mechanics closely resemble those used in the standard CDS template.

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The parties can also at the transaction's outset elect for an additional settlement method called the 'synthetic delivery option'. If cash settlement applies and the synthetic delivery option is applicable, at the valuation date either party may elect to provide the other with a total return swap quotation. This is a quotation to enter into a fully funded total return swap on the reference obligation, and if supplied will be deemed to be the transaction's final price. The parties will then be deemed to have entered into the swap and will execute a confirmation and make the relevant ongoing payments.

(ii) Standard terms supplement for use with credit derivative transactions on mortgage-backed security with pay-as-you-go or physical settlement (Form I) (dealer form); and credit derivative transaction on asset-backed security with pay-as-you-go settlement (Form II): the Form I and Form II PAUG templates:

Shortly after it published the non-PAUG form, ISDA produced a further template, which in its updated form is now called the 'Standard Terms Supplement for a Credit Derivative Transaction on Mortgaged-Backed Security With Pay-As-You-Go or Physical Settlement'. In the event that an interest shortfall, a writedown or a principal shortfall occurs with respect to the relevant underlying instrument and the buyer of protection notifies the seller within a set timeframe, the seller pays the buyer. As the name suggests, these protections may be multiple and can occur throughout the term of the CDS on ABS. PAUG Form I is intended primarily for US residential mortgage-backed securities and commercial mortgage-backed securities.

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Form II is a variation of Form I, but is designed for use in CDS on all types of ABS. Form II was released on December 19, 2005. The forms differ in several key respects. Only Form I has credit events. In contrast, in Form II the seller makes payments only if a floating amount event (writedown (a reduction in the principal or interest due), principal shortfall (non-payment or lesser payment of expected principal) or interest shortfall (non-payment or lesser payment of the expected interest amount)) occurs and the calculation agent or the buyer of protection notifies the seller that a floating payment is due. These events allow ongoing settlement through the term of a CDS on ABS and compensate the buyer for below expected cash-flows being generated from the underlying asset.

Form I specifies writedown, failure to pay principal and interest shortfall as floating amount events and also allows for physical settlement in the event of a failure to pay principal or a writedown. Parties may also elect to include a distressed ratings downgrade as a credit event.

Form I alone includes implied writedown provisions requiring payments compensating for losses on the ABS resulting in a reduction of the outstanding principal when such losses are not provided for in the underlying instruments of the MBS. There are further differences between the two forms in relation to the definition of interest shortfall amounts.

Additional fixed amounts provide for the buyer to reimburse the seller if later adjustments to the underlying asset-backed security mean that the buyer has been paid too much following a floating amount event. Additional fixed amount events may occur under both forms, triggering a writedown reimbursement, principal shortfall reimbursement or an interest shortfall reimbursement. In addition to the above differences, Form II also implements any amendments to the underlying ABS, whereas Form I does not. Form II also treats make-whole premium payments (payments to the obligation holders of a make-whole premium in relation to events such as prepayments under the terms of the obligation) as additional fixed amount events.

Step-up provisions differentiate Form I from the other forms. A 'step-up' is an increase in the coupon of the reference obligation due to the failure of the issuer or a third party to redeem, cancel or terminate an obligation in accordance with the underlying instruments. The step-up provisions give the buyer the option to terminate the transaction or to continue at the higher rate. Under Form II, changes in the coupon of a fixed rate obligation or the spread of a floating rate obligation are implemented, and the transaction continues at the new coupon.

(iii) Credit derivative transaction on collateralised debt obligation with pay-as-you-go or physical settlement (dealer form)

On June 7, 2006, ISDA published the 'Credit Derivative Transaction on Collateralised Debt Obligation with Pay-As-You-Go or Physical Settlement (Dealer Form)'. This form provides a PAUG template for CDOs. Like the PAUG forms, the buyer of protection may choose to have physical settlement of a failure to pay principal or a writedown or use the pay-as-you-go mechanism by triggering payment by the seller of a floating amount. The key differences between the PAUG templates and the CDS on CDO template are the inclusion of a failure to pay interest as an additional credit event, the hard-wiring of distressed ratings downgrade as a credit event and an option for implied writedown.

Looking forward

ISDA's standardised documentation has fuelled CDS on ABS market growth; and as the market continues to develop, both more forms and revised ones are inevitable. At the time of publication of this article, a Standard Terms Supplement for the CDS on CDO form is in the pipeline and a revised Standard Terms Supplement for the CDS on MBS form has just been published, both to facilitate further streamlining and to incorporate substantive updates. Among the substantive updates to the CDS on MBS form are changes (such as the inclusion of restructuring and bankruptcy as optional credit events) intended to facilitate use of the template in the European market.

Behind the flurry of standardised contracts, it was planned that ISDA would, if there was sufficient interest, develop a terms booklet for structured credit products. The effect of this

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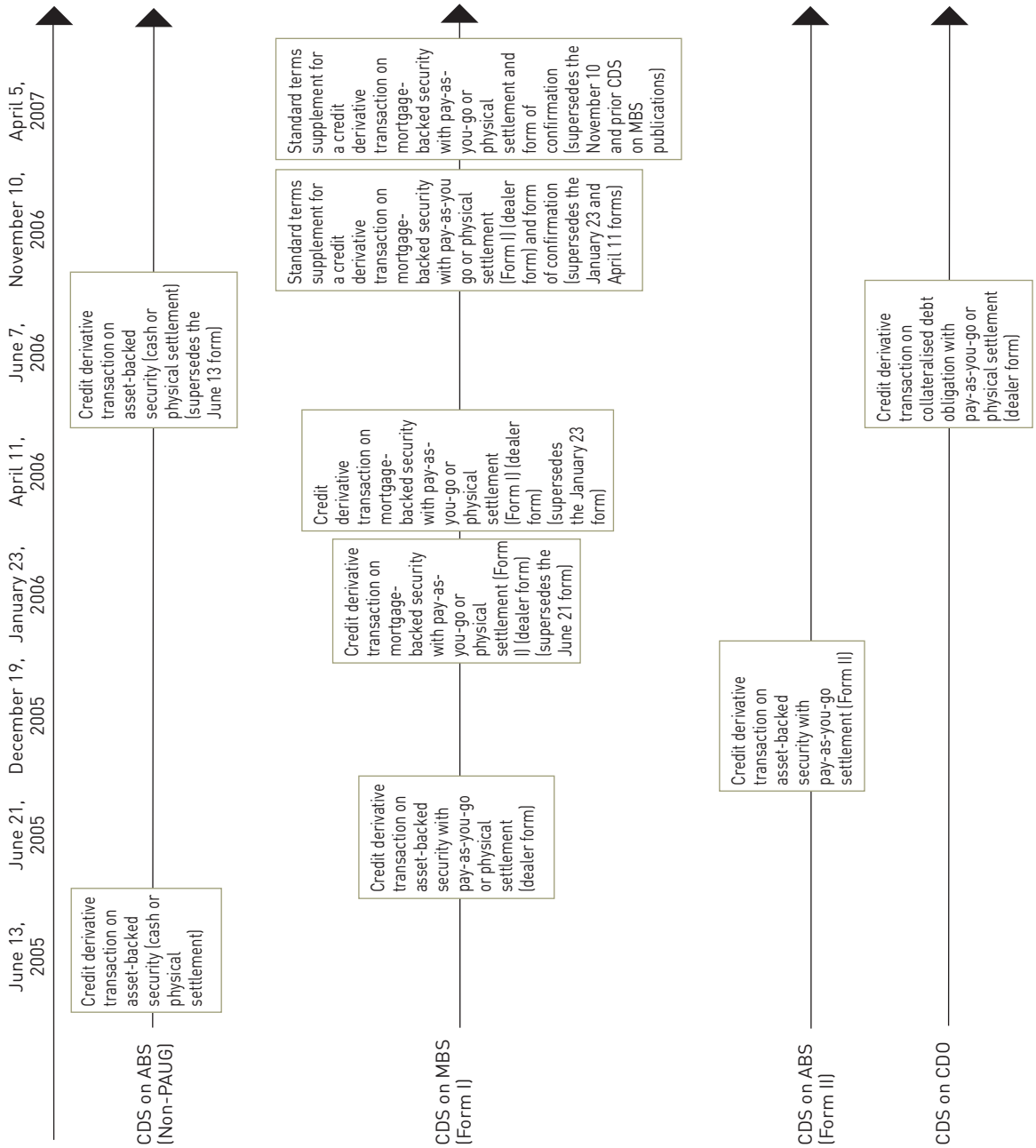
document would be to take the standard terms supplement format one step further by offering parties a set of terms, in the vein of a definitional booklet, that could be incorporated by reference into a short confirmation. The challenges for the market in developing such a booklet include not only settling the existing terms but also anticipating the many permutations that are likely to develop.

The April PAUG Form I states in its footnotes that "ISDA anticipates future publication of one or more template confirmations for use with other types of asset-backed security (such as credit card receivables-backed securitisation notes or collateralised debt obligation notes". While many market participants felt in the end that a standard template for underlying credit card receivables would not be needed in the near term, the need for a CDS on CDO template persisted. This note illustrates well the dynamic nature of this product area. The direction of future template documentation for CDS on ABS will likely contain many turns.

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History of ISDA templates **Exhibit 1**



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