

# FitchRatings

## *Credit Events and the Valuation Process*

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# Overview

- Going Back to Basics
  - Credit Events
  - Valuation Process
- Fitch's Credit Events Study
  - Historical Credit Event Data
  - Analysis of Recoveries

# Credit Events

What is a Credit Event?

- Events that trigger protection payments by synthetic CDO
  - Failure to Pay
  - Bankruptcy
  - Restructuring
  - Repudiation and Moratorium
  - Obligation Acceleration
  - Obligation Default

# Valuation Process

What Happens After a Credit Event is Called in a Synthetic CDO?

- The valuation process determines the payments that are to be paid to protection buyers.
- Specifics:
  - Time Period
  - Sources of Bids, Number of Bids, Number of Valuations
  - Valuation Method

# Valuation Process - Example

## Story of Bad Corp...

- Day 1: Bad Corp. files for Bankruptcy.
- Day 5 Credit Event is called on Bad Corp.
- Day 35-65: Bad Corp. bonds are valued.
- Day 70: Final valuation determined & synthetic CDO makes protection payments.

## Valuation Process - Timing

- The valuation process begins after a credit event is called and ends with the payment by the protection seller.
- Credit event notices may be sent at varying times after the occurrence of a credit event.
- Valuations begin 30 to 60 days after credit events are called and can take 5 to 30 days to determine final valuation.

## Valuation Process – Bidding

- A credit obligation of the reference entity is identified as the security which will be valued by dealers/brokers and the calculation agent.
- Approved dealers are contacted and bids are obtained for designated obligation.
- 2-5 bids are sought in a single day and 1-5 valuation rounds are conducted in total.

# Fitch's Credit Events Study

## Fitch's Research Goals:

- Increase transparency in synthetic CDO market
  - Provide more information regarding credit events
- Examine the integrity of the valuation process
- Determine whether there are factors that influence recoveries in credit events

Fitch publishes:



*Credit Events in Global Synthetic CDOs: 2000-2003, dated May 12, 2003, available on Fitch's website at [www.fitchratings.com](http://www.fitchratings.com)*



# Fitch's Credit Events Study

## ➤ Summary Findings:

- Restructuring accounted for only 3.3% of credit events
- Inconsistency in the documentation for the valuation process
- The greater the number of bids, the higher the recoveries

# Fitch's Credit Events Study

- Summary Findings (cont'd):
  - Length of the valuation process impacts recoveries
  - Higher recoveries under average method than highest method
  - Below average recoveries for CDOs with a limited number of bidders which also included the calculation agent.

## Source of Data

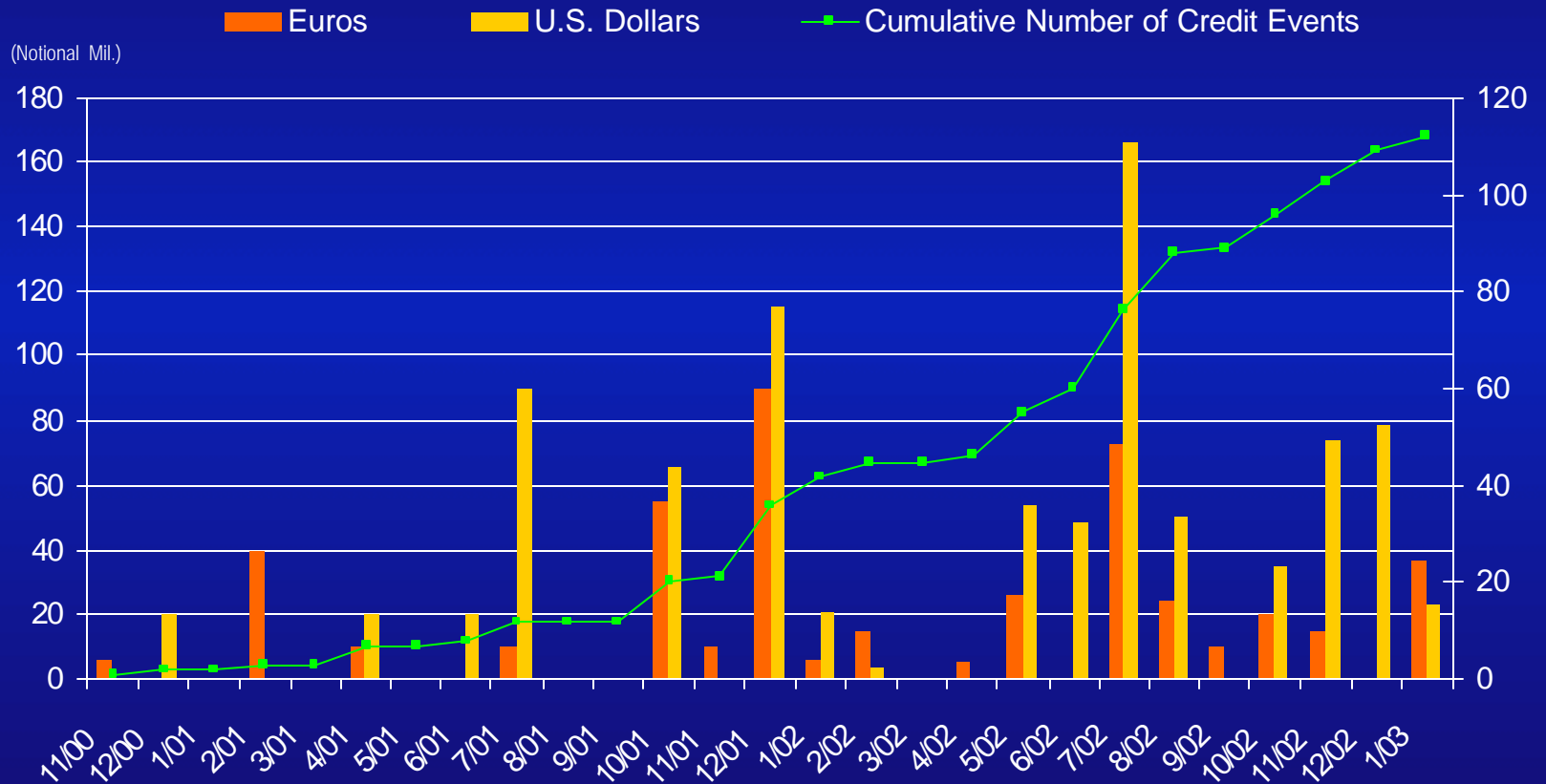
- 115 Fitch rated synthetic CDOs that referenced IG corporate entities via credit default swaps
- No ABS synthetics, CLNs, or total return swap transactions
- Valuation data provided by broker/dealers
- Credit events between Q3 00 and Q4 02

# Credit Event Volume

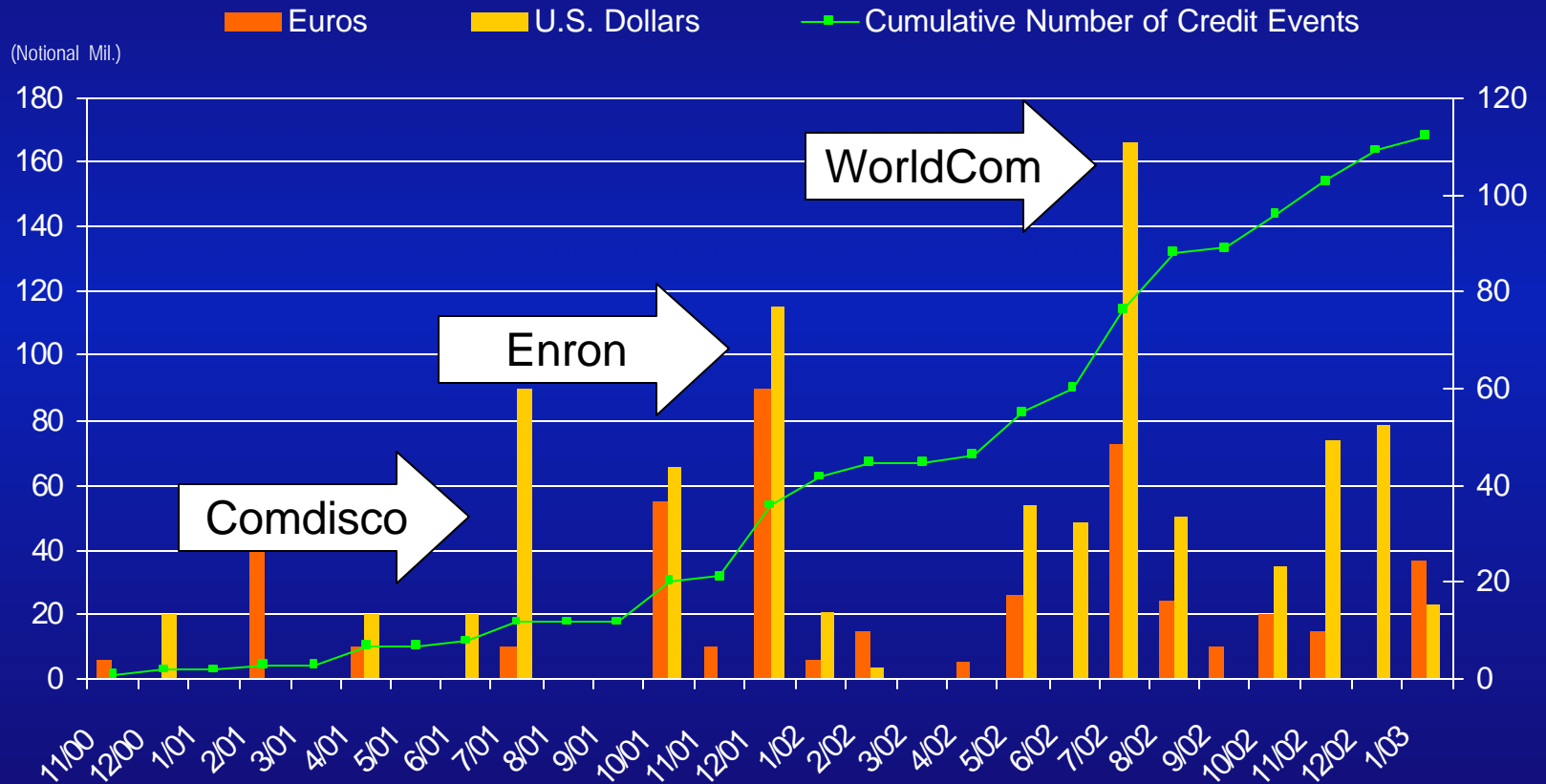
	2000	2001	2002	One Month Ended 1/31/03	Total
Euros (EUR Mil.)	5.5	214.8	192.5	37.3	450.1
U.S. Dollars (USD Mil.)	20.0	311.2	530.8	23.0	885.0
No. of Credit Events	2	34	73	3	112
No. of Reference Entities	2	9	16	1	28
Fallen Angel Defaults ( USD Bil.)	3.7	24.0	35.7	N.A.	63.4

N.A. – Not Available

# Credit Events



# Credit Events



# Most Common Reference Entity

Reference	No. of CEs	Notional Amt (EUR Mil.)	Notional Amt (USD Mil.)	Ave. Recoveries (%)
WorldCom	25	86.0	211.5	13.2
Enron	17	105.0	135.1	14.1
Teleglobe	11	25.5	69.5	1.8
Railtrack	7	35.0	48.5	78.7
Marconi	7	30.0	25.0	15

CEs – Credit events.

# Credit Events in Europe vs. U.S.

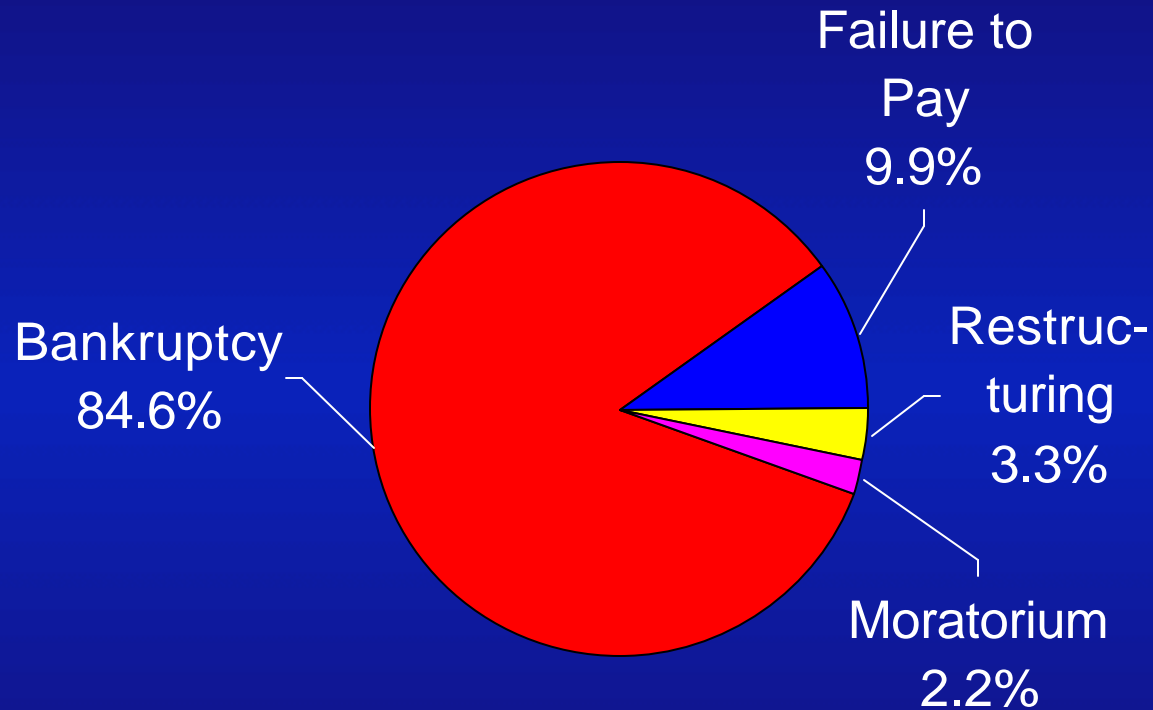
	No. of CEs	No. of CDOs
Europe	57	25
U.S.	55	22
Total	112	47

CEs – Credit events.

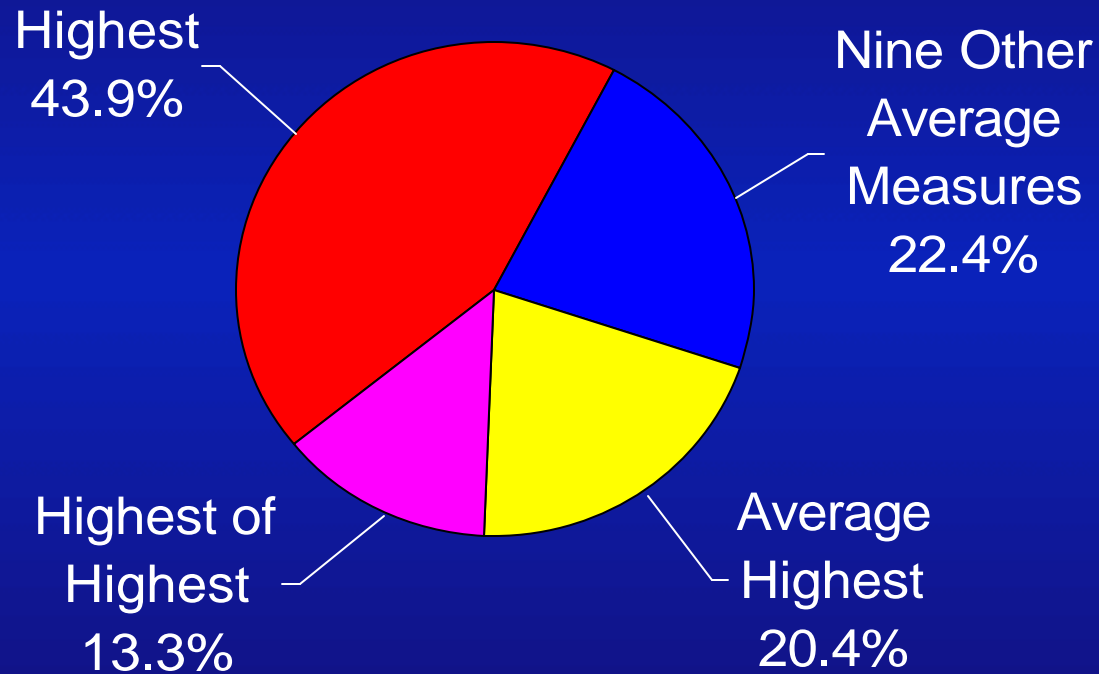
CDOs – Collateralized debt obligations.



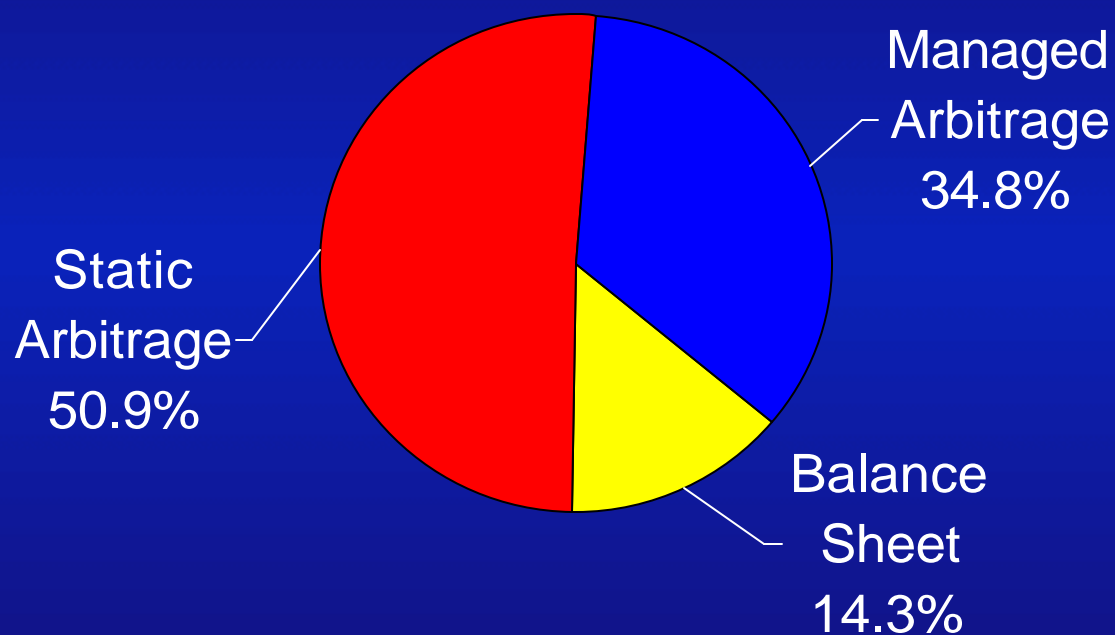
# Credit Event Types



# Valuation Method

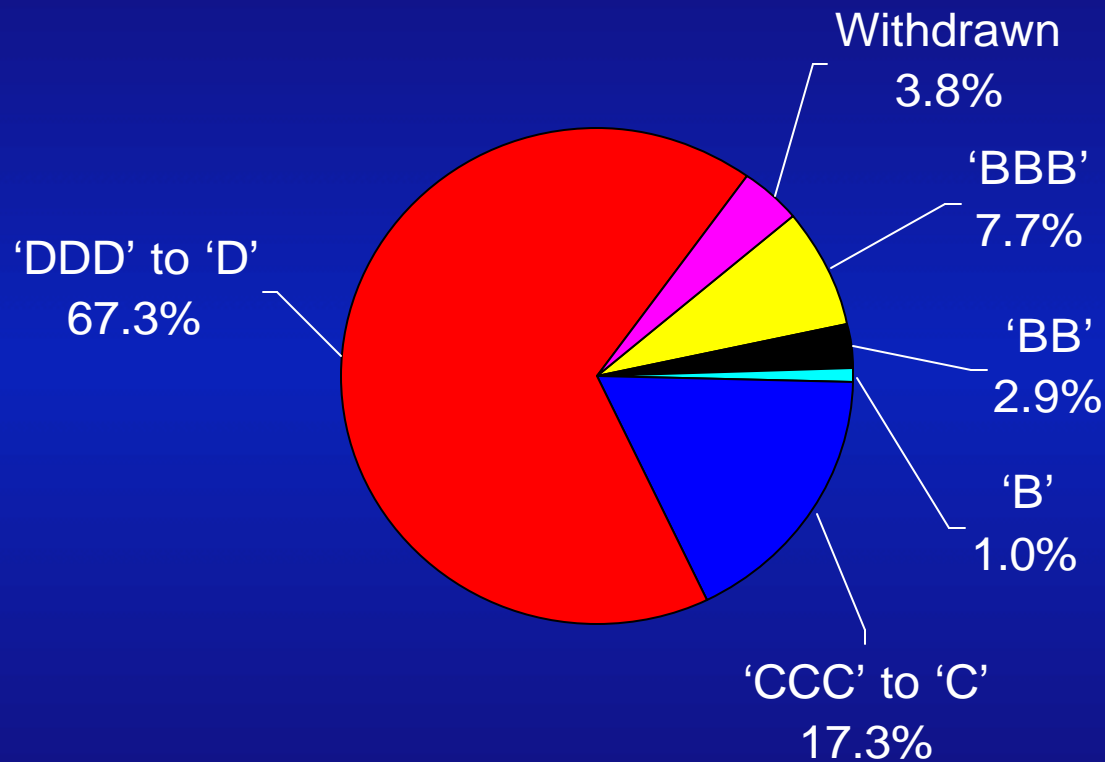


# Credit Events by Deal Type

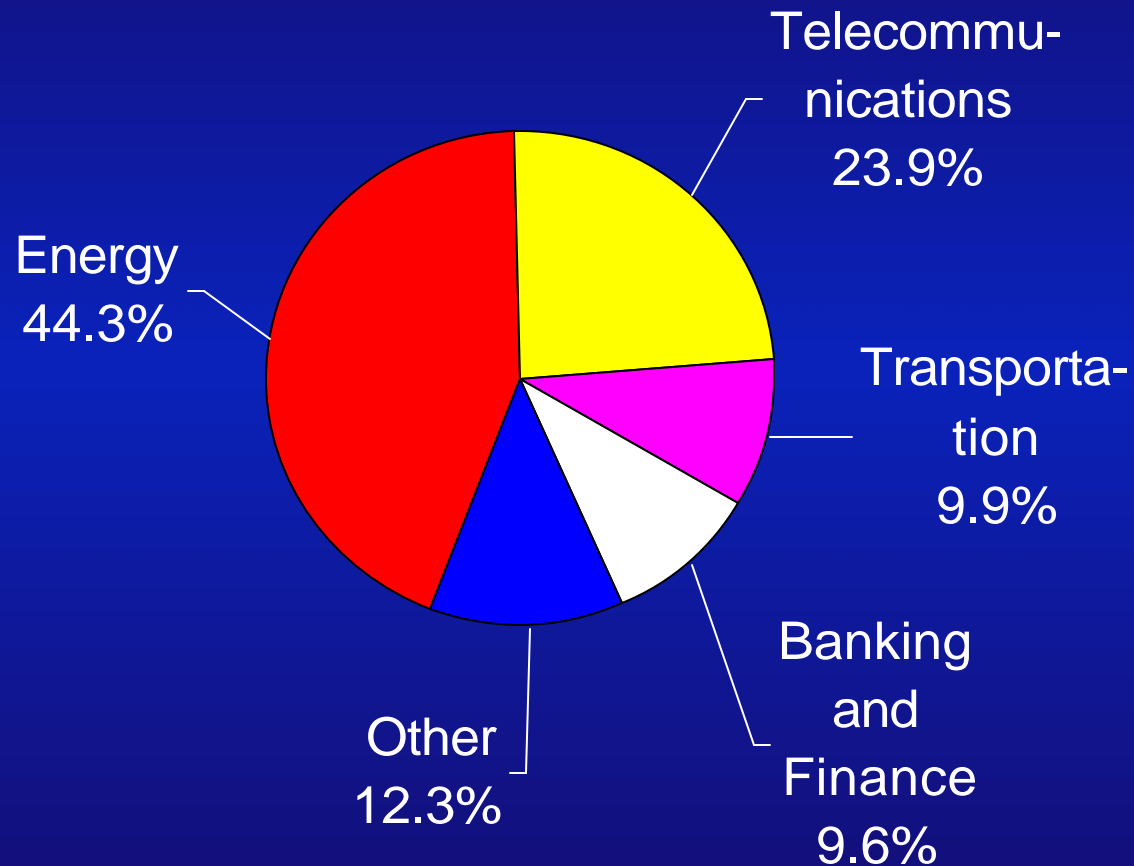


CDO – Collateralized debt obligation.

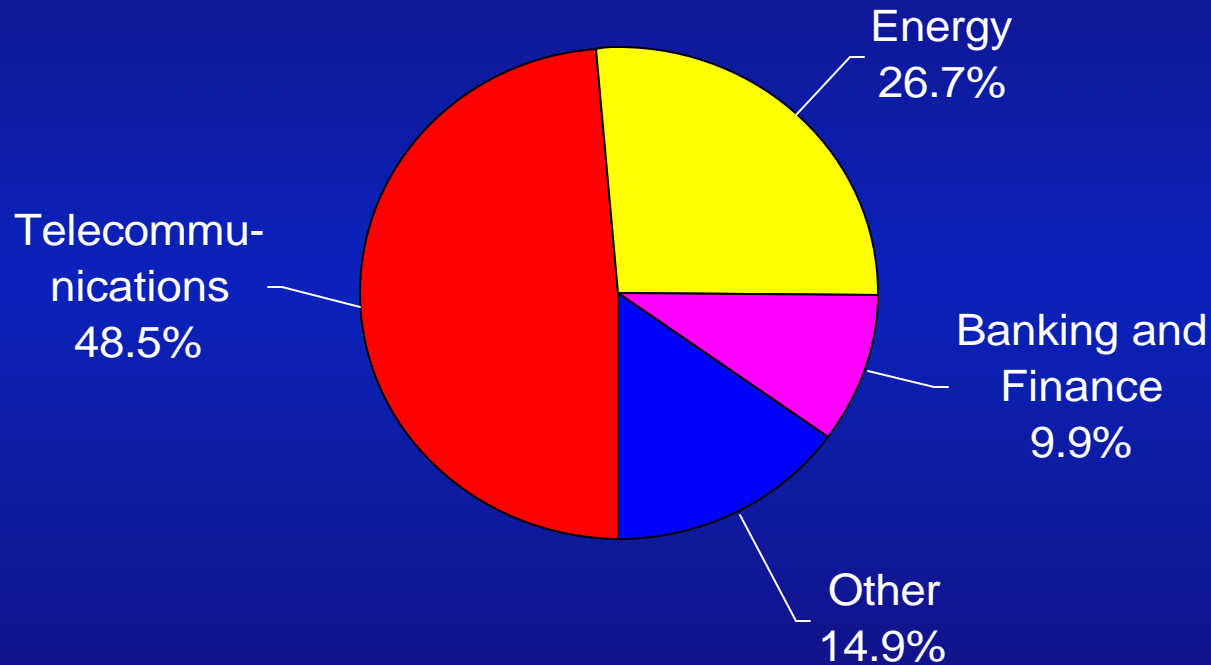
# Credit Events by Rating



# Credit Event Industry Distribution



# Defaulted Fallen Angel Industry Distribution

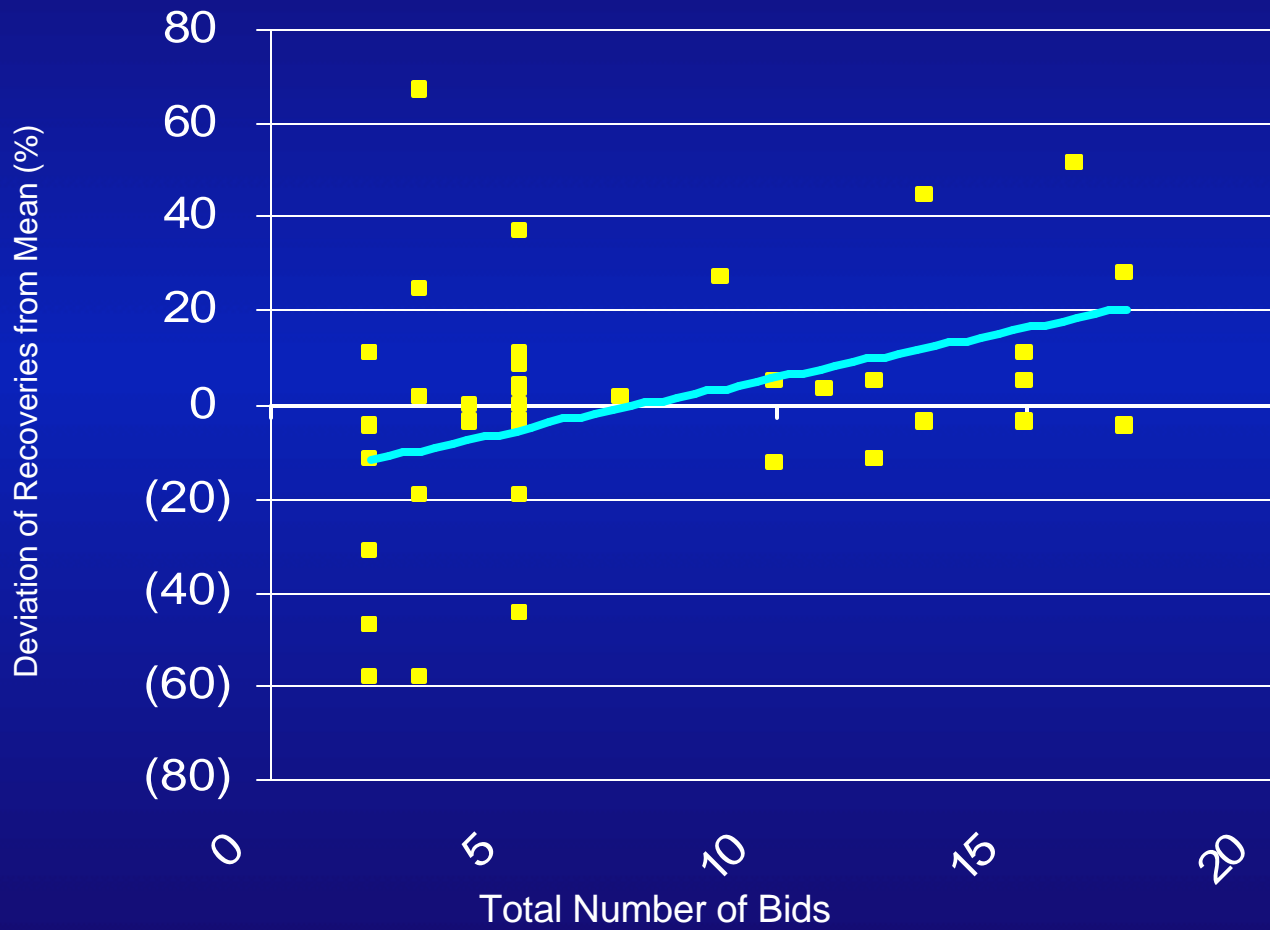


Sources: Advantage Data Inc. and Fitch Ratings credit market research group.

# Conclusions

- How do these factors impact recoveries?
  - Total Number of Bids
  - Length of the Valuation Process
  - Type of Valuation Method
  - Europe vs. U.S.

# Recoveries vs. Total Bids





# Recoveries vs. Total Bids

➤ An example: WorldCom

Bids:

2 bids x 1 val round = 2

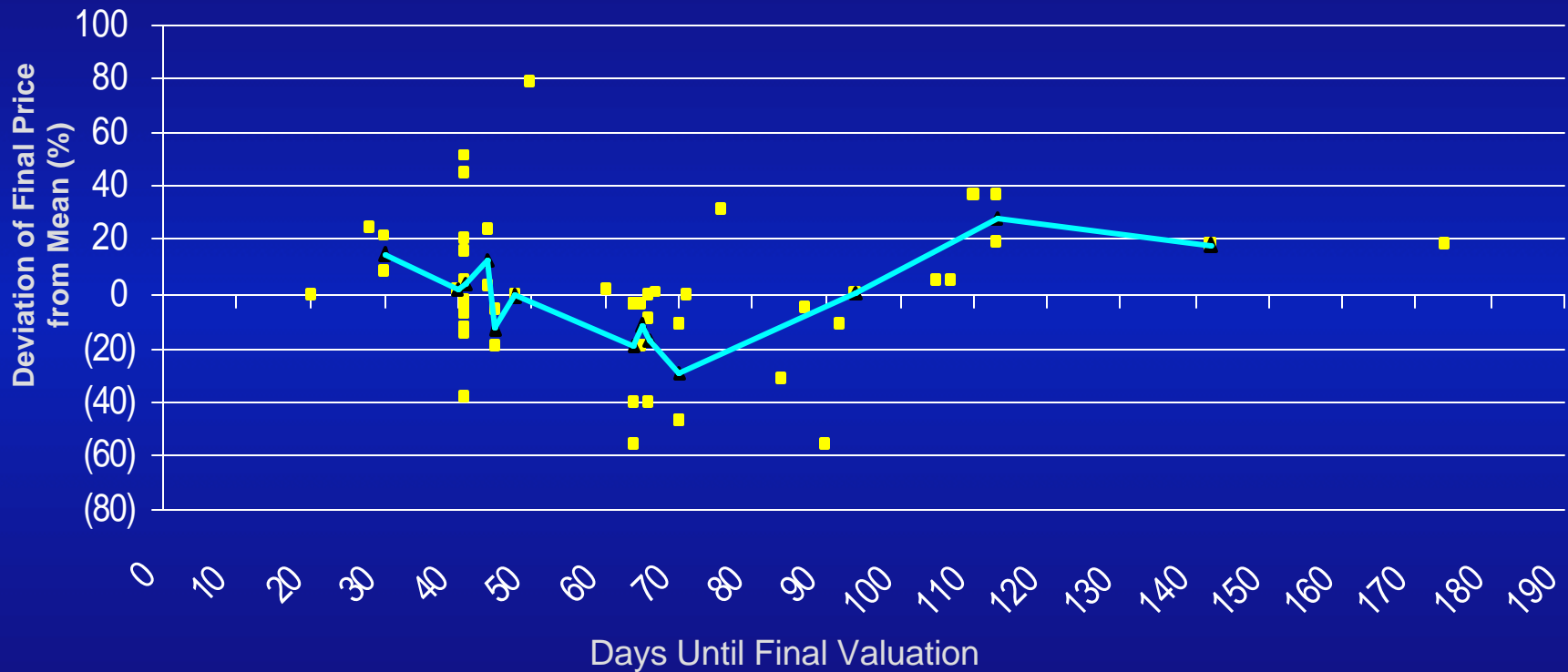
5 bids x 3 val rounds = 15

Recoveries:

7.7%

19.6%

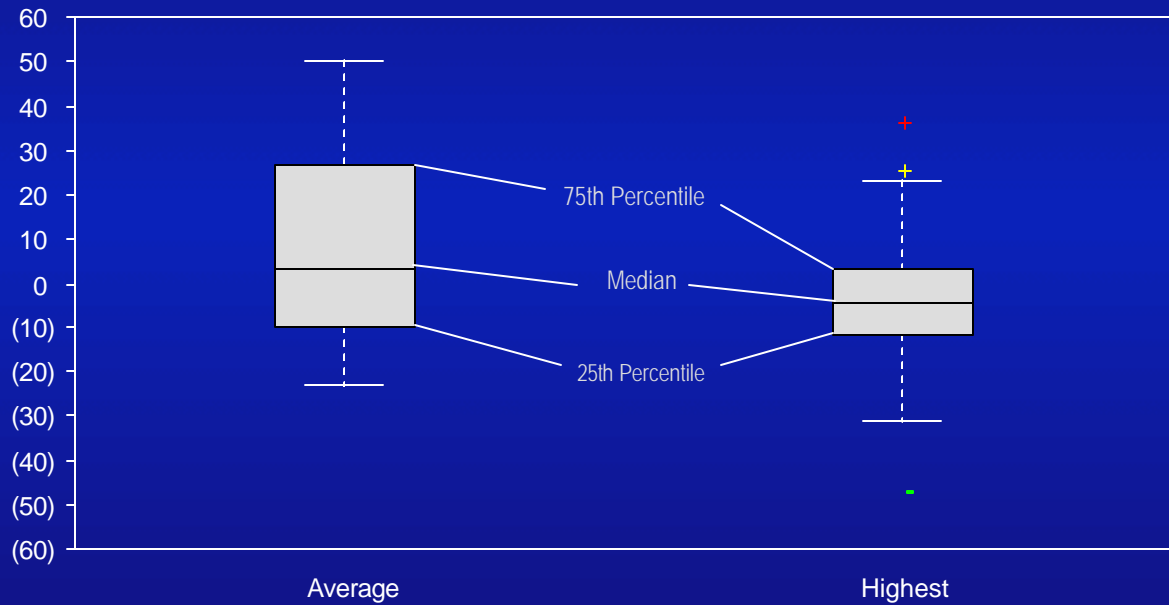
# Recoveries vs. Length of Valuation



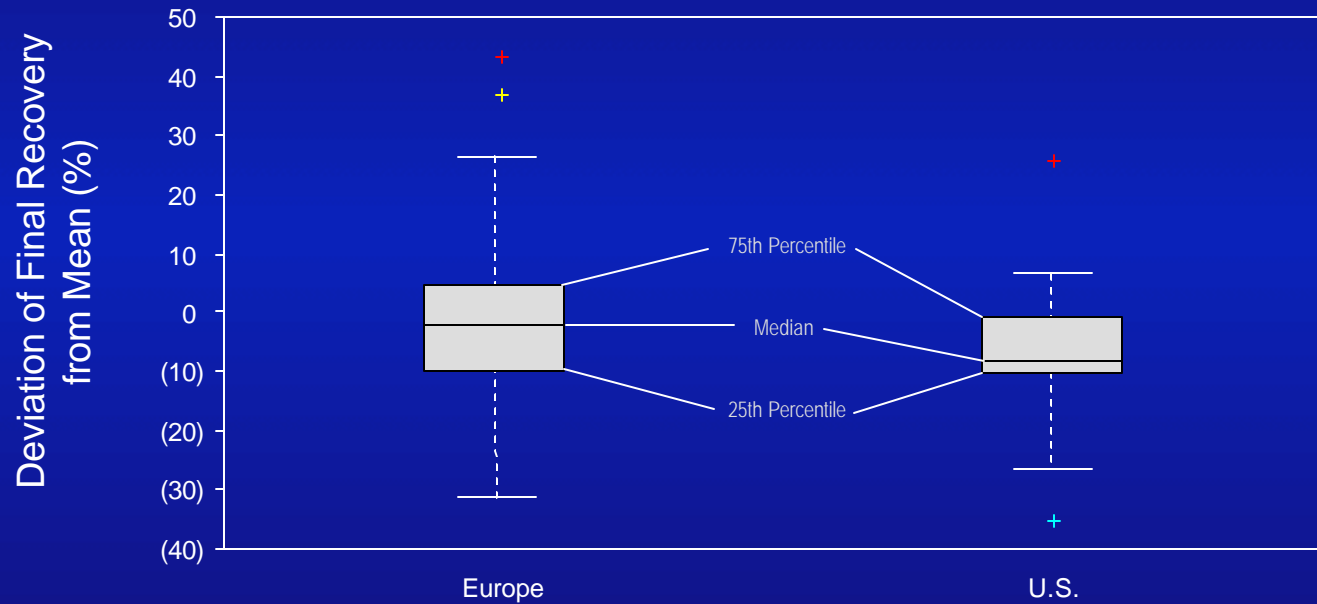
Note: The line represents the average of the deviations where at least two settlements occurred with the same valuation process length.

# Valuation Method vs. Recoveries

Deviation of Final Recovery from Mean (%)



# Europe vs. U.S. Recoveries



# Fitch Preferred Valuation Process

- Seek at least 5 bids per bidding round
- Conduct multiple bidding rounds
- Use highest bid of all bidding rounds (highest of highest)
- Exclude the calculation agent as a bidder

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