

Synthetic CDO equity instruments

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The fast-growing business in the credit derivatives known as synthetic **collateralised debt obligations** almost came unstuck in May 2005. That was when investment banks and hedge funds found that supply and demand in some parts of the market were seriously out of balance.

These two groups realised they had been left with the riskiest exposures in synthetic CDOs. These instruments are a twist on traditional CDOs, which pool together bonds, loans or other kinds of debt instruments and sell notes that represent different levels of risk. Synthetic CDOs pool derivatives rather than actual debt.

Since May 2005, some of sharpest minds in the City and on Wall Street have focused on the task of broadening the market's investor base, and in the past six months these efforts have begun to bear some strange and sophisticated fruit.

Synthetic CDO deals are backed by part of a pool of credit default swaps (CDS) – derivative contracts that insure against non-payment of corporate debt.

The riskiest slices, or tranches, of CDO deals are known as the equity or first-loss pieces, because they bear immediate losses if any of the dozens of companies in the pool underlying the instruments default.

The returns available on synthetic CDO equity shot up in May 2005, but that was because very few wanted to be exposed to it. (For an explanation of what happened, see box.) Furthermore, many investors were restricted from buying into this part of the market even if they wanted to.

Equity tranches are not rated by any of the rating agencies and many so-called "real money" investors – banks, insurance groups and pension funds, for example – are allowed to invest only in highly rated securities or else have very strict limits on lower-rated holdings.

The rocket scientists at Lehman Brothers cracked this problem last month. A number of other banks have already managed to follow with similar deals.

The solution was to get the equity tranche rated. In Lehman's deal, €100m of synthetic CDO equity was rated A3 by Moody's. The bank since has sold €50m more from the deal and says demand has been strong.

At first glance, this looks like financial smoke and mirrors, because there is a high likelihood that some principal will be lost. However, the support for the deal's rating works in a similar way to that used in bonds backed by credit cards or residential mortgages.

"We have taken the returns paid to the equity and used them to build up a subordination fund over time. This acts as protection against losses in the tranche," says Sridhar Bearely, global head of CDO syndication at Lehman.

To secure the rating, the bank had to start with a more highly rated portfolio of CDSs than used in most CDO deals. It also employed an experienced manager, M&G, to help avoid losses.

Other banks have been quick to latch on. "The value of this kind of deal is in stabilising the market by increasing the diversity of investors throughout," Mr Bearely says. "From the perspective of arranging banks wanting to keep more balanced books, this is very attractive."

Some bankers doubt the value of this trade, saying that the higher-quality portfolio needed to support it limits the returns available.

However, others say that compared with the returns on other rated tranches, or on other similarly rated investments, "rated equity" is likely to prove attractive.

This particular trade is still new, but banks have also shifted synthetic CDO equity risk by providing principal protection.

The most popular such trade takes the form of constant proportion portfolio insurance, or CPPI.

This structure allows the lion's share of the principal to be put in a very safe investment – almost guaranteeing the return of principal

at maturity – while the rest is invested in riskier but higher-yielding instruments such as CDO equity.

Kareem Serageldin, head of synthetic CDOs at Credit Suisse, says this is where his bank has been most active and where the investor base is most diverse.

There is a limit on this market because modelling the returns from the risky element in order to give the coupon payments a rating remains challenging.

But it is not just “real money” investors that banks have been trying to attract. A parallel strategy has been to convince hedge funds to take on more CDO equity risk. This spawned an idea that proved popular in the first half of this year, the zero coupon equity strip.

With a traditional equity tranche, an investor puts down no money and receives a running coupon, or premium – but the investor must cover the cost of a default if one occurs.

With zero coupon equity, the investor receives no premium, but instead pays a fraction of the total notional exposure up front and collects the full value of the notional at maturity, minus losses from any defaults.

For example, the cost of zero coupon equity tranche on a 10-year deal is about five cents for every dollar returned at maturity, assuming no defaults.

Dirk Muench, credit derivatives analyst at JPMorgan, says the attraction for hedge funds is that they get their desired high-returning exposure but know the most they can lose is the five cents they paid up.

“The big advantage of zero coupon is that investors take the same equity risk but limit the amount they can possibly lose to the up-front premium paid,” he says.

Zero coupon deals are generally done for relatively long maturities of seven to 10 years because the longer the deal, the lower the initial cost for the investor.

The limited losses investors face compared with the possibility of a large payout at maturity means these structures could also appeal to retail investors.

This article is the third in a series on capital markets innovations.

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