INVESTOR'S GUIDE TO SYNTHETIC CDOs

There are many investment considerations in connection with CDO investments in general, and SCDOs are no different. Yet the emphasis may be different when looking at a synthetic transaction, and we suggest that the following considerations be included in an investor's due-diligence process in addition to their typical CDO due-diligence process:

- Reference portfolio: Quality and correlation are key
- Portfolio management: Static, lightly, or fully
- Credit event definitions: Capturing the essence of default
- Loss calculation: Methods differ, but multiple bids are best
- Settlement procedures: Now or later
- Discrete defaults: Avoid continuous default assumptions
- Bifurcated risk: Considering the high-quality assets

Reference Portfolio: Quality and Correlation Are Key

We urge investors to pay particular attention to the portfolio of reference credits. Owing to the high leverage of investment-grade SCDOs, just a handful of credit events can have significant implications for the performance of the investment. If the transaction is static and motivated by arbitrage reasons, investors should determine how the portfolio was constructed, including the parties involved and their interests, and carefully consider each name in the portfolio. For senior tranche investors and equity investors, we also urge careful consideration of the default correlation within the reference pool. High default correlation could be devastating to senior investors and beneficial to equity investors (see the earlier discussion "A Word of Caution: Portfolio Selection").

Portfolio Management: Static, Lightly, or Fully

Investors should consider whether the transaction is static, lightly managed, or fully managed. This will guide the due-diligence process. For static transactions, the focus is the portfolio of reference entities, whereas more emphasis is given to the manager in managed transactions. Unique to synthetic transactions is the concept of lightly managed transactions. In a compromise of sorts, equity investors and the supersenior investor have agreed to allow the portfolio manager to engage in a limited number of trades per year; usually these are credit risk trades. Supersenior investors generally favor static transactions because it is easier to quantify the risk associated with their investment, whereas equity owners frequently prefer giving the portfolio manager discretion to remove credits that appear to be deteriorating. Finally, portfolio managers should have experience in CDS documentation and established trading relationships with a broad range of CDS brokers, which demonstrates their market access.

Credit Event Definitions: Capturing the Essence of Default

Much discussion has been devoted to the nuances of what constitutes a credit event, and unfortunately, some of these issues still need resolution. The CDS market has attempted to react as unforeseen events have occurred (e.g., Conseco, Inc., Railtrack, and National Power PLC), but there is still considerable discussion surrounding the definition of restructuring and guarantees.

Investors should study the credit event definitions. Broadly worded definitions will increase the risk to the protection seller, whereas narrowly worded definitions do not. For example, the CDS in an SCDO may specify full restructuring, modified restructuring, or modified, modified restructuring or some variant of any of these as a credit event. Investors should understand these differences (see "Credit Events and Defaults"). The interests of various participating parties drive the definition of credit event, and investors should be aware that the interest of the other parties might conflict with their own. In general, the rating agencies favor terms that simulate the default of a cash investment because their rating methodologies are based on cash-based default and recovery data. However, investors should be sensitive to the differences between a default in the cash market and a credit event in the credit default swap market.

Loss Calculation: Methods Differ but Multiple Bids Are Best

On the occurrence of a credit event, there is tremendous variation in the methods of loss calculation. As mentioned earlier, some methods specify multiple valuation rounds and multiple bids, whereas others permit as little as one round and two bids—of which one could be a party involved in the transaction. We recommend that investors require valuation methods that incorporate at least five nonaffiliated bids for CDS on corporate names and three for CDS linked to structured-finance securities. Furthermore, time constraints should be considered. If fewer than three bids are used to value the defaulted reference obligation or strict time constraints are applied to the pricing process, valuations could be depressed, which could increase the loss incurred by the investor.

Write-Down: Now or Later

When a credit event is cash settled, some SCDOs write down the principal of the equity and notes in reverse order of seniority as credit events occur and are settled, whereas other SCDOs wait until the end of the transaction. If write-down is postponed until the end of the transaction, SCDO debt that may be principally impaired will continue to receive interest on the full notional amount of the investment. Conversely, if the notes are written down immediately, impaired noteholders will receive only a portion of their expected interest payment.

Discrete Defaults: Avoid Continuous Default Assumptions

Investment-grade SCDOs are susceptible to event risk within the pool of reference assets, just like their cash counterparts. The highly leveraged nature of investment-grade CDOs (commonly, the equity tranche consists of less than 3.5% of the entire liability structure) increases the impact of losses on equity holders and junior note holders. By historical standards, a 2% to 3% cumulative default rate that would significantly impair the equity of an investment-grade CDO is high for a five-year period, but in a pool of 100 names this equates to a small number of names experiencing problems. For instance, one default in a pool of 100 names is significantly below the historical average, whereas two defaults are significantly above it. Increasing diversity can mitigate much of the default "lumpiness," but we recommend that investors also identify and evaluate the weakest credits in the collateral pool. In large part the performance of their investment will depend on those securities. Implicitly, therefore, we also recommend that investors measure defaults in terms of the number of defaults and not default rates (e.g., a 0.5% default rate is not possible in a pool of 100 equally weighted credits), which tends to underestimate the possibility of large losses and overestimate the stability of returns.

Other events also can affect equity and note holders adversely. Many would argue that the historical default numbers used to structure many corporate investment-grade CDOs did not anticipate the relatively high incidence of accounting fraud that has rocked the investment-grade market in 2001 and 2002. Investment-grade corporate CDOs created in the late 1990s were not structured with this added stress in mind, and the sudden demise of previously investment-grade credits in this manner does not allow the portfolio manager or deal structure to react effectively.

Bifurcated Risk: Considering the High-Quality Assets

Investors who purchase CLNs depend not only on the creditworthiness of the reference entities but also on the performance of the high-quality assets that support their position. Frequently, the proceeds of the CLNs are invested in a guaranteed investment contract (GIC), but sometimes highly rated asset-backed securities or Treasurys are also used. Regardless, the CLN's performance depends on the performance of those high-quality assets, as well as on the performance of the reference pool. The insolvency of the GIC provider or a default in any of the high-quality holdings would adversely affect the deal's ability to pay principal and interest when due. Although many market participants may consider default by any of these entities a remote possibility, we suggest that investors consider the merits of the high-quality collateral and perform due diligence on the GIC provider, if any.

CONCLUSION

The structured-products market and the credit derivatives market have merged to create SCDOs, a product that is attractive to investors and issuers alike. Investors find SCDOs appealing for a variety of reasons, including more efficient structures that typically feature bullet payments, the ability to source credit risk on a wider variety of credits, and greater structural flexibility. Issuers are also attracted by the structural simplicity of SCDOs, as well as the way in which these structures eliminate currency and interest-rate mismatches. In addition, SCDOs can be executed in a shorter time frame and, in the case of corporate-related credits, offer practically nonexistent ramp-up periods.

The learning curve for investors who currently participate in the cash CDO market should be relatively short because SCDO structures bear similarity to the cash market, and many cash CDO concepts are transferable. Other concepts such as ISDA documentation and credit default swap mechanics have been presented here to provide investors with the basic tools to understand those areas which are different from the cash CDO market.

In the form of SCDOs, the CDO market continues to prove its structural flexibility. Emerging from its humble beginnings as a tool for banks to obtain regulatory capital relief, SCDOs have become a dominant fixture in the greater CDO market. Today, the SCDO market includes arbitrage transactions tied to corporate credits and structured finance securities (e.g., asset-backed securities, commercial mortgage-backed securities, residential mortgage-backed securities) as well as balance-sheet transactions. This variety provides a myriad of investment opportunities tailored to a particular risk appetite and credit exposure that often can be difficult to source in the cash market. Given the flexibility of the SCDO product, market participants should expect continued evolution and expansion of this market.