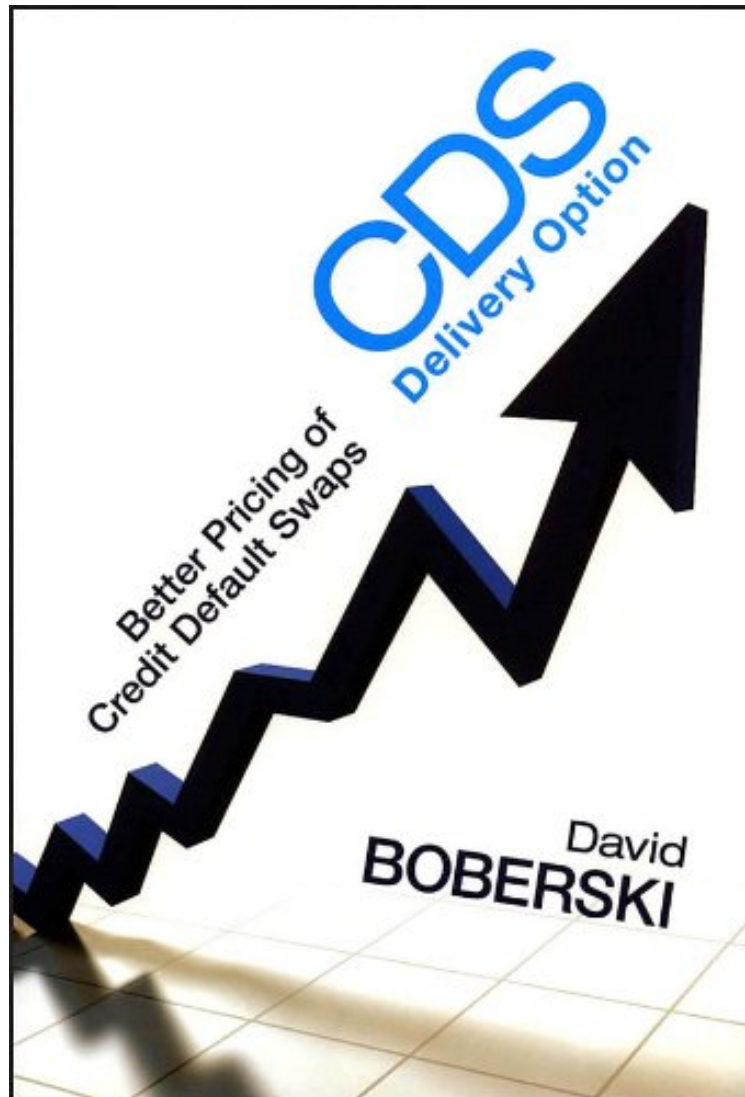


(Download ebook) CDS Delivery Option: Better Pricing of Credit Default Swaps (Bloomberg Financial)

CDS Delivery Option: Better Pricing of Credit Default Swaps (Bloomberg Financial)

David Boberski

audiobook / *ebooks / Download PDF / ePub / DOC



[Download](#)

[Read Online](#)

#2760267 in eBooks 2010-05-13 2010-05-13 File Name: B003NE61NK | File size: 53.Mb

David Boberski : CDS Delivery Option: Better Pricing of Credit Default Swaps (Bloomberg Financial) before purchasing it in order to gauge whether or not it would be worth my time, and all praised CDS Delivery Option: Better Pricing of Credit Default Swaps (Bloomberg Financial):

4 of 4 people found the following review helpful. What's needed is not there, and a lot of what's there could have been omitted. By Thoreau Devotee. needless editorial on the cause of the financial crisis. Covered ad infinitum and ad nauseam in newspapers, books, magazines, and blogs and blogs... what is missing was focus on credit default swaps! for some reason I thought if the title had both CDS and Credit Default Swaps, it would be almost all about CDS. Not

quite. The delivery options in the Treasury market are well known (you can choose amongst many bonds that have different net basis and implied repos) and the fact that there is a couple of hours of lag in the futures market closing and the selection of the delivery of the actual bond blah blah blah. I was looking to be educated about the authors real views on the credit market auction process, triggers by protection buyers vs protection sellers, any issues around new protocols etc. It comes through that the book is by a rates guy looking at the credit markets with a binocular. 4 of 5 people found the following review helpful. Adds little to current understanding of CDS. By ccw This book covers a lot of different topics, but a convincing paradigm for better pricing of credit default swaps is not one of them. The overall organization is unfocused and appears pointless. Boberski touches on the current financial crisis, how the cheapest-to-deliver option works in treasury futures, factors to consider in designing a new CDS contract, and an attempt to apply the framework of treasury future cheapest-to-deliver to corporate CDS. This framework appears hypothetical at best, and an illusion at worst. If you're looking for an analysis of the roots of the current crisis, there are better books out there: like Morris' *The Trillion Dollar Meltdown* or Cooper's *The Origin of Financial Crises*. I admire the author's attempt to apply the delivery option to corporate bonds, but I don't think it works.

For traders trying to navigate the increasingly volatile credit default swap market, *CDS Delivery Option* provides worked-out examples, over 30 charts, a case study of Delphi, and detailed explanations of how the subprime crisis caused the credit crisis and the near collapse of the GSEs. The book includes detailed information on: how to value a CDS contract how to value the delivery option how contract value changes when the yield curve flattens or becomes steeper how contract value changes with bullish or bearish market moves how to figure out when to buy protection and when to sell protection how to hedge CDS risk when and how to unwind a contract prior to settlement when to hold a trade through delivery how to navigate a "squeeze" (when the notional value of contracts going through delivery is larger than the supply of the cheapest-to-deliver issue) when buying contracts can make their prices go down how to construct a basis trade how to find arbitrage opportunities how to analyze default probability and corporate debt when to settle via auction and when to settle via physical delivery which note is the cheapest to deliver This book is an indispensable resource for all market professionals working in the CDS market.

About the Author David Boberski is executive director and head of exchange-traded derivative strategy within Prime Services at UBS Investment Bank. Institutional Investor has named Boberski to its All-American Fixed-Income Research Team for his work in federal agency debt and interest-rate derivatives. Boberski is also the author of *Valuing Fixed Income Futures*. Excerpt. copy; Reprinted by permission. All rights reserved. Chapter 4 Delivery Option: The Link Between Futures and Credit Derivatives; Credit derivatives, which began as a means of hedging the loan exposure of banks, have taken on a life of their own. Now they are used for many purposes for which they were not originally designed. For example, some investors use derivatives to construct synthetic corporate bonds. As current convention has it, this is done with two instruments: a credit default swap (CDS) and an interest rate swap. The credit default swap is a contract in which one party sells default protection to another. The interest rate swap is a contract in which one party makes interest payments at a fixed rate and the other makes payments at a floating rate. One would create a basis trade by exchanging a corporate bond with a credit default swap bundled with an interest rate swap. If the credit default swap premium plus the interest rate swap yield are better than or equal to the yield on the underlying corporate bond, then exchanging the cash for the synthetic makes sense. Assumptions Behind the Credit Default Swap Basis The important question to ask is: Should a credit default swap spread be added to an interest rate swap when constructing a synthetic corporate bond? When one does so, one assumes that the factors affecting credit spreads will not also affect interest rate swap spreads. In other words, the assumption is one of zero correlation. If this assumption is violated; in other words, if movements in credit spreads are correlated with movements in interest rate spreads; then the above construction offers far more risk than is present in the corporate bond. For example, if the credit swap has a spread DV01 (dollar value of 1 basis point) of \$450 and the interest rate swap has an interest rate DV01 of \$450, then the two better not be correlated, because if they are, the total risk of the position will be greater than \$450 for every basis point change in rates. The corporate note in the cash market has a DV01 of only \$450, so any correlation between credit spreads and swap rates adds unintended risk. Constructing a basis trade this way makes an interesting assumption about the correlation between the two derivative pieces, considering that one might imagine that an interest rate swap spread, the residual left from receiving on an interest rate swap and selling a Treasury, is itself a credit spread. If it's not a Treasury bond, there is a risk of default! However, the going assumption in the credit derivatives market is that the credit risks in interest rate swap spreads are independent of corporate default probabilities. How good is this assumption? As Figure 4.1 illustrates, there are times when it isn't realistic to assume independence between the derivative legs of a basis trade. Yield changes in a cash corporate note can be attributed to either a change in interest rates or a change in the probability that the bond's issuer will default. Of course, both risk factors can change at the same time, but each influence can still be considered separately, because we can measure the price risk of a note by perturbing its yield by just one basis point. The same may not be true of credit default swap and interest rate swap spreads; there is

evidence that during the period illustrated in Figure 4.1 there have been times when the two spreads have moved together. In this case, any positive correlation between the two would lead to a greater price risk in the synthetic bond than is present in the cash note. A true basis trade would swap identical risks to measure the pricing differences between each side. One can always make more money by taking more risk, but the point of constructing a basis trade is to take identical risks to discover pricing discrepancies. A first stab at arbitrage is to search for mispricings between risks that, by all rights, should be interchangeable. In order to adjust for correlation, one could measure the historical movement between the sides and then scale up or down the derivative pieces so that the statistical risk is comparable to the cash note. There are several problems with this approach. First, statistical measurements drift. Second, there is the problem of which side should be scaled—the credit or interest-rate swap? On the one hand, it is amazing that such a large market has grown up with such imperfect relative value approaches, but this might also be a testament to how sorely the credit market needed derivatives and how much utility they afford users.

Default Probability, Corporate Debt, and the Delivery Option Before digging into the mechanics of evaluating the delivery option, it is instructive to take a step back and consider the inter-actions we are studying. Accurately evaluating a credit default swap necessitates analyzing two markets: one for default probability and one for the debentures of the company. Rather than being divorced from the cash corporate market, credit derivatives are quite closely linked to this market through the structure of the embedded delivery option. The delivery option is a feature of trillions of dollars worth of outstanding credit derivatives. While the delivery option does have elements that behave like interest rate options, the triggers are very different. Interest rate options go in the money when there is a market move past a certain threshold. The delivery option goes in the money when a credit event occurs. The cash flows of a credit default contract are influenced by changes in the probability that a particular company will default. Presumably, the higher the premium paid in the default swap, the more likely it is that a company will default or the greater the severity of that default will be. (The severity of default refers to the loss incurred by the protection seller after paying par for a note that may be worth less than par. Typically, one considers the probability of default and loss severity to move in lockstep, since it is relatively unusual for a company to be in financial distress but pose little risk of loss to its bondholders. The exception to this could be collateralized debt, a separate situation from evaluating the unsecured debentures of a company, which constitute the vast majority of credit default swaps.)

Even though default probabilities are the most important factors to consider when evaluating the cash flow of a default swap, it is also necessary to evaluate the structure of the market for the underlying debenture to determine the value of the delivery option. Consider a default by a company with just one note outstanding: there is no delivery option since there are no alternatives for delivery except that one note. What if the company has two notes outstanding? The situation may or may not be very different than it is for the “one note” firm, depending on the differences between the two notes. For example, the two notes could be just three months apart in maturity, with the same coupon, in which case price movements would be nearly identical between the two. Although there is technically a choice about which note to deliver, the economic differences between the choices are relatively small. But what if a company has two notes with a twenty-nine-year difference in maturities and the long bond is a zero-coupon issue? In this case there would be a great difference between the risks of the two issues, which would make the right to choose which note to deliver upon settlement of the contract quite valuable. Of course, companies rarely finance themselves with such a berserk barbell structure of discount notes and 30-year bonds. In fact, most firms have a fairly orderly structure to their liabilities. However, the point worth making is that the value of a delivery option is tied to the structure of the notes available in the cash bond market...