

# Table of Contents

## **PART 1 MARKET, INSTRUMENTS AND MOTIVATIONS**

### **Chapter 1 Credit Derivatives: Structure, Evolution, Motivations and Economics**

Credit risk: the challenge of our times:	4
Derivatives: the building block of credit derivatives	5
Securitisation: The other building block	5
Instruments of credit risk transfer	6
Meaning of credit derivatives	6
What is a credit derivative?	6
A definition of credit derivatives:	7
Quick guide to basic jargon:	7
A quick example:	9
Synthetic lending:	10
Reasons for trade in credit risk	10
The elements of a credit derivative:	11
Bilateral deals and capital market deals:	11
Reference asset or portfolio:	12
Structured portfolio trade:	12
Basket trades:	13
Index-based credit derivative trades:	13
Credit default swaps on asset backed securities:	13
Loan-only credit default swap:	14
Protection buyer	14
Protection seller	14
Funded and unfunded credit derivatives:	15
Credit event:	15
Notional value:	16
Premium:	16
Tenure:	16
Loss computation:	17
Threshold risk or loss materiality provisions:	17
Cash and physical settlement:	17
Deliverable asset:	18
ISDA documentation:	18
Quick introduction to the types of credit derivatives:	19
Credit default swap:	19
Total return swap:	19

Credit linked notes:	20
Credit spread options:	Error! Bookmar
Portfolio default swaps:	Error! Bookmar
Index trades:	Error! Bookmar
Credit derivatives and traditional financial guarantee products:	Error! Bookmar
Credit derivatives and guarantees:	Error! Bookmar
Credit derivatives and credit insurance:	22
Credit derivatives and loan assignments:	22
Credit derivatives and securitisation:	24
Motivations:	24
Motivations for the protection buyer:	24
Reducing regulatory capital	24
Economic capital relief:	25
Offers easier alternative to securitisation:	25
Reduction of credit concentration:	26
Better portfolio management:	26
Solves cross border problem:	27
Enhancing RARoC:	27
Trading motive:	27
Motivations for the protection seller:	27
Synthetic lending:	28
Arbitraging opportunities	29
Yield enhancement:	30
Risk diversification	30
Balancing the risk balance sheet:	30
Much less costly:	31
Resolves problems of availability by cloning cash assets:	31
Motivations for the traders and re-packagers:	31
Economic impact of the credit derivative market:	32
The positive side	32
Financial stability:	32
Allows banks to focus on credit asset creation:	33
Brings down the cost of credit:	33
Increases supply of bank credit:	34
Effective risk management by diffusion of risk	34
Securitisation results into disintermediation: credit derivatives reinforces the role of commercial banks:	36
Credit derivatives and pricing of credit risks	37
The negative side	37
Lack of transparency in transfer of risks:	37
Cross-sector risk transfers:	38
Transfer of risks to the lesser informed:	39
Increased leverage:	39
Promotes riskier lending:	39
Insider trading:	40
Unconfirmed trades and operational problems	41

Have not been tested in adverse market conditions:	41
--	----

## Chapter 2: Credit Derivatives: Market, Evolution and Current Status

Evolution of credit derivatives:	47
Credit derivatives and secondary markets in loans:	48
Emergence of credit linked notes:	49
Four stages of development:	49
Pre 1997: Early period of skepticism:	50
The 1997 and 1998 crises: credit derivatives get a boost:	51
Enron, WorldCom, Argentina:	53
Standardization of credit default swaps:	53
Advent of Index trading:	54
Advent of credit derivative product companies	54
Synthetic balance sheet securitisation:	55
Current state of the market:	55
Growth in credit derivatives relative to other OTC market segments:	55
Major centres of credit derivatives activity:	58
Major market players:	<b>Error! Bookmark</b>
Protection buyers:	<b>Error! Bookmark</b>
Protection sellers	58
Banks:	60
Concentric nature of the credit derivatives market:	61
Trading versus hedging motive:	63
Insurance companies:	<b>Error! Bookmark</b>
Financial guarantors:	64
Hedge funds	64
Dealers:	<b>Error! Bookmark</b>
Hedge funds and credit derivatives:	65
Growth of the hedge fund industry:	66
The advent of credit strategies hedge funds:	66
Role of hedge funds and credit derivatives:	68
Hedge funds as suppliers of equity to credit derivatives:	69
Credit derivatives losses and hedge funds:	69
Implications of the intensive hedge funds role:	71
Major products:	72
Reference risks: sovereign versus corporate	72
Credit quality of reference entities:	74
Physical versus cash settlement	76

## **PART 2      SINGLE NAME INSTRUMENTS**

### **Chapter 3    Credit Default Swaps**

Meaning of credit default swaps:	81
Summary of terms:	81
Numerical illustration:	83
Main terms of the credit default swap:	83
Reference obligation:	83
Notional value:	84
Premium:	84
Credit events:	85
ISDA's credit events:	85
1. Bankruptcy	85
2. Obligation Acceleration	86
3. Obligation Default	86
4. Failure to Pay	87
5. Repudiation/Moratorium	87
6. Restructuring	87
Common credit events:	87
Notice of credit event:	88
Terms of settlement:	89
Physical settlement:	89
Deliverable obligation:	89
Cash settlement:	89
Valuation of the defaulted obligation:	89
Threshold amount:	89
Collateral provisions:	90
Funded credit default swap:	90
How do the parties to a credit default swap encash value:	91
Impact of time decay on Mark to market valuation:	92
Credit default swaps on sovereign names:	92
Basket default swap:	92
Portfolio credit default swap:	93
Structured portfolio default swap:	96
Binary swaps:	98

### **Chapter 4    Total Rate of Return Swaps**

Meaning of TROR swaps:	99
CDS and TROR swaps:	100
Impact of a TROR swap:	101
Terms of a TROR swap:	101

Reference asset:	101
Credit events:	102
Settlement methods:	102
Examples of applications of total return swaps:	102
Advantages of a TRS:	103
Index-based total return swaps:	104
Structured TRS:	<b>Error! Bookmar</b>
TROR swaps and equity swaps:	104
TROR swaps and property derivatives	104
Total return swaps and camouflaged lending transactions	<b>Error! Bookmar</b>

## **Chapter 5 Credit- Linked Notes**

Meaning of a credit linked note:	107
Distinctive features of credit linked notes:	108
Structured risk transfer through CLNs	109
CLNs issued by SPVs:	109
Self-referenced CLNs	111

## **Chapter 6 Credit Default Swaps on Asset- Backed Securities and Derivatives Exposures**

Need for credit default swaps on asset backed securities:	113
Development of credit default swaps on asset backed securities:	113
Major differences between asset-backed securities and corporate debt:	114
Documentation templates for different structured finance products:	<b>11Error! Bookm</b>
Special features in the documentation templates:	<b>11Error! Bookm</b>
Notional value of the swap:	<b>11Error! Bookm</b>
Credit events in case of ABS:	117
Credit events in case of MBS- physical or cash settlement terms:	117
Meaning of failure to pay:	<b>11Error! Bookm</b>
Failure to pay during the term of the transaction:	<b>11Error! Bookm</b>
Failure to pay upon final maturity:	<b>11Error! Bookm</b>
Meaning of Loss event:	<b>11Error! Bookm</b>
Bankruptcy as a credit event in case of CDS of ABS:	<b>11Error! Bookm</b>
Rating downgrade to distressed level:	119
Restructuring:	<b>11Error! Bookm</b>
Credit events under the PAUG terms:	<b>11Error! Bookm</b>
Physical delivery option under PAUG:	<b>11Error! Bookm</b>
Two modes of settlement: PAUG and traditional:	<b>Error! Bookmar</b>
Payments by the protection buyer:	120

Payments made by the protection seller:	<b>Error! Bookmark</b>
Writedown:	<b>Error! Bookmark</b>
Principal shortfall	121
Interest shortfall	121
CDS of CDOs:	122
Credit events in case of CDS of CDOs:	122
Contingent CDS:	122
Notional amount of the transaction:	123
Mark to market value:	123
Interim payments:	<b>Error! Bookmark</b>
Credit events:	124

## Chapter 7 Loan- only CDS

Meaning of leveraged loans	125
The LCDS market:	126
Motivations of the protection buyer:	127
Motivations of the protection seller:	127
Distinctive features of LCDS as compared to vanilla CDS:	128
European and US LCDS	128
Secured loans:	128
Physical settlement:	128
Relevant secured list:	129
Auction protocol:	129
Cancellability when no deliverables of required seniority exist:	129
ISDA documentation for LCDS	130
LCDS basis	130
Reasons for basis spreads (LCDS: leveraged loans):	130
Reasons for basis spreads (LCDS: CDS)	130
LCDX	131
iTraxx LevX:	131

## Chapter 8 Credit Derivatives Options and Volatility Trades

Credit spread trades:	133
Credit default swaptions:	133
Payer option:	134
Receiver options:	136
Out of money swaptions:	140
Combination trades:	<b>Error! Bookmark</b>
Straddle:	<b>Error! Bookmark</b>
Strangle:	<b>Error! Bookmark</b>

Butterfly:	Error! Bookmark not defined.
Swaptions on indices:	Error! Bookmark not defined.
Knock out feature:	Error! Bookmark not defined.
Constant-to-maturity CDS:	145
Distinctive Features of CMCDS:	Error! Bookmark not defined.
Genesis of CMCDS:	147
Uses of CMCDS:	147
Capped CMCDS:	148
Index CMCDS:	148

## **Chapter 9 Equity Default Swaps, Recovery Swaps and other Exotic Products**

Equity default swaps:	151
Synthetic position on various elements in the capital structure:	151
The intuitive idea behind equity default swaps:	15Error! Bookmark not defined.
Emergence of equity default swaps:	15Error! Bookmark not defined.
Preferred default swap:	15Error! Bookmark not defined.
Recovery swaps:	153
Combining a plain vanilla CDS with a digital CDS:	15Error! Bookmark not defined.
Recovery swaps:	154
Market in recovery swaps	
15Error! Bookmark not defined.	

## **PART 3 PORTFOLIO PRODUCTS**

### **Chapter 10 Portfolio Credit Derivatives and Introduction to Structured Credit Trading**

Portfolio credit derivatives vs single name credit derivatives:	159
Nature of the tranches:	160
Subordination and credit enhancement:	160
Attachment and detachment points:	161
Leverage:	161
Tranching: the essence of structured credit trading:	161
Why portfolio for tranches:	161
Key features of portfolio formulation:	161
Managed versus index/ index- tracking transactions:	162
Quality of credits:	162
Diversification:	162
Number of credits:	162
Number and sizing of the tranches:	163

Range of structured credit products:	163
Funded and unfunded transactions:	164
Special purpose vehicles:	164

## **Chapter 11 Introduction to Collateralized Debt Obligations**

Terminology: CDO, CBO and CLO	167
Types of CDOs	168
Cash and Synthetic CDOs:	168
Balance sheet and arbitrage CDOs:	169
CDO Types Based on Collateral	170
Par Value and Market Value-Based Structures:	170
Managed and static pool structures:	171
Fully-ramped, and to-be-ramped up structure:	171
Typical structure of a CDO	171
Basic economic drivers of CDOs	172
CDO Market and the Health of Banking	175
Growth of the CDO market	175
The spurt and spike in CDO activity in 2006 and 2007	176
CDO Market Trends	177
Balance Sheet CDOs	177
Traditional, Cash CDOs	178
The Creation of a Balance Sheet CDO	178
Underlying Assets	179
Diversity	179
Reinvestment period:	179
Credit enhancement structure	180
Structural Tests	180
Synthetic CDOs	180
The Creation of a Synthetic CDO	180
Advantages of Synthetic CDOs over cash CDOs	182
Arbitrage cash CDOs	187
The steps in creating an arbitrage cash CDO are as follows	187
Legal Structure	188
Underlying Assets	188
Reinvestment Period	188
Credit Enhancement Structure	189
Illustration of Potential Returns from Arbitrage CDOs	189
Arbitrage Synthetic CDOs	189
Creating an Arbitrage Synthetic CDO	190
Asset Quality Tests	191
Weighted average rating factor	191
Minimum and maximum weighted average coupon	191
Diversity Tests	191
Concentration limits	191



Diversity score	192
Asset and Income Coverage	192
Over-Collateralization Test	192
Interest Coverage Test	194
Ramp- up Period	195
Qualities of the CDO Manager	195
Balancing Between Equity Investors and Debt Investors	197
The CDO Manager's Fees	198
Resecuritisation or Structured Finance CDO	198
Growth of Structured Product CDOs	198
Assets of Structured Finance CDOs:	199
Collateral and Structural Risks in CDO Investing	199
Correlation Risk	199
Interest Rate and Basis Mismatch:	200
Cross Currency Risk	200
Liquidity Risk	200
Ramp-Up Risks	201
Reinvestment Risks during the Revolving Period	201
Lack of Granularity	201
Asset Risks	202

## Chapter 12 Index Trades

Reasons for popularity of index trades:	203
Development of the index trades:	205
Tranche trading:	206
Index options and tranche options:	206
iTraxx Europe	207
iTraxx Europe Investment grade:	207
iTraxx HiVol:	20Error! Bookm
iTraxx Crossover:	207
Price fixings in iTraxx	20Error! Bookm
iTraxx Asia:	209
iTraxx Total return indices	209
LevX	20Error! Bookm
Eurex iTraxx Credit Futures:	20Error! Bookm
Advantages of index traded futures over OTC index trades:	20Error! Bookm
Manner of computing iTraxx futures prices:	2Error! Bookma
Treatment of default:	210
CDX:	210
ABX:	211
Tranches:	2Error! Bookma
Composition of the index and settlements:	212
CMBX	212
LCDX	213

TABX:	213
Index spreads and intrinsic spreads	214

## **Chapter 13 Single- Tranche Synthetic CDOs, CPDOs and Other CDO Innovations**

Single tranche synthetic CDOs:	217
Concept of delta hedging:	219
The concept of PV01	220
Why would structurers prefer single tranche structures:	220
Distinction between a traditional CDO and STCDO:	220
Credit CPPI CDO:	220
Constance proportion portfolio insurance:	221
Basic idea of principal protection:	221
Portfolio insurance:	222
Illustration of constant proportion portfolio insurance:	222
Enter credit CPPI:	224
CPDOs:	225
Structure of CPDOs:	225
Impact of leverage:	227
CPDOs: from boom to bust:	227
Leveraged super senior CDOs:	227
Transaction structure of an LSS CDO:	227
Performance of leveraged super senior CDOs:	228
Case study: STARTS leveraged super senior CDO:	228
Long/short CDO:	229
Collateralized commodity obligations:	230
Case study: Barclays CCO transaction:	230

## **Chapter 14 CDO Case Studies**

DBS Bank's Alco 1:	233
Transaction structure:	234
The SPV	234
The notes:	234
Risk transfer:	235
Reference portfolio:	236
The credit default swap:	236
Investment of the collateral:	237
Interest rate swap and put option:	237
Economics of the transaction to DBS Bank:	238
Economic capital relief:	239

Basle II and the Alco 1 transaction:	239
CAST 1999-1 Non-SPV structure	239
Features of CAST 1999-1	240
Principal protection to subordinate class:	241
Investor interest	241
Cast 2000-1	242
Promise program by KfW Germany	243
Promise A 2002-1	244
Transaction structure:	244
The notes and Schuldscheine:	245
The reference portfolio:	246
Loss structure:	246
Amortization of the notes:	246
Promise-I 2002-1:	247
Later Promise transactions:	248
Standard Chartered Bank's START series and Sealane (Trade Finance) transaction:	249
Notes:	249
Portfolio:	249
Trade Finance CLO:	249
The notes:	249
The portfolio:	250
Synthetic Credit asset securitisation: SMART from Australia:	250
Synthetic versus cash transfer of lease receivables:	250
Credit protection:	251
Asset structure:	252
ANZ's Resonance Funding:	252
Jazz synthetic arbitrage CDO	253
Hybrid between cash and synthetic structure:	253
All that Jazz it has:	254
Synthetic versus cash liabilities:	254
The collateral manager	255
Liquidity facility:	255
Over-collateralisation and Interest cover tests:	256
Robeco arbitrage synthetic CDO:	257
White Oak synthetic CDO of structured obligations:	258
The reference portfolio:	259
Credit events:	259
Funding:	259
Regulatory arbitrage?	259

## **Chapter 15 Credit Derivative Product Companies**

Development of rating-oriented vehicles:	263
--	-----

Derivative product companies: a general introduction:	264
Market risk:	264
Credit risk:	264
Workout risk:	265
Case study of DPCs: Lehman's subsidiaries:	265
Lehman Brothers Derivative Products	265
Lehman Brothers Financial Products	266
Credit derivative product companies: development	266
Typical structure of credit derivative product companies:	267
Rating agencies' conditions for CDPCs	268
Constitutional and legal structure:	269
Operating modes:	270
Case study: Primus Financial:	270
Portfolio	270
Financials of Primus	271
Quadrant Structured Credit Products	271
Asset Portfolio	272
Operating modes:	272
Suspension mode:	272
Winding up mode:	273
Capital model:	273
Cashflow Waterfall	273

## **PART 4      PRICING AND VALUATION OF CREDIT DERIVATIVES**

### **Chapter 16   Approaches to Quantification of Credit Risk**

Credit risk: semi analytic approaches:	280
Financial statement analysis:	280
Multivariate models:	280
Altman's ZETA score:	280
Probit and Logit models:	281
Option-theoretic models:	282
Merton Model:	282
Foundation of the Merton Model:	283
Critical factors in bankruptcy risk:	283
Value of assets:	284
The Merton formula for probability of default:	286
Implementing the Merton formula	286
Adding simulation with the Merton formula	287
The KMV model:	287
Measuring default probability:	288
Asset value and volatility:	288
Computing the distance to default:	289

Computing default probability:	290
Intensity or hazard rate models:	290
Back-computing implied probability of default from the market:	290
Pricing of credit risk in a defaultable bond:	290
Computing probability of default from the market spreads	292

## **Chapter 17 Pricing of a Single Name Credit Derivative**

Establishing multi-period probabilities of default:	293
Working with probability of default:	293
Getting the probabilities of default from credit spread curve:	294
Pricing of a credit default swap:	295
Approach to pricing:	295
Defining the cash inflows and outflows:	295
Expected value of the inflow:	296
Expected value of the outflow:	297
CDS Price:	297
Introducing details:	297
Pricing of a derivative vs pricing of a bond:	298
Relevance of recovery rate:	299
Valuation of a credit default swap:	299
Value of upfront payment in a CDS	302

## **Chapter 18 Pricing of a Portfolio Credit Default Swap**

Basic principles of pricing of portfolio default swaps:	303
Meaning of a portfolio:	303
A portfolio without correlation:	304
Binomial Distribution	305
Tranching of the risk:	306
Pricing of the tranches:	307
Simulation method to derive probability distribution:	30Error! Bookm
Comparing the results of binomial and simulation approaches:	309
Introducing different exposures and different recovery rates:	310
Introducing correlation:	311
Incorporating correlation in simulation approach:	311
Impact of correlation on the shape of the probability distribution:	313
Correlation and tranche pricing:	313
Market implied correlation and correlation trading:	315

## **PART 5 LEGAL, REGULATORY, OPERATIONAL, TAX AND ACCOUNTING ASPECTS**

## Chapter 19 Legal Aspects of Credit Derivatives

Legal nature of credit derivatives:	319
Credit derivatives and contingent contracts:	320
Credit derivatives and actionable claims:	320
Contract of guarantee or surety:	320
Contract of indemnity:	324
Credit derivatives and bank letters of credit:	325
Credit derivatives and insurance contracts:	325
Robin Pott opinion on credit derivatives and insurance:	327
Are they gaming, gambling or wager contracts:	327
Are they securities?	328
Are they investment contracts	328
Bilateral contract or transferable:	329
Credit derivatives and commodities:	330
Enforceability of credit derivative contracts:	331
Regulatory enforceability of the derivative contract:	331
Enforceability of the reference obligation:	331
Whether credit event?	332
Meaning of different credit events:	332
Bankruptcy:	333
(a) Dissolution:	333
(b) Insolvency:	333
(c) Arrangement or composition with creditors	334
(d) Institution of bankruptcy or winding up proceedings:	334
(e) Winding up resolution	335
(f) Administration, receivership, etc	335
(g) Foreclosure action by creditors:	335
(h) Analogous proceedings	336
Obligation Acceleration:	336
Obligation default:	336
Failure to pay:	337
Repudiation/moratorium:	337
Restructuring	338
More than one credit events:	339
Legal disputes on credit derivatives:	339
Deliverable obligations:	339
Service of notices and physical delivery:	340
Demerger and the meaning of the successor entity:	340
Fraud allegations:	341
Significance of writing proper legal names of reference entities:	341
Derivatives-related regulation applicable to credit derivatives:	342
General bar on derivatives:	342

Commodity futures law in the USA:	343
Exemption to OTC derivatives	343
Commodity Futures Modernization Law:	344
Permission for trading in credit futures on exchanges:	345
Legal nature of total return swaps:	346
Legal nature of credit-linked notes:	346
Credit derivatives: Legal authority for banks:	347
Whether a part of banking business	347
Whether banks can be protection buyers:	348
Whether banks can be protection sellers:	348
Legal authority of a party to enter into a derivative:	348
Legal position of netting rights:	349
Derivatives trades and need for netting:	350
Bankruptcy laws and derivative contracts:	350
Bankruptcy Code safe harbour to credit derivatives:	351
Early bankruptcy safe harbour in the USA:	351
Financial Contract Netting Improvement law	352
The Bankruptcy Reform Act 2005	353
Revised definition of “swap agreements”:	353
Definition of “financial participant”	354
Definition of “master netting agreement”	354
Power to terminate, etc under sec 561	355
Amendment of automatic stay provisions:	355
Collateral rights:	356
General provisions relating to collateral:	356
Collateral rights in bankruptcy:	357
UK insolvency law and netting:	357
EU law on collateral and netting:	358
Netting in other countries:	358
Assignment and Novation	358
Choice of law:	359
Conseco restructuring event:	360
Argentina	361
Xerox:	361
Goodyear	362
Marconi	362
Modified restructuring definition:	362
Modified Modified Restructuring:	363
Restructuring practices:	364

## Chapter 20 Documentation for Credit Derivatives

Overview of derivatives documentation	365
Legal impact of master agreements:	366
Key features of ISDA Master Agreement:	366
Conditions precedent:	367
Netting:	367
Grossing up for withholding taxes:	367
Representations and warranties of both the parties:	367
Mutual covenants on compliances, etc:	368
Events of default:	368
Failure to pay:	368
Breach of agreement:	368
Credit support default:	368
Misrepresentation:	368
Default under specified transactions and cross default:	368
Bankruptcy:	368
Merger without assumption:	369
Termination events:	369
Illegality:	369
Tax event and tax event upon merger:	369
Credit event upon merger:	369
Consequences of events of default:	369
Consequences of termination events	369
Early termination:	370
Early termination payments:	370
Choice of jurisdiction	370
ISDA Documentation for credit derivatives:	371
Confirmation:	371
Stand alone confirmation:	371
Opening paras of the Confirmation:	371
General terms of the Confirmation:	372
Financial terms:	373
Notice requirements:	373
Credit events:	374
Obligations and Obligation Characteristics:	374
Settlement terms:	375
Master Confirmation format:	378
Physical settlement matrix:	378
Documents in case of specific credit derivatives:	378
Novation protocol	378
Credit support agreement	379

## **Chapter 21 Taxation of Credit Derivatives**

The tax basis of credit derivatives	381
-------------------------------------	-----



Nature of credit derivatives from tax viewpoint:	382
Guarantee:	382
Insurance:	382
Notional principal contracts:	383
Option contracts:	383
Key issues in taxation of credit default swaps:	383
Taxation of the protection buyer	38Error! Bookm
Integration with the reference obligation:	38Error! Bookm
Option contract treatment:	384
Notional principal contract:	38Error! Bookm
Meaning of notional principal contracts:	385
Are credit derivatives notional principal contracts?	38Error! Bookm
Hedge tax rules applicable to notional principal contracts:	386
No hedge tax accounting for Notional principal contracts:	386
Total rate of return swaps:	387
Is it a case of constructive transfer of the asset?	387
Taxation of credit linked notes:	388
Taxation of the protection seller:	388
Mark to market rules:	388
Book/tax conformity and safe harbor rules:	389
Tax treatment in other countries:	390
Taxation of derivative transactions in UK	390
Taxation of credit linked notes:	391
Tax treatment of closeout settlement	391

## **Chapter 22 Accounting for Credit Derivatives**

Whether derivatives accounting standards applicable?	393
The meaning of a derivative:	393
Physical settlement deals:	394
Credit default swap and financial guarantees	394
Total rate of return swap:	397
Credit linked note:	398
Basics of derivative accounting rules:	398
Basics of accounting for financial instruments	398
Basics of hedge accounting:	399
Why and when hedge accounting?	400
Impact of hedge accounting:	400
Conditions for hedge accounting:	400
Fair value hedge accounting:	401
Cashflow hedge accounting:	401
Accounting for credit default swaps:	402
If the CDS is a financial guarantee contract or credit insurance:	402
If the CDS is not merely a financial guarantee contract:	402

Accounting in the books of the protection buyer:	403
No hedge-accounting:	403
Hedge Accounting:	403
Fair value hedge:	403
Cashflow hedge:	404
Examples:	404
Accounting in the books of the protection seller:	406
Examples:	406
Accounting for total rate of return swap:	407
Books of the protection buyer:	407
Example:	408
Books of the protection seller:	408
Accounting for a credit linked note:	408
Separation of embedded derivative:	408
Books of the protection buyer:	409
Books of the protection seller:	409
Example	410
Valuation of credit derivatives:	410

## **Chapter 23    Regulatory Capital and Other Regulations on Credit Derivatives**

Evolution of regulations:	413
US Supervisory guidance of 1996:	414
Guarantee-like treatment	414
Examiner-determined treatment for the protection buyer:	415
Dealing with structured credit risk transfers: Guidelines of 1999	415
The FSA UK's guidelines of 1998:	416
Basel II and credit derivatives:	416
Basic approach of Basle II:	416
Credit risk, market risk and operational risk:	417
Three approaches to risk assessment:	417
Basic approach on Credit derivatives: Credit risk mitigation	419
General Conditions for capital relief in case of credit derivatives and guarantees:	419
Operational requirements for credit derivatives:	420
General rules for capital relief:	420
Computation of the risk weights:	421
Substitution approach:	421
Tranched cover:	421
Maturity mismatches:	421
Risk weights in case of the protection seller:	422
Basket default swaps:	422

Treatment of first-to-default protection:	422
Treatment in case of second-to-default protection:	422
Treatment in case of IRB approaches:	422
Trading book treatment	423
Second pillar: Capital charge for Residual risk:	423

## **Chapter 24 Operational issues**

Credit derivatives procedures	425
Master Agreements:	427
How trade is done:	428
Confirmations:	428
Trade information warehouse:	428
Short form and long form confirmation:	429
Confirmation options: electronic matching, centralised counterparty, etc:	430
Outsourcing of backroom operations:	430
Centralised clearing:	430
Electronic trade matching services:	430
Netting of payments and centralized clearing services:	431
Assignments and novations:	431
The operational risk issue:	432
Growing number of trades	432
Trade capture errors and rebooking of trades:	432
The problem of unconfirmed trades:	433
Regulatory intervention on unconfirmed trades:	433

## **Credit Derivatives Terminology** 435