

Agency Credit Default Swap Futures

The government Agency component of the CDX credit derivative index will be traded for the first time as a futures contract, tapping into the tens of trillions of dollars of notional value that is now locked up in the index. A separate government tranche of the index including Freddie Mac and Fannie Mae opens the door for new credit spread strategies as well as the creation of synthetic Agency notes. Agencies are the largest issuers of corporate debt and deserve a prominent place in credit derivative trading. Agency credit default swap futures are a rare example of a product that is relevant to both credit and interest rate traders.

In an innovative arrangement the exchange will list two versions of the same contract, appealing to two distinct groups of traders. One version of the index is “unfunded” and will solely represent the cash flows of Fannie Mae and Freddie Mac credit default swaps. The second contract is “funded” and includes the same credit default swap cash flows as the first contract plus an interest rate swap. Pooling liquidity of the two contracts should be easy enough since the spread between them is simply an interest rate swap.

Traders who want to use the Agency index for credit spread trades against the CDX or its components may gravitate to the “unfunded” contract. Traditional Agency investors creating synthetic positions may gravitate to the “funded” form that includes the interest rate swap, since it replicates a cash note and efficiently bundles three trades in one: two Agency CDS as well as an interest rate swap of the same tenor.

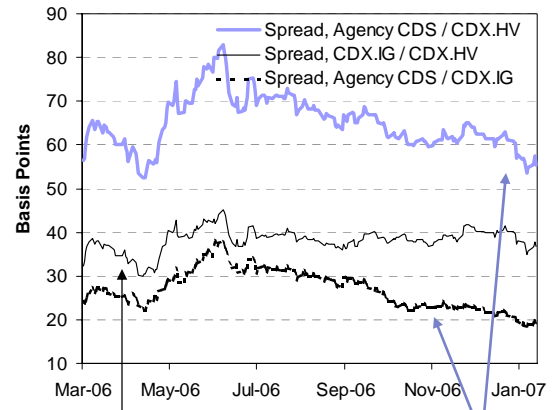
The new futures contract brings all of the advantages of an exchange-traded product while matching the OTC contract specifications. Previous attempts to bring credit derivatives to US exchanges have been stymied by the SEC, which prohibits futures on registered securities like corporate bonds. In order to list credit default swaps the CBOT and CME have been forced to create alternative designs, like fixing the payout rate in case of a default, leading to different economic results than OTC market. However, Agency debentures are exempt from registration with the SEC, allowing the USFE to match OTC contracts exactly, without basis risk.

The hallmark of all successful markets is diversity of users. The advantage of Agency credit default swap futures is that they appeal to two distinct groups: traditional Agency investors interested in creating synthetic structures as well as corporate managers who solely trade credit risk. The new futures contract allow for the creation of:

- Synthetic Agency bullets at *positive* LIBOR spreads
- Spread trades against CDX indices for high-octane credit trades

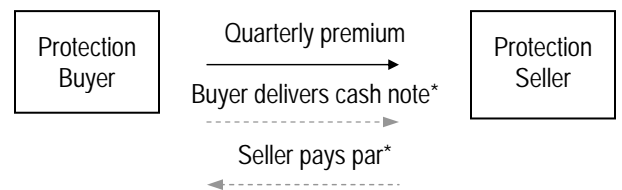
The Agency component of CDX is the ultimate high-grade index for spread trades against the investment grade (IG), high-yield (HY) and crossover credit indices, as well as sovereign and emerging market CDS. Agency CDS futures offer the closest proxy possible for US government risk, given the direct credit line between the Agencies and the US Treasury, allowing for comparisons against sovereign credit worldwide.

Figure 1: Agency CDS less volatile than CDX.IG,HY



CDX.IG and HV are too highly correlated to make effective credit spread bets. Agency CDS is less correlated with other parts of the CDX index, allowing for more volatile spread trading.

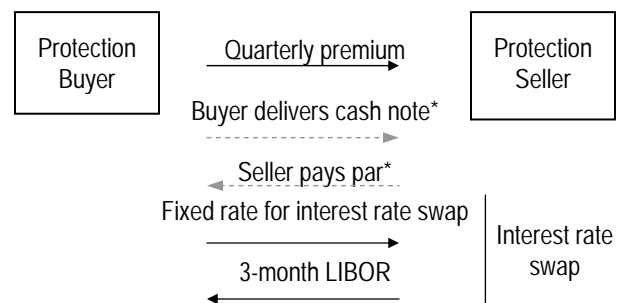
Figure 2: “Unfunded” CDS futures: credit risk only



* If there is no credit event the protection buyer pays the seller the quarterly premium without change for the life of the contract. The protection seller pays nothing unless there is a credit event, defined by ISDA.

Agency CDS futures call for physical delivery of any of the \$1.5 trillion senior notes from the GSEs in a credit event.

Figure 3: “Funded” CDS futures: credit + rate risk



Source Data: Bear, Stearns & Co.

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