

A Guide to the CDS Package (Draft)

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1 Introduction

A Credit Default Swap (CDS) is a financial swap agreement between two counterparties in which the buyer pays a fixed periodic coupon to the seller in exchange for protection in the case of a credit event. The International Swaps and Derivatives Association (ISDA) has created a set of standard terms for CDS contracts, the so-called “Standard Model.” This allows market participants to calculate cash settlement from conventional spread quotations, convert between conventional spread and upfront payments, and build the yield curve of a CDS. The **CDS** package implements the Standard Model, allowing users to value credit default swaps and calculate various risk measures associated with these instruments.

2 CDS Basics

A CDS is a simple and popular form of credit derivative. It was originated in the late 1980s and was popularized by a team at J.P. Morgan including Blythe Masters in 1994 (Lenzner, 2009; Lanchester, 2009). The CDS market started to develop soon afterwards as banks used CDS contracts to hedge their credit exposures on the balance sheets. Many different types of CDS have since emerged including basket default swaps (BDSs), index CDSs, credit-linked notes, et cetera (Kallianiotis, 2013). In the **CDS** package, we focus on calculations related to a single-name CDS contract.

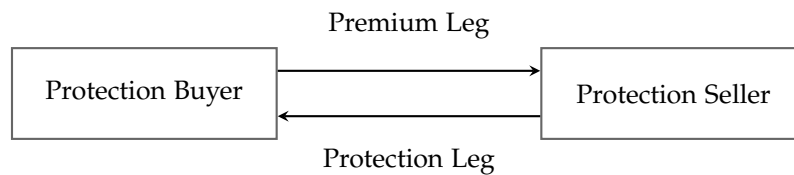
A single-name CDS contract provides a transfer of credit risk between two parties. The buyer of a CDS contract, a.k.a. protection buyer, transfers the credit risk to the CDS seller (or called protection seller) by paying a series of payments before the contract terminates. In other words, the protection buyer is short credit by selling the credit risk of an underlying loan to the protection seller. As shown in Figure 1, the buyer pays a stream of coupon payments, called the premium leg, in order to receive a one-off, contingent payment (protection leg) in the case of a credit event.

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Figure 1: Mechanics of a CDS contract



A CDS contract between two counterparties typically specifies the following key terms:¹

Reference Entity refers to the legal entity which is the subject of a CDS contract.

Notional is the amount of the underlying asset on which the payments are based.

Maturity a.k.a **tenor**. It refers to the length of a CDS contract. Most CDSs are written with 5 years of maturity. The protection buyer continues to make payments to the protection seller till maturity of the contract or the occurrence of a credit event.

Coupon is often quoted in basis points. It specifies the payment amount from the protection buyer to the seller on a regular basis.

Premium Leg refers to the cashflows of the fixed payments made by the protection buyer.

Contingent Leg , a.k.a. **protection leg**, is the payment of notional less recovery amount by the protection seller after a credit event.

Par spread is quoted in basis points per annum. It represents the fair rate for a contract of 1 year beginning on the trade date.

Seniority specifies the order of which the debt will be paid in liquidation or bankruptcy. In general, there are four levels of seniority - Senior, Subordinated, Junior, and Preferred.

Credit Event triggers the settlement under a CDS contract. Possible credit events specified by the ISDA Credit Derivatives Definitions include:

- **Bankruptcy** - It typically occurs when the reference entity has filed under a bankruptcy law (or an equivalent law).
- **Failure to pay** - The reference entity fails to make interest or principal payments when due after the applicable grace period expires.
- **Debt restructuring** - The specifications of the debt obligations are changed such that the protection buyer is unfavorably affected.
- **Obligation acceleration** - A debt obligation becomes due before it would otherwise have been because of a default.

¹Some of the definitions come from *Credit Derivatives Glossary* (Markit, 2009), *Standard Corporate CDS Handbook* (Leeming et al., 2010), *Credit Derivatives* (Green and Witschen, 2012), and *The Pricing and Risk Management of Credit Default Swaps, with a Focus on the ISDA Model* (White, 2013).

- **Obligation default** - A debt obligation becomes capable of being declared due before it would otherwise have been because of a default.
- **Repudiation/Moratorium** - The reference entity announces repudiation or moratorium on debt obligation and subsequently fails to pay.

3 The ISDA Standard Model

In April 2009 in North America and June 2009 in Europe, the ISDA introduced a series of mandatory modifications to the CDS contract known as the “Big Bang Protocol.” Among these changes were the standardization rules on the first accrual dates, fixed coupon rates (100 bps or 500 bps), and the recovery rate (40 %).

This section provides some key specifications of the ISDA Standard Model.² The default calculations and parameters in the **CDS** package follow the Standard Model. Additional default settings in the package which are not specified by the Standard Model, such as the default notional amount, are also listed.

3.1 Standard Model Specifications

An ISDA standard CDS contract specifies the following:

Trade Date refers to the date of the trade.

Maturity is the length of the contract. Most of the standard contracts have a maturity of 5 years.

Maturity Date falls on one of the four dates (Mar/Jun/Sep/Dec 20th) in a year. One can add the maturity of the contract to the trade date; the next available date among those four dates is the maturity date.

Backstop Date is the date from which protection is provided,

$$\text{Backstop Date} = T - 60 \text{ Calendar Days.}$$

Notional Amount is denoted in millions.

Standard Coupon is quoted either 100 bps or 500 bps per annum for CDS contracts in North America, and 25 bps, 100 bps, 500 bps or 1000 bps in Europe.

Recovery Rate is the estimated percentage of par value that bondholders will receive after a credit event. It is commonly reported in percentages. A CDS contract for investment grade bonds are assumed a 40% recovery rate when it is valued. The recovery rate is assumed to be 20% when valuing a subordinate level CDS. 25% is assumed for emerging markets’ CDSs (both senior and subordinate).

²Refer to the *ISDA Standard CDS Converter Specification* for details.

Par Spread is the spread value which makes the present value of a CDS contract zero. It is quoted in basis points.

Upfront Payment is quoted in the currency amount. Since a standard contract is traded with fixed coupons, upfront payment is introduced to reconcile the difference in contract value due to the difference between the fixed coupon and the conventional par spread. There are two types of upfront, dirty and clean. Dirty upfront, a.k.a. **Cash Settlement Amount** refers to the market value of a CDS contract. Clean upfront is dirty upfront less any accrued interest payment, and is also called the **Principal**.

Points Upfront , or simply **points**, are quoted as a percentage of the notional amount. They represent the upfront payment excluding the accrual payment. High Yield (HY) CDS contracts are often quoted in points upfront. The protection buyer pays the upfront payment if points upfront are positive, and the buyer is paid by the seller if the points are negative.

3.2 Standard Model Pricing

The Standard Model allows market participants to convert between the par spread and the upfront payment, and compute the cash settlement amount for a standard contract. A few key assumptions and definitions used when valuing a Standard CDS contract are the following:³

Trade Date (T) means 11:59pm on the trade date.

Days of Protection are the difference in the number of days from Maturity Date to Trade Date.

Mark-to-market (MTM) represents the contract value to the protection buyer. It is computed by discounting the expected protection leg and premium leg cashflows to T.

Accrued Premium is the premium that has accrued from accrual begin date to T where both dates are inclusive.

The ISDA also standardizes the interest rates used by the Standard Model in valuing a CDS contract. There are two types of rates used in valuing a USD denominated CDS contract - cash rates and swap rates. Cash rates are of maturity 1, 2, 3, 6 months, and 1 year. They are provided by the British Bankers' Association (BBA). Swap rates are of maturity 2, 3, 4, 5, 6, 7, 8, 9, 10, 12, 15, 20, 25, 30 years and are provided by ICAP (Markit, 2013). The Standard Model follows the conventions below for interpolation of the entire USD yield curve:

- The day count convention (DCC) for money market instruments and floating legs of the swaps is **ACT/360**.
- DCC for floating legs of the swaps is **30/360**.
- Payment frequency for fixed legs of the swaps is 6 months.

³Please refer to <http://bit.ly/1kg5qPw> for more information on the ISDA standard CDS model assumptions.

- Payment frequency for floating legs of the swaps is 3 months.⁴
- A business day calendar of weekdays (Monday to Friday) is assumed. Saturdays and Sundays will be the only non-business days.
- If a date falls on a non-business day, the convention used for adjusting coupon payment dates is **M** (Modified Following).

One component essential to the mark-to-market calculation of a CDS contract is **PV01**. It is the present value of a stream of 1 basis point payments at each CDS coupon date. It is sometimes referred to as the **CDS duration** or **risky duration**.

Analytically, PV01 can be calculated by

$$PV01 = \sum_t Df(t_i)S(t_i)B(t_i),$$

where

- i = coupon index,
- t_i = coupon date,
- $Df(t_i)$ = discount factor until t_i ,
- $S(t_i)$ = survival probability until t_i ,
- $B(t_i)$ = day count fraction at t_i .

We can thus calculate the principal amount (clean upfront payment) paid from the protection buyer to the seller using the following formula:

$$\text{Principal Amount} = (\text{Par Spread} - \text{Coupon}) \times PV01.$$

Using the concept of PV01, we show the calculation of the main risks (exposures) of a CDS position, **Spread DV01**. Spread DV01 reflects the risk duration of a CDS trade, also known as **Sprdd DV01**, **Credit DV01**, **Spread Delta**, and just **DV01**. It measures the sensitivity of a CDS contract mark-to-market to a parallel shift in the term structure of the par spread. DV01 should always be positive for a protection buyer since she is short credit and a rising spread is a sign of credit deterioration. Starting with PV01 and taking the derivative with respect to the spread give us:

$$\begin{aligned} PV &= (S - C) * PV01 \\ DV01 &= \frac{\partial PV}{\partial S} \\ &= PV01 + (S - C) \frac{\partial PV01}{\partial S}, \end{aligned}$$

where S is the spread of the contract and C is the coupon.

Both DV01 and PV01 are measured in dollars and are equal if the spread equals the coupon.

Some other risk measures of a CDS contract are as follows:

⁴See <http://www.fincad.com/derivatives-resources/wiki/swap-pricing.aspx> for details on floating and fixed legs calculation.

IR DV01 is the change in value of a CDS contract for a 1 bp parallel increase in the interest rate curve.

IR DV01 is, typically, a much smaller dollar value than Spread DV01 because moves in overall interest rates have a much smaller effect on the value of a CDS contract than does a move in the CDS spread itself.

Recovery Risk 01 is the dollar value change in market value if the recovery rate used in the CDS valuation were increased by 1%.

Price refers to the clean dollar price of the contract.

$$\begin{aligned}\text{Price} &= (1 - \text{Principal/Notional}) * 100 \\ &= 100 - \text{pointsupfront.}\end{aligned}$$

For example, if a CDS contract is quoted as 3 points to buy protection, the price will be 97. The protection buyer still pays the 3% as an upfront fee. A CDS will have a price greater than 100 if the points upfront are negative, that is, the CDS buyer needs to receive money to obtain protection because he promises to pay a coupon of, say, 100 even if the spread is 60. This is analogous to a bond investor paying more than the face value of a bond because current interest rates are lower than the coupon rate on the bond.

4 Using the CDS package

Currently, a market participant can conduct CDS-related calculations by using the **CDSW Calculator** on a Bloomberg Terminal or the Markit CDS Calculator.⁵ The **CDS** package provides tools for valuing a single-name CDS contract. The default setting allows a user to value a USD-denominated CDS contract following the Standard Model. She can also specify her own set of parameters to customize the calculation. In this section, we will demonstrate the use of the **CDS** package with a series of examples.

The default settings of valuing a CDS contract in the **CDS** package follow the Standard North American Corporate (SNAC) CDS Contract specifications:⁶

- Currency: USD.
- Trade Date (T): the current business day.
- CDS Date: Mar/Jun/Sep/Dec 20th of a year.
- Maturity: 5 years.
- Maturity Date (End Date): It falls on a CDS date without adjustment.
- Coupon Rate: 100 bps or 500 bps.

⁵The Markit CDS Calculator is available at <http://www.markit.com/markit.jsp?jspage=pv.jsp>.

⁶See <http://www.cdsmodel.com/assets/cds-model/docs/Standard%20CDS%20Contract%20Specification.pdf> for details.

- Notional Amount (MM): 10MM.
- Recovery Rate (%): 40% for senior debts.
- Premium Leg:
 - Payment Frequency: quarterly
 - DCC: ACT/360
 - Pay Accrued On Default: It determines whether accrued interest is paid on a default. If a company defaults between payment dates, there is a certain amount of accrued payment that is owed to the protection seller. “True” means that this accrued will need to be paid by the protection buyer, “False” otherwise. The default is “True,”
 - Adjusted CDS Dates: “F”. It means that it assumes the next available business day when a CDS date falls on a non-business day except the maturity date.
 - First Coupon Payment: It is the earliest Adjusted CDS Date after $T + 1$.
 - Accrual Begin Date (Start Date): It is the latest Adjusted CDS Date on or before $T + 1$.
 - Accrual Period: It is from previous accrual date (inclusive) to the next accrual date (exclusive), except for the last accrual period where the accrual end date (Maturity Date) is included.
- Protection Leg:
 - Protection Effective Date (Backdrop Date): $T - 60$ calendar days for credit events.
 - Protection Maturity Date: Maturity Date.
 - Protection Payoff: Par minus Recovery.

For illustrative purposes, we call the function `CDS` to construct an object of class “CDS”. Below we use the default settings as mentioned.

```
> library(CDS)
> cds1 <- CDS(entityName = "IBM",
+             RED = "49EB20",
+             TDate = "2014-04-15",
+             maturity = "5Y",
+             coupon = 100,
+             parSpread = 50)
```

`entityName` indicates the name of the underlying entity which is the subject of the CDS contract. RED is a Markit product. It stands for Reference Entity Database. Each entity/seniority pair has a unique 6 digit RED code. Each deliverable bond has a 9 digit RED code, the first 6 digits of which matches the 6 digit code of the associated entity/seniority. Each entity also has a “preferred reference obligation” that is the default reference obligation for CDS trades. A user can input either the six-digit

RED code or the nine-digit RED pair code. TDate indicates the trade date of the CDS contract. maturity is the maturity of the contract. coupon is the fixed coupon of the contract. parSpread, ptsUpfront and upfront refer to the par spread (in bps), points upfront (in %), and upfront payment (in dollar amount) of a CDS contract, respectively. One of the three arguments has to be specified in order to construct the “CDS” class object.

Here the user has entered the CDS contract which has “IBM” as the underlying entity with “49EB20” as the RED Code. She sets the spread at 50 bps and the coupon rate at 100 bps. However, the valuation of a CDS contract requires neither the entity name or the RED Code. She does not have to know the information to use the package. As shown below, insofar as she inputs the same TDate, coupon, parSpread, and maturity information, the valuation of the contract will be the same.

```
> cds2 <- CDS(TDate = "2014-04-15",
+             maturity = "5Y",
+             coupon = 100,
+             parSpread = 50)
```

Calling summary on a “CDS” class object provides some essential information on the contract (including trade date, maturity date, spread, and coupon rate as specified by the user) and some relevant calculations based on the input CDS contract.

```
> summary(cds1)
```

Contract Type:	SNAC	TDate:	2014-04-15
Entity Name:	IBM	RED:	49EB20
Currency:	USD	End Date:	2019-06-20
Spread:	50	Coupon:	100
Upfront:	-256,577	Spread DV01:	5,086
IR DV01:	66.14	Rec Risk (1 pct):	90.03

```
> summary(cds2)
```

Contract Type:	SNAC	TDate:	2014-04-15
Entity Name:	NA	RED:	NA
Currency:	USD	End Date:	2019-06-20
Spread:	50	Coupon:	100
Upfront:	-256,577	Spread DV01:	5,086
IR DV01:	66.14	Rec Risk (1 pct):	90.03

In the summary output, Upfront shows the cash settlement amount (dirty upfront). It is the sum of the principal and the accrual. Spread DV01, IR DV01, and Rec Risk (1 pct) are the eponymous results mentioned in Section 3.2. Moreover, summary(cds1) and summary(cds2) give the same output besides entityName and RED.


```
> cds2.CS10 <- CS10(cds2)
> cds2.CS10
```

```
[1] 25385.2
```

CS10 is a method which calculates the change in value of the CDS contract when the spread of the contract increases by 10%. CS10 takes in a CDS class object formed by calling the CDS function.

```
> cds3 <- update(cds1, spread = 55)
```

The update method updates a “CDS” class object with a new spread, points upfront or upfront by specifying the relevant input. cds3 is a new “CDS” class object with a spread of 52 bps; all other specifications of the contract are the same as those in cds1 since it is updated from cds1. One can also specify upfront (in dollar amount) or ptsUpfront (in bps) in the update method.

Besides calling the summary method, one can type in the name of the “CDS” class object in the current R Session and obtain a full description of the CDS contract.

```
> cds3
```

CDS Contract

Contract Type:	SNAC	Currency:	USD
Entity Name:	IBM	RED:	49EB20
TDate:	2014-04-15	End Date:	2019-06-20
Start Date:	2014-03-20	Backstop Date:	2014-02-14
1st Coupon:	2014-06-20	Pen Coupon:	2019-03-20
Day Cnt:	ACT/360	Freq:	Q

Calculation

Value Date:	2014-04-18	Price:	102.24
Spread:	55	Pts Upfront:	-0.0224
Principal:	-223,692	Spread DV01:	5,064
Accrual:	-7,500	IR DV01:	59.35
Upfront:	-231,192	Rec Risk (1 pct):	88.87
Default Prob:	0.047	Default Expo:	6,223,692

Credit curve effective of 2014-04-15

Term	Rate	Term	Rate
1M	0.001517	7Y	0.022630
2M	0.001923	8Y	0.024580
3M	0.002287	9Y	0.026265
6M	0.003227	10Y	0.027590
1Y	0.005465	12Y	0.029715

```

2Y 0.005105 15Y 0.031820
3Y 0.009265 20Y 0.033635
4Y 0.013470 25Y 0.034420
5Y 0.017150 30Y 0.034780
6Y 0.020160

```

There are three parts of the output. They are the basic contract information, the valuation of the contract, and the interest rates used in the calculation.

Calling the function `getRates` produces the rates used in building a curve for CDS valuation.

```
> cds1Rates <- getRates(date = "2014-01-15")
```

The output consists of two list objects. The first list contains rates of various maturities. They are directly obtained from the Markit website based on the specifications (Markit, 2013).

	expiry	matureDate	rate	type
1	1M	2014-02-17	0.00159	M
2	2M	2014-03-17	0.002055	M
3	3M	2014-04-17	0.002368	M
4	6M	2014-07-17	0.003355	M
5	1Y	2015-01-19	0.005681	M
6	2Y	2016-01-17	0.00496	S
7	3Y	2017-01-17	0.00881	S
8	4Y	2018-01-17	0.01322	S
9	5Y	2019-01-17	0.017375	S
10	6Y	2020-01-17	0.020875	S
11	7Y	2021-01-17	0.02384	S
12	8Y	2022-01-17	0.026155	S
13	9Y	2023-01-17	0.028045	S
14	10Y	2024-01-17	0.029695	S
15	12Y	2026-01-17	0.032195	S
16	15Y	2029-01-17	0.034545	S
17	20Y	2034-01-17	0.03655	S
18	25Y	2039-01-17	0.03742	S
19	30Y	2044-01-17	0.03788	S

The second list reports the specific day count conventions and payment frequencies regarding the interest rate curve used.

```

text
effectiveDate "2014-01-15"
badDayConvention "M"

```

mmDCC	"ACT/360"
mmCalendars	"none"
fixedDCC	"30/360"
floatDCC	"ACT/360"
fixedFreq	"6M"
floatFreq	"3M"
swapCalendars	"none"

5 Conclusion

In this paper, we describe the basics of a CDS contract, the ISDA Standard Model, and its valuation. We also provide a simple collection of tools to implement the Standard Model in **R** with the CDS package. Moreover, the flexibility of **R** itself allows users to extend and modify these packages to suit their own needs and/or execute their preferred models for CDS contracts. Before reaching that level of complexity, however, CDS provides a good starting point for valuing CDS contracts following either the Standard Model or user specifications.

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