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Questions about Skew Notes

Please read the feature article from Risk Magazine and the other background articles posted on the Compass site. Prepare a brief report to address the questions below.

- **Question 1.** What is the CDX "skew"? How exactly is it calculated. What arbitrage trade is available to market participants in mid 2016, and who is taking the other side of this trade?

- **Question 2.** Suppose you work for a bank and want to take advantage of the opportunity to issue a skew bond. Assume the "skew" is -15 bp when the transaction is initiated. Design a transaction that can pay investors LIBOR + 200 bp with certainty. Explain the terms of the deal and what trades your bank needs to undertake to set up the note, and to guarantee that investor's principal is protected. Show a diagram of where all the cash-flows go in your structure.

  You may find it helpful to read the prospectus for the Libretto 2016 bonds issued by Citibank that is on the Compass site.

- **Question 3.** Explain what happens in your transaction if, afte rthe deal is sold, the skew gets more negative. Assume that positions in index CDS contracts are marked to market but that single-name CDS contracts are not. Does any party (either your bank or your investors) have to pay in additional cash? If so, how does this affect the risk/reward characteristics of the transaction?

- **Question 4.** Explain what financial engineering problem skew bonds solve. Do you think their function is beneficial to financial markets overall?