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ABN Amro in new structured credit offering

By Paul J Davies

ABN Amro has launched a product that aims to give fixed-income investors fully rated and leveraged exposure to the main credit derivatives indices in the US and Europe.

The Dutch bank closed the first issue of the new investment last week, having sold two tranches of notes worth $100m and €100m. It expects to close a second stage this week after placing another three tranches of notes worth Y10bn, A$100m and NZ$100m.

Steve Lobb, ABN's global head of structured credit marketing, said the bank expected the new structure to have an impact similar to the introduction of synthetic collateralised debt obligations, which give exposure to part of a pool of credit derivatives. "We think this is the most exciting development in credit investing since the single tranche CDO," he said.

The notes are based on a new structure with the ungraceful title "constant proportion debt obligations" (CPDOs). It shares features with two popular structured credit products of recent years, synthetic CDOs and credit CPPI (constant proportion portfolio insurance).

It is a true fixed-income product, rated triple-A by Standard & Poor's to pay a regular coupon of Libor plus 200 basis points. But, said ABN, it would not be exposed to the correlation risks of a synthetic CDO.

Correlation is what drives the pricing differences between differently rated tranches of synthetic CDOs. It is a complex mathematical output of CDO models and can change in sudden, unexpected and costly ways.

Credit CPPI, meanwhile, is not always a truly fixed-income product because while such deals are always rated for principle protection, it is much more difficult to rate their regular payment of coupons. For investors who are constrained to invest in rated products, accounting for a CPPI can be difficult.

"A lot of investors need rated product, but with CPPI it's difficult to rate the coupons," said Richard Whittle, global head of credit and alternatives trading at ABN. "Synthetic CDOs can fit the picture, but many investors either don't like correlation risk or have enough of it and want to diversify."

The investment works by selling protection on the main US and European indices of investment grade credit default swaps, which are a kind of insurance against non-payment of corporate debt.

To generate a high level of income from these indices, the structure will sell protection on a notional credit exposure worth up to 15 times the initial investment.

The investor's original principle is kept on deposit, acting as a margin for the unfunded protection selling on the CDS indices, which S&P highlighted as a source of risk because a sudden leap in default rates when the deal was highly leveraged would be likely to wipe out the principle.

There is also risk for ABN, because the investor is limited to losing only the original principle with ABN making up any losses beyond.

The product aims to reach a point before final maturity where enough returns have been generated to cover all future coupon payments with an investment in a risk-free bond.

The leverage in the deal is lifted or lowered depending on how far the value of the notes are from reaching this "cash in" point, which the bank said was expected to be hit after about seven years, three years ahead of maturity.