

Philosophia Naturalis
principia Mathematica

Principia Partners

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Challenges in Managing Credit Derivatives

Def. I.

Quantitas materie est mensura ejusdem orbe
illius densitate et magnitudine conjuncta.

Aer duplo densior in duplo spatio quadruplus est.

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Rapid Growth

- **Credit derivatives notionals expected to exceed USD8.2 Trillion by 2006 (source: BBA)**
 - London projected to continue to lead world in transactional volume -- \$3.5 Trillion by 2006
- **Increasing credit derivative usage by buy-side: hedge funds, insurance companies and asset managers (source: GEAM)**
 - 33% non-banks/broker-dealer are net buyers of protection
 - 52% non-bank/broker-dealers are net sellers of protection
- **Significant growth in the use of derivatives by asset and fund managers (source: Eurex)**
 - Approximately 60% of European managers as compared to 45% last year.
- **Credit derivative uptake by traditional funds managers hasn't been strong**
 - Expected strong increase in use of credit products over the coming year – especially France, Germany and the UK.

Product Evolution

Mathematica

- **Liquid credit derivative market focused around**
 - Single name credit default swaps
 - Synthetic credit indices (iTraxx and CDX)
- **Credit fixings process established in Mar-05 within European will open up next generation of credit derivatives**
 - Cash settled credit default swaptions and credit index options
 - Futures contracts
 - Constant maturity credit default swaps
 - Range accruals
- **Overlap between structured finance and structured credit market**
 - Credit default swaps on ABS
 - Single-tranche CDOs / Index tranches
 - Nth-to-default basket CDS
 - Next-generation structured credit products

Market Drivers

➤ **Regulatory changes and rules allowing greater adoption.**

- Ucits III rule on mutual funds sold within Europe allow use of more credit derivatives.

➤ **Increased understanding of credit derivatives by market participants**

➤ **Increased liquidity and transparency**

- Established index trading, e.g. iTraxx, DJ, CDX
- Greater price transparency of credit instruments, e.g. Markit

➤ **Improved standardisation**

- ISDA standardised confirms, reference entity database (RED), and protocols (FpML)
- Electronic trading (TradeWeb / MaketAcess) and automated trade confirmation (DTCC)

Market Drivers

➤ **Credit fund business opportunity**

- Lifting of explicit mandates by fund managers
- Increase in the number of new credit funds
- Rated credit bond funds

➤ **Performance of credit market**

- Impact of GMAC and Ford downgrades in May-05 on overall spread market
- Impact of credit tranche trades and correlation plays

➤ **Impact of increase in hedge fund participation on market stability (Fitch, FSA).**

Use of Credit Derivatives

- **Flexible and cost-effective mechanism to transfer credit risk**
 - Bond funds starting to more aggressively use CDS as hedging tool
- **Facilitate consistent delivery of absolute returns**
 - Derivatives are becoming an integral part of a traditional asset management
 - Efficient portfolio management and hedge specific unwanted risks
- **Allows users to achieve incremental returns**
 - Additionally take advantage of arbitrage opportunities
 - Capitalise on market dislocations between cash and credit default markets
- **Implementing multiple credit trading strategies**
 - Long-only, long-short, credit curve arbitrage, basis arbitrage, correlation trading ...
 - Greater flexibility in the name and type of trading strategy than in cash market

Use of Credit Derivatives

- **Increase in universe of tradable credits**
 - More flexible tenors and often greater liquidity than in cash market
- **Gain exposure to overall market more efficiently through selling protection on credit indices**
 - Geographical and sector driven.
- **The unfunded nature of these products allow greater leverage and more efficient use of capital**
- **Provides an alternative to funding in the repo market**
- **Useful information source for credit research-intensive asset managers**

Challenges Managing Credit Derivatives

➤ **Strong risk management controls**

- Ability to hedge and drill-down within structured credit products
- Maintain internal limit and concentration risk policies
- Increasingly important for investors and compliance base

➤ **Ability to implement and manage specific credit strategies**

- From an execution as well as risk management perspective.
- Adopting advanced credit and liquidity management techniques from other vehicles (SIVs).

➤ **Operational controls and audit compliance**

- Ensuring accurate deal-capture and processing through to settlement
- Legal risk associated with accurate reference obligations (RED) and documentation
- Minimize operational and settlement risk (eg FSA)

Challenges Managing Credit Derivatives

➤ **Independent Mark-to-Market valuations and pricing transparency**

- Data vendors can provide comprehensive and accurate data for liquid instruments (Markit)
- Critical to investors / fund-of-fund managers: Compliance based on independent verification
- Standardised valuation techniques additionally facilitate the above process

➤ **Installing or upgrading systems and procedures to manage derivatives**

- Integration into existing fund systems and process flows
- Ability of fund administrators to process and independently value these products

➤ **Expertise and transparency**

- Building up internal expertise in derivatives and credit derivative products
- Helping investors understand their use within the overall fund strategy
- Increased transparency to the investor of their exposed risks

Contact

➤ **Article:: Evolving Credit, Hedge Fund Review.**

➤ **Company Information:**

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