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"The possibilities are endless"

This week's Provider Profile looks at software firm Principia Partners

Principia Partners provides the new generation of buy-side firms specialising in structured finance with a technology solution that enables them to manage their entire operational infrastructure. Principia SFP is a solution that allows firms to concentrate on their core competence - investing in structured finance securities and credits, while managing a dynamic funding pool of short- and medium-term liabilities.



As product complexity grows in the credit markets, the requirement to support the operational infrastructure of credit derivative product companies (CDPCs), structured investment vehicles (SIVs) and security arbitrage conduits in maintaining their triple-A ratings has become paramount. "These are small firms, usually with 5-15 people, but with the operations of a small bank. So far, they have been woefully under supported by software houses that concentrate on sell-side firms in capital markets," remarks Douglas Long, evp business strategy for Principia Partners.

Having a relatively small staff, coupled with the need to maintain high credit ratings, inevitably requires an intensive use of technology. For example, Long says: "A SIV needs to manage its accounting, cash flows, operations and risks. The vehicle is buying structured credit assets, and issuing commercial paper and MTNs to fund this activity. But it must also remain market neutral through the use of hedging derivatives."

SIVs also have many compliance tests to satisfy, such as capital adequacy, liquidity, portfolio composition and cash outflow tests. And the limits within which they must stay are extremely narrow.

"The ability to demonstrate compliance across these myriad tests on an ongoing

Douglas Long

basis, through cashflow and exposure analysis as well as dynamic portfolio management techniques, is absolutely key to maintaining their triple-A rating," notes Long.

"This is an incredibly complex set of operations to run," he adds. "And they need consistency in their operations to maintain market neutrality; any unnecessary risks need to be taken away. Principia enables them freedom to do all this by consolidating all these administrative tasks into a single package. So far we help around 60% of the SIV market to manage their operations in this way."

Tracking a dynamic, ever-changing portfolio - due to the prepayment risk of underlying investments, for example - means that the management of technology is a core competence. "Technology gives the transparency and consistency in accounting. You can drill down on risks, and expose and pre-empt potential problems. Will I break any of my compliance limits? SIVs need this re-assurance to be able to prove what's going on and report back to investors," Long explains.

He says that a SIV is unlikely to grow or evolve without a backbone of technology in place. "It's fine to get a snapshot and say you're OK now, but it's managing the ongoing process that makes it so complicated. You need to be able to make a change in the portfolio and see the impact on compliance and mark to market. It's an operationally complex process."

CDPCs must also have a strong infrastructure in place, as ratings agencies look set to rate the managers themselves to provide an independent verification. According to Long, key factors in achieving a good rating are robust operations, technology and back-up support, as well as the contingencies that are in place for when a key person leaves.

The funding of the operation is increasingly important too. "The mezzanine capital notes issued will in time also need to be rated, especially when Basle II fully comes into effect; people will not want unrated debt on their books. However, right now it's still up to an individual SIV to publish the rating," adds Long.

The operational support requirements of these firms are tending to merge in today's market, which is characterised by deepening liquidity and reduced spreads. "You cannot talk about SIVs, CDPCs and the like in their own right anymore. There is a convergence of product investment, as firms leverage techniques from other areas because of reduced arbitrage opportunities caused by increased liquidity. Therefore technology is needed to help innovate in a market with tight spreads: it enables you stay one step ahead," says Long.

Increased transparency in market data has cemented the comfort level for managers, as new products emerge to create such liquidity. Long sees a rapidly evolving market with an emerging product set as offering a platform for diversity. "CDPCs will create more liquidity in structured products. Look at how the market has evolved in recent times: CDPCs don't just write protection on single names now, they have evolved considerably. The single name market has moved on, to mature and deepen. You can now invest in CDS on ABS and tranching products; the possibilities are endless."

Long therefore recognises that CDPCs are an "ideal growth vehicle for diversity" in structured credit, with new activity observed on both sides of the Atlantic. He says: "There are possibly twelve new firms coming to the market in the next eighteen months, out of both the US and Europe. We can only see this increasing given the opportunities and growth appetite within the structured credit market."

The advent of CDPCs will undoubtedly be a strong evolutionary influence on other structured finance vehicles and the structured credit market. It will further contribute to the convergence of dynamic portfolio management and funding techniques as witnessed in the cross-breeding of managed operations such as CDPCs and SIVs with traditionally more-static businesses such as CDOs.

However, there are still several structural challenges to overcome if the full evolution of structured credit is to occur. As Long concludes: "The old problems are still there in the structuring of CDOs: full transparency and independent pricing of the payment waterfall is not yet there. That said, the structured finance operating companies are rapidly resolving such age-old issues by borrowing best-of-breed portfolio management and administration practices. Moreover, evaluated pricing for structured finance securities and credit derivatives have become more widely available, providing more reliable and consistent market data. Look at how the market has changed in the last two years. It is has come on miles from where it was, and it will be miles further on in another two years."

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