

## LEARNING CURVE®

### Credit Derivative Product Companies – A Primer

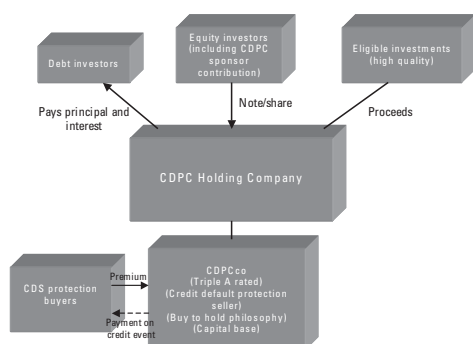
Credit derivative product companies have been described as highly rated, capital efficient and successful managers of diverse and complicated risk – so why have so few made it to market? The number of CDPCs only just exceeds 10. And this is a product with origins in credit derivatives' early childhood: 1999.

CDPCs are AAA-rated companies whose sole purpose is to make a profit for their investors from the premiums received from selling credit protection. This credit protection is usually highly leveraged against the CDPC's assets. This is sometimes by as much as six times, making a AAA rating for a new company with obligations far in excess of its assets both essential to bring in business and difficult to achieve. Consequently there is a long and hazardous road to market and few arrive.

#### CDPC Structure

Established sponsors or parent companies found CDPCs, then, once incorporated, they inject vast sums of capital to provide the CDPC with an attractive capital base. Further investment then comes from debt and capital investors. Enough to ensure that the CDPC can get a AAA rating. Once the CDPC is up and running and writing credit-default swaps those incoming credit protection premiums boost the reserves further, especially since the CDPC can leverage itself by selling credit protection on low risk reference entities for many times the CDPC's capital value. The capital itself is invested in highly rated

securities in much the same way as with a synthetic CDO. 'Buy to hold' is the core CDPC strategy. This translates as sell credit protection and don't trade it. The strategy



tries to buffer the CDPC against market volatility and provide the rating agencies with some modeling certainty in return for that AAA rating. It is the AAA rating itself which drives the CDPC model. CDS counterparties can obtain full regulatory capital relief and also be confident that if a credit event occurs their credit derivative contract will be honored. At the same time the permitted levels of leverage mean that the CDPC investors make a good return on their investment.

#### A History Of CDPCs

Back in 1999, when CDPCs were first conceptualized, derivative product companies were nothing new: entities dedicated to trading interest-rate risk had been around since the early part of the decade.

**Primus Financial Products** was the first credit derivative product company in the market though, attaining its AAA rating, after three years of rating agency negotiation in 2002. After going public in 2004, Primus diversified from selling single-name, highly rated CDS into non-investment grade CDS and more complex credit derivative products.

This contrasted with **Athilon Structured Investment Advisors**, which was launched at a time of wide credit spreads in December 2004, and focused on selling protection on super senior tranches of CDO debt. This evolution toward selling credit protection through more complex structured products was a result of the growing market confidence in CDPCs, increased expertise by the CDPCs themselves and the willingness of the rating agencies to maintain an AAA rating.

#### The CDPC Road To AAA Rating

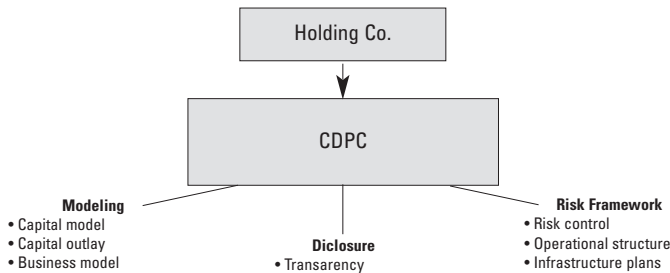
CDPCs are dependent on their AAA rating, and rating agencies understandably have stringent criteria to be satisfied before they give their badge of highest quality to a new entity with no trading history and liabilities in excess of its assets.

There are three principal exams which a CDPC must pass to get a AAA rating. These are in modeling, disclosure and risk framework.

## Modeling

A CDPC's principal selling point is its rating, both in terms of the debt it issues to fund its capital base and its counterparty rating when selling credit protection. The rating agencies are involved at many levels and much of their scrutiny during the structuring stage focuses on the CDPC's capital funding structure.

CDPC sponsors are obliged to put together intricate capital models, business models, operational structures and infrastructure plans complying with stringent rating agency criteria. It's a lengthy and costly process, involving planning, structural analysis, and tough negotiation to get approval and an AAA rating.



## Disclosure

An obligation to provide transparent reporting is closely related to potential collateral posting requirements. Any credit protection buyer wants to be sure that it will be paid if a credit event occurs. An AAA rating ensures that the CDPC will not have to enter into credit support arrangements with its counterparty to support those potential obligations. If it did, the leverage provided by selling credit protection far in excess of the capital base (the business model which makes CDPCs so attractive) would be destroyed.

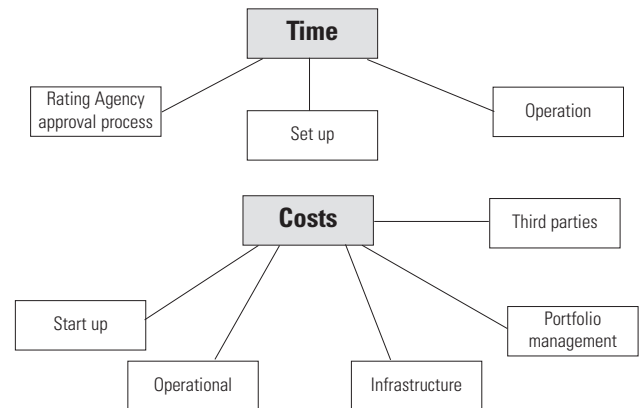
CDPCs must justify their rating by maintaining market and counterparty confidence, and offer investors and counterparties

access to performance and trend information on their portfolio. This means that counterparties are prepared to enter into credit-default swaps with CDPCs without credit support.

## Risk Framework

The rating agencies also want to see evidence the CDPC is independent of its sponsor. This is especially the case where the sponsor is an established institution. When analyzing the CDPC's infrastructure and the operative guidelines, the rating agencies will seek comfort that the CDPC has sufficiently robust systems in place to handle portfolio management, manage exposure and carry out risk analysis. And at the base level, the CDPC must also be able to competently manage the day-to-day operations of trade settlement, documentation, credit event mechanics and accounting too.

These infrastructure requirements may be more easily serviced where the CDPC has an institutional sponsor with its own sophisticated back office expertise. Even so, the rating agencies will be keen for any relationship to be kept at arm's length.



<i>The key characteristics and risks inherent in the CDPC structure are as follows:</i>	
Key characteristics of a successful AAA CDPC structure:	Key risks in a CDPC Structure:
Prime quality portfolio	Falling standards- if any of the modeling, disclosure or risk framework standards fall a ratings downgrade may not be far away.
Rich capital base/Managing team profile	Downward credit rating migration—leading to capital shortfall as leverage becomes difficult
Risk framework	Tightening spreads in the market—smaller premiums mean smaller profits
Transparency reporting	Default risk—i.e. of the securities which the CDPC has invested its capital in
Strong parenting.	Counterparty default—fewer premiums make fewer profits
	Model Risk—i.e. that the rating agencies have got it wrong and the models as to cash flow, liquidity and assumptions on recovery fail.
	Legal Risks—i.e. the issue of bankruptcy remoteness, and the necessity of ensuring that the CDPC is separate to its sponsor's bankruptcy.
	Asset based risk—i.e. the more innovative and the more complex the credit products the CDPC invests in, the greater the asset based risk.
	Collateral risk—as with synthetic CDOs, the highly rated securities in which the CDPC's capital is invested may themselves default.
	Human resource error—i.e. the team behind the CDPC is not as competent as thought.

## Why So Few?

Following the CDPC road to market is time consuming and costly, and this has inhibited their number.

Rating agencies and the market require CDPCs to have at least a USD100 million capital base. There are operational costs and complexities too in setting up the trading and portfolio management infrastructure, not too mention the lengthy rating agency approval process and legal and other third party costs.

## What Is The future?

The future is uncertain. In the fall out of structured credit product downgrades, if ratings agencies feel that they are suffering a confidence crisis, one reaction may be to scrutinize CDPCs even more closely. If spreads widen though, market conditions may favour the creation of new CDPCs. Several are already in the pipeline.

*This week's Learning Curve was written by Edmund Parker, partner, and Melanie Barrow, professional support lawyer at Mayer Brown in London.*