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Contents

<table>
<thead>
<tr>
<th>ABS/CBOs/CLOs</th>
<th>1</th>
<th>Equities/Equity Derivatives/Equity Hybrids</th>
<th>7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Adequacy</td>
<td>3</td>
<td>Inflation and Property Derivatives</td>
<td>7</td>
</tr>
<tr>
<td>Capital Securities</td>
<td>3</td>
<td>Insurance and Weather Derivatives</td>
<td>8</td>
</tr>
<tr>
<td>Covered Bonds</td>
<td>4</td>
<td>Legal and Documentation Issues</td>
<td>8</td>
</tr>
<tr>
<td>Credit Derivatives</td>
<td>4</td>
<td>New Products/Ideas/Financial Engineering</td>
<td>10</td>
</tr>
<tr>
<td>Debt Markets</td>
<td>5</td>
<td>Wealth Management</td>
<td>11</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>6</td>
<td>Sources</td>
<td>12</td>
</tr>
</tbody>
</table>

ABS/CBOs/CLOs

Well, it finally happened – sort of. One late afternoon in 1987, our unripe lawyer’s brain found itself puzzling over a term sheet sent over by our esteemed clients at Citigroup, describing the planned securitization of the bank’s emerging markets trade finance portfolio. Some 6 years later we tackled the same transaction in our role as that bank’s Head of ABS for Emerging Markets, before passing on that particular baton to our able successors Malik and Hwang with the sagacious advice to avoid it like the plague. We had nothing against trade, please note, nor against any of the emerging market branches that would most benefit from a successful execution of the transaction; we simply had concluded that coordinating numerous booking centers across wildly different time zones, funding costs, legal and regulatory jurisdictions, country risks and tax regimes – not to mention the inevitably massive egos of the business heads in more than 25 jurisdictions – did not seem like a recipe for a happy ending.

We were only partly wrong. On December 16, 2006 – or some 19 years after that first dreaded term sheet appeared before our mystified eyes – IFR announced the successful placement of five classes of notes from Citigroup’s trade finance securitization program, with ratings ranging from triple-A to single-B and backed by loans from Taiwan, Hong Kong and Singapore. While the program supposedly provides for the inclusion of loans from Asia, Latin America, Europe and the Middle East, we suspect the structure and ratings process were much simplified by restricting the initial selling units to three countries that share largely identical financial cultures, time zones and credit ratings.

We eagerly await the arrival of the next tranche blending together Pakistan, Macedonia, Ecuador and Yemen. (IFR, December 2 and 16).
■ The **produit du jour**, as even our much-loved five-year old daughter Yasmina knows, is CPDO, short for Constant Proportion Debt Obligation. (*Credit*, December 2006; *IFR*, November 4, 18 and 25, December 2 and 9; *DW*, November 20 and December 15). This 10-year triple-A product offers an attractive spread over Libor – in the 100 to 125 bps range currently – by using the investor’s money to collateralize a sold protection position on investment grade indices, leveraging the position to some 10 times the investor’s principal. Thus absent excessive defaults or certain unusual spread movements, the 30 bps or so on offer under iTraxx and CDX translate into 300 bps annually on the principal amount, enabling the structure to pay coupons to investors and generous fees to arrangers – and leaving something in escrow for a rainy day.

Should the rain never come, it does not take long for the escrow balance to reach the present value of the note’s future obligations to the holders, causing the structure to defease all future liabilities, unwind its credit positions, and sit there looking pretty. We are omitting a couple of subtleties but in a nutshell this is it.

Important risks that could screw things up include large credit losses, unusual spread changes, widening bid/offers and diminished liquidity for the credit indices and, to a lesser degree, interest rate movements. The rating agencies have run simulations that confirm aggregate loss/default expectations consistent with triple-A. Skeptics worry that hedge funds and others will be successful in moving the market in an adverse direction given the programmatic nature of CPDO rebalancing and the very little discretion currently provided to any party under the structures seen so far. The structures also assume a mean reversion effect for spreads which is historically warranted but (presumably) not guaranteed in future given the extraordinary tightness of spreads today.

By early December the rating agencies were revisiting their criteria, particularly with regard to the possibility of widening bid-offer spreads, the risk of a credit curve inversion (which would generate losses on index roll dates), and to better reflect the impact that a large issuance volume could have on the strategy’s viability – a sort of “victim of its own success” syndrome.

■ Never one to disappoint in the area of conduits, Citigroup announced the launch of its new structured investment vehicle Zela Finance, allegedly the first SIV with the ability to short credits out of revenues earned from selling protection. (*DW*, November 6). Inclusion of shorts reduces portfolio volatility and allows the vehicle’s income notes to earn a rating of single-A-minus from S&P. Limits exist on how many shorts the vehicle can implement based on excess spread generated after paying coupons.

■ The ABX index market was preparing for the launch of standardized tranches in mid-
February, following the healthy growth in trading of the untranched index. The triple-B sub-index will be sliced into 0-3%, 3-7%, 7-12%, 12-20%, 20-35%, and 35-100%, while the triple-B-minus sub-index will be broken down into 0-5%, 5-10%, 10-15%, 15-25%, 25-40%, and 40-100%. Pricing of correlation on ABS is perceived to be more complex than for corporate credit due to the structural complexity of some of the instruments. (IFR; January 6 and 27; DW; January 15). In recent weeks hedge funds were increasingly using the index to implement bearish views on US housing, with spreads on the triple-B-minus index approaching 1000 bps.

**Capital Adequacy**

- US federal bank and thrift regulators ruled that FAS 158 will not affect banking organizations’ regulatory capital. (www.riskcenter.com) The new rule requires a bank that sponsors a single-employer defined benefit pension or healthcare plan to recognize the overfunded or underfunded status of such plan as an asset or liability on its balance sheet, with corresponding adjustments in OCI, a component of equity capital. The regulators plan to provide regulatory reporting instructions to banks, to assist them in implementing the interim exclusion of the effects of FAS 158 on OCI from the measurement of reg cap.

- Some of the more esoteric provisions of Basel 2’s treatment of ABS are continuing to attract criticism. (IFR, November 4; IFLR, December 2006). One bone of contention centers around the issue of asset substitutions in revolving ABS transactions, with regulators tightening the scope of permitted substitutions out of concern that sellers have used the provisions to provide implicit support. The current rule appears to prohibit any substitution that changes the quality of the assets, an outcome that is practically inevitable in CMBS and CDO transactions where pool homogeneity is absent. A second issue concerns the applicable risk weight to be assigned to program-wide credit enhancement facilities of ABCP conduits; some regulators are suggesting that the risk weight of the least creditworthy asset in the pool should be used, presumably because the credit enhancement is most likely to be drawn due to a default on that asset. A final unresolved issue relates to the appropriate risk weight to be assigned to a swap between a bank and the SPV that issues the ABS, with regulators agreeing that is should depend on the position of the swap in the waterfall (with lower positions obviously requiring higher risk weights).

**Capital Securities**

- Again the period was far from dull. The US regulatory front finally took a turn for the better with the NAIC’s temporary ruling reclassifying hybrids as debt rather than equity.
– bringing their capital requirement for insurance investors down from 30% to 0.3% - 1% in most cases, depending on the exact structure. (Credit, November 2006). The good news was quickly dampened by an announcement from Moody’s that certain non-cumulative preferred stock instruments – and hybrid securities with non-cumulative features – would be rated one notch lower than dictated by existing notching practices. (IFR, November 25). The rating agency is particularly targeting hybrids it classifies as “strong” or “moderate”, essentially ones that skip periodic payments either on a mandatory basis when pre-specified triggers are breached or on an optional basis, and also which are either non-cumulative or settled through the issuance of common stock or other qualifying equity-type instruments. Some 300 securities were expected to be affected.

Meanwhile, our favorite lover of complexity for its own sake, Cemex, enthralled the markets with its dual-currency non-call 5 and non-call 10 perpetuus, with rights to defer coupons that result in equity treatment under Mexican GAAP and IFRS and hence improved compliance with leverage covenants. (IFR, December 9). Rating agencies were divided on the likelihood that Cemex would ever exercise the deferral right, with Fitch playing it down but S&P taking it seriously enough to notch down the rating by one degree. The coupon steps up by some 300 bps if the instruments are not called on their call date, which virtually guarantees that the call will be exercised given the company’s investment grade rating. For the rating agencies the notes continue to count as debt, doing nothing for the company’s ratios, but we suspect the thrill of announcing such a landmark, sophisticated and complex transaction proved irresistible to the finance and investor relations departments.

Covered Bonds

– Two developments of notes included (i) the launch by France’s Veolia of a program to issue covered bonds backed by its receivables from government entities, via a société de crédit foncier, making it the first corporate to be given the green light to issue this instrument traditionally reserved for banks and mortgage lenders (IFR, January 27); and (ii) the inaugural $2 billion issue by HBOS in the US market, despite concerns that US investors do not understand the product well enough and would not throw significant money at it until a domestic issuer had taken the plunge (IFR, November 11).

Credit Derivatives

– Innovations have included (i) Markit Group’s launch of a trade finance pricing and index service, prompting expectations that customized CDS contracts on trade loans
would soon follow (IFR, December 2); and (ii) Citigroup’s rollout of leverage-triggered credit default swaptions, dubbed SAILS, to allow bondholders to buy protection from spread widening caused by companies that leverage their balance sheet (IFR, December 16). SAILS are structured similarly to vanilla payer CDS swaptions, but instead of protecting against general spread widening are triggered according to pre-specified leverage events – diminishing the probability of exercise and thus reducing their premium. Triggering events are written to include instances in which debt-to-EBITDA or total debt rises by a significant amount between the trade and exercise dates, in connection with an announced going-private transaction or other “aggressive leveraging event”.

Debt Markets

Competition among rating agencies may finally become more serious following last year’s new US legislation that makes it easier to acquire the much-coveted status of a “nationally registered statistical rating agency”, or “NRSRO”. Previously aspiring applicants faced a classic circularity of logic since the NRSRO status would be conferred only on those who are “widely recognized as issuers of credible and reliable ratings by the predominant users of securities ratings in the US”, while among institutional investors recognition was invariably based on the SEC’s stamp of approval as an NRSRO. (Risk, January 2007). The new definition merely requires the applicant to have been in the business for at least three consecutive years preceding its application, and to have issued credit ratings to at least 10 QIBs that own at least $100 million of securities from entities with which it is not affiliated. Currently the only NRSROs are S&P, Moody’s, Fitch, DBRS and AM Best, the insurance specialist.

The new legislation also instructs the SEC to consider a number of contentious issues and determine if they warrant additional regulation: (i) whether large frequent debt issuers receive preferential ratings since fees are paid by issuers and not investors; (ii) whether the agencies are sometimes conflicted by their desire to generate ancillary business, such as risk management and consulting, from the same entities they are rating; (iii) whether the concentration of debt underwritings among the bulge bracket firms gives those entities undue leverage over the agencies by promising future business in return for lenient assessments; (iv) the continuing concern that unsolicited ratings are a tool by which rating agencies pressure recalcitrant customers to hire them; (v) the familiar dispute on notching practices in CDO ratings, pursuant to which a CDO security backed by a pool of assets is rated lower when a significant percentage of the underlying assets have not been rated by that agency; and (vi) possible tying by the rating agencies of an issuer’s rating to the purchase of additional services from that agency.
Insightful research into yield curve trading strategies is summarized in the November 2006 issue of *CFA Digest*. The authors investigate the returns generated by strategies that aim to profit from mean reversion in the level, slope and curvature of the yield curve. Their results suggest that strategies pursuing mean reversion in the absolute level of yields do not offer consistently superior returns; strategies pursuing mean reversion in the slope of the curve offer superior returns if they focus on mean reversion between just two adjacent points in the curve rather than focusing across the entire curve; and strategies pursuing mean reversion in the curvature of the yield curve offer consistently superior returns.

As with all such strategies returns can be significantly diluted by transaction costs, causing the authors to suggest that trading frequency be reduced and the threshold signal for entering a trade raised.

**Emerging Markets**

- The Russian ABS market received a big boost with the $430 million securitization by MDM Bank of its auto loan portfolio. (*Euromoney*, November 2006). In addition to achieving a rating of Baa1/single-A-minus on its senior tranche, the transaction included a particularly innovative Rouble/USD cross-currency swap with a “balance guaranteed” mechanism which causes the swap to amortize in tandem with amortizations in the portfolio balance. This feature makes the swap especially difficult to hedge for its provider since the portfolio prepayment rate depends on many factors that are hard to model in consumer finance markets with little history.

- Greece, India and our own little Lebanon are often cited as countries that produce outstanding talent but next-to-moronic government officials. As if to demonstrate the point beyond reasonable doubt comes now the Reserve Bank of India with its new guidelines announcing most derivatives more complex than an FRA to be *ultra vires* for its domestic end-users. (*Risk*, January 2007). The guidelines seem to prohibit swaptions and even short-term FX hedges in which one currency is the Indian Rupee – with short-term meaning less than 3 years. The regulator also revives the soothing distinction between “first order” derivatives – which are good things – and “second order” ones – which are terrible and must be banned immediately. The former term supposedly describes normal derivatives while the latter covers evil ones such as compound options and options on futures. Combinations of vanilla derivatives, however, may be offered to companies that are already using mark-to-market accounting.

Estimates of potential lost business rise to some 40% of current volumes. We are once again left to ponder, in amazement, why a country that produces a hefty percentage of
the world’s best derivatives traders, structurers and academics feels the urgency – according to its government officials – to nanny its restless natives. Meanwhile, we will inquire whether our defunct license to practice law in the State of New York may be transferred to Mumbai – where undoubtedly the largest fortunes in the financial industry will be made in coming years finding loopholes among these gems of regulatory diktat.

**Equity/Equity Derivatives/Equity Hybrids**

- Sharpe ratio derivatives have arrived, courtesy of the geeks at Société Générale. (*IFR*, January 20). The Sharpe ratio, we remind our duller readers [get it?], measures an investment’s performance on a risk-adjusted basis by dividing its excess return over the risk-free interest rate by the volatility of its returns; the higher the ratio, the more you are being compensated for each additional unit of volatility assumed. A typical structure would be a seven-year note that pays an annual coupon linked to the swap rate but adjusted upward by an amount that reflects the Sharpe ratio of a fund of hedge funds. Pension funds and life insurance companies are the main target audience for the product, given their concern with risk-adjusted returns. We found especially insightful, however, the opinion of a market observer that “[m]y initial reaction is that it must have a ridiculous amount of fees and margins built into it”.

- The boom in M&A was certain to give rise to a parallel explosion in corporate equity derivatives. (*Risk*, November 2006). An important innovation has been the hedge that incorporates deal-contingency – e.g. a currency hedge for a foreign target’s purchase price that knocks out if the underlying transaction falls through due to regulatory impediments or uncooperative shareholders. Much of the hedging of the contingency in question is achieved simply by building a diverse book of business and relying on the law of large numbers. The due diligence focuses, among other items, on whether the customer has control over the contingency, whether the contingency is correlated to any market variables, and whether the documentation defining the contingency is unambiguous and exhaustive.

**Inflation and Property Derivatives**

- Merrill and Axa completed the first French property derivative transaction. (*Risk*, January 2007; *DW*, January 8; *IFR*, January 6). The transaction was intended to hedge part of the property portfolio of one of Axa’s clients and references the Investment Property Databank French Offices Annual Index. The UK market for property derivatives is the largest in Europe by far, with its size estimated to have reached £4.5 billion; but decent growth is expected in France, Germany, Ireland, Italy, the Netherlands, Sweden and Switzerland.
Insurance and Weather Derivatives

- We finally found the opportunity to write a story on our all-time favorite US federal regulation, the marvelously-named Regulation XXX – which represents the NAIC’s attempt to regulate the regulatory reserves of US life insurers that issue guaranteed-level premium term life insurance policies. (IFLR, August 2006; IFR, November 4). The regulation imposes conservative methodologies and assumptions for the calculation of these statutory reserves, far greater in the issuers’ opinion than the economic reserves that would confidently suffice to cover future contractual obligations. This excess survives for up to 30 years and increases for the first 10 years of the policy’s life before beginning to decline gradually. Rating agencies project up to $100 billion of this excess in aggregate over the next five years.

Because Reg XXX does not apply to non-US reinsurers, it makes sense to transfer the reserve requirement into the re-insurer market, which achieves relief from the statutory requirement provided an L/C supports the credit risk of the re-insurer – for which the market is typically short-term and thus subjects the insurer to re-pricing risk.

Inevitably, therefore, it has dawned on insurers to replicate synthetic CDO technology and set up a special purpose re-insurer which issues notes to the market paying a spread over Libor in return for assuming the very remote risk that the economic reserves prove insufficient and that losses edge towards the statutory estimate. Since the rating agencies share the opinion of the insurers regarding the likely losses of these portfolios, they issue triple-A ratings on the senior notes in line with their attaching at or close to the economic reserve level rather than the statutory level. One recent transaction for Shenandoah Life Insurance Company priced at Libor + 37.

- Deutsche has begun offering event-loss swaps, a derivative linked to catastrophe risk which pays out a pre-determined amount when industry-wide insured losses from US wind or earthquake disasters exceed a pre-determined trigger. (IFR, November 25). Much of the structure of CDS contracts has been retained in the documentation, causing the predictable expectation that once a minimum liquidity is achieved, the packaging and tranching of portfolios of these contracts cannot be far behind. Use of the instruments by insurers and reinsurers should provide regulatory and rating agency capital relief once they are better understood.

Legal and Documentation Issues

- A year after the initiation of Reg AB’s disclosure regime for public offerings of ABS, issuers continue to struggle with complex disclosure requirements including most
particularly the requirement that they supply financial information regarding derivative counterparties. (*IFLR*, December 2006). A number of non-US providers cannot meet the necessary standards either because they do not prepare US GAAP financials or because they do not prepare separate financials for the exact legal vehicle which acts as counterparty to the ABS.

Disclosure requirements depend on a good faith estimate of maximum probable exposure (“MPE”), meaning broadly the same thing as risk managers mean when they refer to a transaction’s PSR, CFE, loan-equivalent, or whatever. The extent of the disclosure increases as the MPE migrates upward from less than 10%, to between 10% to 20%, to more than 20% – all these being expressed as ratios of the maximum probable exposure to the total principal balance of the pool assets, generally – reaching a requirement ultimately that full audited financials for the derivatives provider must be delivered. SEC staff has even interpreted the relevant language to require disclosure of financial information regarding a swap-writing subsidiary even if it is wholly owned by the parent and the parent fully and unconditionally guarantees its obligations. Reg AB permits non-US companies to provide financial statements that are reconciled with US GAAP in the manner prescribed by SEC rules, but these reports are burdensome and expensive.

The problem is especially acute for providers of cross-currency swaps since the MPE for a sufficiently long-dated swap can easily exceed the 20% threshold that triggers the strictest consequences; the problem is unlikely to arise with a simple interest rate swap, unless the tenor is particularly long.

Solutions have accordingly been devised around way of lessening the extent of the MPE by designating triggers based on the position’s mark-to-market which anticipate the point at which disclosure requirements are becoming likelier and then require certain actions to be taken to reduce the significance percentage of the exposure, including the posting of collateral or assign a portion of his position to another derivatives provider so as to reduce the SPV’s net exposure to him alone.

Practitioners are pursuing alternative approaches with the SEC which center on the belief that what truly matters is the condition of the consolidated group (when a full and unconditional guarantee is available) and that the likely consequence of the current language will be to concentrate the ABS derivatives business into the hands of a small number of dealers who can provide the necessary disclosure – reducing competition and pricing transparency for the ABS industry as a whole.

- Bondholders are continuing to rely on technical covenant breaches to squeeze out windfall gains from issuers. (*IFLR*, November 2006). It is well known that a number
of US issuers have been late in meeting SEC reporting requirements in recent times, particularly on account of the ongoing investigations related to stock option backdating. In a recent US case, the company, BearingPoint, was late in filing statements with the SEC, whereupon holders of 25% of a convertible bond issue served acceleration notice on the basis that they were required to have received those statements within 15 days of their filing date with the SEC. Defendant’s cute response was to argue that no default had occurred since the SEC filing had not taken place at all so that the 15-day clock could not start ticking; but the court rejected the argument altogether, pointing to various sections of the Trust Indenture Act which in the court’s view created an independent obligation towards the trustee whose purpose was to ensure that information was regularly provided to bondholders.

The BearingPoint case confirms a trend among aggressive bond investors, including of course hedge funds, to bring actions in court for technical breaches of covenants and either seek acceleration of debt they had bought previously at a discount or demand large fees in return for waiving the covenant breach. Merrill Lynch has reported that at least 25 companies in the last 18 months have had their bonds accelerated in this way or were forced to pay multi-million dollar fees to bondholders.

Bearing Point has filed an 8-K pointing out that as a result of the successful acceleration, it must reclassify all its outstanding debentures as current liabilities, which would raise concerns that its auditors would issue a going concern qualification in respect of its financial statements in its pending Form 10-K. The company has also had to withdraw its previously announced financial guidance for its fiscal year due to the uncertainties surrounding the court decision.

New Products/Ideas/Financial Engineering

■ An OTC contract protecting against the maximum loss on an underlying has begun appearing on the radar of structuring desks. (DW, January 22). The instrument references the so-called maximum drawdown, which measures the difference between the peak and the trough of an asset’s price.

The instrument bears some similarities to lookback put options, where the strike is set at the highest price reached by the underlying during the life of the option, but differs inasmuch as the lookback would not provide a payout equal to the maximum loss over the contract’s life.

■ Diamond derivatives could come soon: will they be forever? Leumi Bank of Israel, India’s ICICI, and ABN AMRO have released a discussion paper about developing a
standardized market in diamonds. *(IFR, December 9).* An attempt to create a derivative market in diamonds during the 1980s flopped, due to the lack of pricing transparency in the industry at that time. A major driver of the potential interest in hedging tools today is the increase in price volatility since DeBeers changed its business model to reduce its dominance of the industry.

**Wealth Management**

- We have not often had much good to say about hedge funds, so we will hedge ourselves by reporting the news that a recent survey of hedge fund investors found only 3% of them dissatisfied with their investments’ performance, and 72% opining that their hedge fund had performed within 1% of their target expectations. We dare not suggest that some CYA may be at work here, but wonder what must be the probability that the 101 institutional investors polled in this survey could have had such closely aligned expectations in the first place.

- US equity index funds suffer significantly from their need to minimize tracking error, which gives arbitrageurs opportunities to trade against them to the detriment of their performance. *(CFA Digest, November 2006).* One estimate is that between the S&P 500 and Russell 2000 trackers at least $1 billion of net worth, and possibly up to $2.1 billion, is dissipated annually because of the inflexibility of the trackers’ trading strategies. Russell 2000 fund investors apparently lose up to 184 bps annually due to this effect; and even S&P 500 investors, whose underlying investments are infinitely more liquid, leave 12 bps on the table.

  Much of this value erosion is concentrated around the annual reconstruction of the index, when arbitrageurs find it easiest to anticipate the trackers’ next trades. The predictability or pre-announcement of index changes creates most of the opportunities for a wealth transfer from fund investors to arbs.

  A solution would be to use “silent” indices, i.e. ones that announce their changes only after they are made, but this is not permissible under current SEC regulations. The authors suggest reducing the relevance of tracking error and focusing more on overall risk and return of the portfolio, to eliminate the necessity on the part of fund managers to trade on the effective date of index changes.

- JP Morgan was set to launch the FX market’s first set of volatility indices, in an effort to develop a multi-dealer FX volatility index market. *(IFR, December 9).* The bank’s family will comprise VXY for G7 currencies and an emerging market index to be called EM-VXY. As with equities, FX vol has been running at unusually low levels for some time, with the VXY for the G7 index at 6.2% versus the 9.85% it has averaged since 2000.
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