Natixis AM – Feb 2009

PART II: STRUCTURED FINANCE PRODUCTS AND CREDIT DERIVATIVES

*Q 30 and 31: **analysis of the SFPs and credit derivative markets**: which experience regarding information for pricing such products? Can you provide details regarding the respective role of pricing services using proprietary models and consensus pricing services?*

Recent turmoil in structured credit market has questioned the paradigm of base-correlation, and shown its limits: purely static framework, instability of deltas, impossibility to fit fair spreads of super-senior tranches for the CDX. Developing new pricing models that overcome the weakness of base correlation framework has become a concern both for arranging banks and academics. Such a context is likely to produce heterogeneity in pricing models, unless a new standard emerges that proves its accuracy. Some steps towards new market standards and transparency rules are made. For instance, Merrill Lynch's Credit Derivative Strategy of January promotes the use of a stochastic recovery model (exposed in a paper by quants from BNP Paribas). However, even if a change in market practices is happening, all pricing models for CDOs are heavily dependent on the basic inputs (CDS spreads, and a set of CDOs for correlation calibration). Without these basic inputs a pricing, even if using the same framework/model, can result in outputs far from market prices. Besides, it must be emphasized that some additional costs appear in the prices of CDOs, as in the price of any exotic derivative: Internal costs due to particular hedges (correlation hedges, jump to default on risky names, for instance), size of bid-offer for CDS spreads, reserves calculated by the risk-management of the arranging bank. All these costs can represent an important part of the price.

One of the key parts of information for pricing such products is collecting observable trading data on underlying components of these markets.
We have observed from our experience that the dealer community has been active in reducing access to key information for investors who were willing to pay for that access in order to maintain a certain level of lack of information which they considered as vital for their margin on this market.
An example of this is the objection by a major data provider to sell to asset managers and other investors data regarding base correlations on bespoke portfolio (i.e. non index portfolios).
The reason for that, as explained by this data provider, is that dealers, who contributes to prices and are also its shareholders/partners, have contractually banned it from selling this information to its clients that are not dealers/contributors.
We are viewing this kind of practice as adverse to transparency and healthy competition in the market.
This is not a problem on more risky markets such as Equity derivatives as trading data are publicly provided by stock-exchanges and brokers.

In relation to OTC credit derivative contracts including, but not limited to, credit default swaps and synthetic CDOs, we suggest that there should be a minimum level of disclosure and transparency in relation to determinations and calculations made by a designated calculation agent and/or valuation agent.
The calculation agent and/or valuation agent should, for example, have obligations to disclose the source of data used for a calculation, to provide (on request) reasonable explanations as to

the methodology and models used in making calculations and to use reasonable care in making any determination that requires an exercise of its discretion.

We have not used external pricing services for CDOs except those provided by some arranging banks (for the transactions we are managing).

*Q32 to 39: **ABSs securities**: Which benefits and drawbacks of a post-trade transparency regime for ABSs? Would it be desirable for all types of ABSs, or not (e.g. only AAA RMBSs)? Could we segment post-trade transparency between 'higher liquidity' ABS and 'lower liquidity' ABS? What post-trade information should be published: price, volume, time, portfolio composition, asset class, other information? When should it be published; immediately after the trade?*

Question 32 : Post-trade transparency regime gives information on price of trade, helping market participants to derive valuation levels. It also gives more information on market activity.
Due to low current trading volumes and small numbers of active ABS investors, it is important that all market participants join such transparency regime.
Given current illiquidity in cash markets and the existence of "forced or distressed sellers" (liquiditation of funds), some trades do not necessarily reflect the fundamental credit quality of such assets. It may be interesting to know what type of market participant were involved in the trade (market-makers vs investors…).

Question 33: Post-trade transparency may be limited. Segmentation may be based on ABS type and size of deals, excluding bespoke products or non-public deals.

Question 34: Given the usual deal structures, number of ABS market participants and size of different tranches, it may be useful to limit post-trade transparency on initially investment-grade rated tranches.

Question 35: As most European ABS are floating-rate notes, cash prices are not sensitive to interest rate. Time of the transaction is therefore not so relevant.
Volume, initial interest (seller vs buyer) and type of market participant involved are useful and may help to consider trades for valuation purpose.
It may be interesting to also get indicative WAL and margin (derived from the effective traded cash price).
For some ABS, CDS trading levels may also add information.

Question 36: See above. Post-trade information may be collected and published on a daily basis.

Question 37: Such post-trade transparency regime should be implemented in connection with industry efforts to improve quality of information and standardisation of reporting.

Question 38: No

Question 39: Our organisation is involved in buying ABS

*Q40 to Q50: **CDOs**: Which benefits and drawbacks of a post-trade transparency regime for CDOs? Would it be desirable for all types of CDOs, or not (e.g. only cash CDOs or synthetic*

CDOs)? Could we segment post-trade transparency between 'plain vanilla' CDOs and Structured Finance CDOs? To which extent post-trade transparency would reduce bid/ask spreads or price dispersion? What post-trade information should be published: price, volume, time, portfolio composition, asset class, other information? When should it be published; immediately after the trade? When facing inactive markets, would a post-trade information regime be applicable? Can observable prices in the secondary market help to test or promote internal valuation models?

Which benefits and drawbacks of a post-trade transparency regime for CDOs?
The implementation of transparency rule can attract new market participants. This may improve liquidity. On the other hand, it can also lead to speculative trades as opportunities may arise. These trades, if they are overleveraged may be harmful for the market, and create systemic risk.

Would it be desirable for all types of CDOs, or not (e.g. only cash CDOs or synthetic CDOs)?
A minimum transparency is welcome for both cash and synthetic, however disclosing too much information, especially for synthetic, could indirectly promote the creation of new structured products designed to bypass these new transparency rules. The resulting situation could be, in this case, worse than the existing one.

Could we segment post-trade transparency between 'plain vanilla' CDOs and Structured Finance CDOs?
From our point of view, this natural segmentation should be combined with another level of differentiation. A separation should be made between investors and dealers for cash deals, or between swap counterparties for synthetics. For instance, the investors on structured synthetic transactions should be provided with detailed information on the transaction by the dealers. In many cases, a sensitivity analysis and quantitative explanation of various risk-factors may be necessary, especially when the pricing models are not easily available.

To which extent post-trade transparency would reduce bid/ask spreads or price dispersion?
Cf. first point.
We can add regarding rating agencies that their front-loaded fees structure does not favour market stability.
Rating Agencies take fees on an upfront basis for assigning a rating a running for monitoring this rating. We consider that rating agencies shall have more commitment to be adverse to any risk by changing the upfront part of their fees into a Running fee that will depend on the credit performance of the security they have rated.

What post-trade information should be published: price, volume, time, portfolio composition, asset class, other information?
Regarding cash CDO's, especially CLO's, post-trade information could definitely improve both market liquidity (bid/ask spreads decrease) and market efficiency (avoidance of private information).
We tried to rank the needed information by importance:
- Mandatory public ratings for leveraged loans: credit estimates and shadow ratings benefits to insiders, rating agencies have no obligation to review credit estimates
- Unique ISIN for leveraged loans: as the leveraged loan is a private market it's very difficult to identify clearly a leveraged loan tranche

- Harmonisation of Trustee Reports available information: some CLO's benefits from full detailed information (leveraged loans market prices, purchase & sales market prices …) and some don't.
- Offering Circular full review by rating agencies: the structuring banks have designed very different CLO structures. It means that the principal and interest waterfall could vary from a CLO to another without rating agencies disclosure (Event of Default wording, CCC assets, discount obligations, interest cash diversion …)

Rating Agencies shall also make publically available all information they used to price. We have observed indeed that Rating agencies are paid by issuers to assign public ratings. Rating Agencies publishes such rating and a document often called "pre-sale" analysis. They do also provides more details and updates for investors that pays access to their websites.
We consider that such information, data and models used by rating agencies should be available free of charge (as they are already paid by issuers for rating and monitoring).

When should it be published; immediately after the trade?
All public information should be available before trading. The application of post-trade information should not be link to the market activity. Observable prices in the secondary market could not help for internal valuations models due to the heterogeneity of the CLO's underlying portfolio and the differences among the CLO's waterfall structures

When facing inactive markets, would a post-trade information regime be applicable?
Any information can be useful in these circumstances in order to use internal valuation models.

Can observable prices in the secondary market help to test or promote internal valuation models?
Observable data is often a good indication to test, calibrate internal models. However, in case of stress in the market, observable prices could be misleading especially in illiquid market. There can be observable prices without a real secondary market.
In our view, a bank or any other financial institution that arranges, issues (or advises a non-financial issuer) a financial instrument should commit (or find partners that can commit) in running a secondary market. This bank could be obliged to quote on a BID and ASK basis (subject to certain conditions) on transactions that it has promoted and/or sold.

We can also have a solution where this institution, in the absence of secondary market, is obliged to provide for all the tools or data in its possession that are related to the financial instrument (at request). This can be a cash flow model, a valuation methodology and assumptions as well as the sources of data that the bank used to price the security.

*Q51 to 55: **Asset Backed Commercial Papers**: Which benefits and drawbacks of a post-trade transparency regime for ABCPs? Would it be desirable for all types of ABCPs, whatever their structures or maturities, or not? What post-trade information should be published?*

As a starting point, it is useful to remind that ABCPs may take various forms: an ABCP may in fact for instance be a "Euro-CP" or else may be a "domestic" CP, for example a French "Billet de Trésorerie". In that sense, ABCPs are not different from CPs issued by more classic entities like banks or corporations. What that means is that the post-trade transparency regimes that currently apply to various ABCP programmes are in line with their relevant

category. For example, the post-trade transparency regime that currently applies to an ABCP programme which is a French "Billet de Trésorerie" will be in line with that of French "Billets de Trésorerie" in general, whereas the post-trade transparency regime that currently applies to an ABCP programme which is a "Euro-CP" will be in line with that of Euro-CPs in general.

An important ABCP-specific post-trade piece of information that would be very useful to us would be the current size of all outstanding issues of the relevant programme (including all currencies). That information should be published in a timely fashion, ideally refreshed every day. That is because we, as fund managers, must abide by various regulatory or sometimes internal requirements that precisely depend on that particular figure. For example, a fund may not hold more that x% of a given ABCP programme. It is easy to understand that such a regulatory requirement would be better implemented if the information about the size of all outstanding issues of the relevant programme were known in a more timely fashion.

For the sake of clarity, it is useful to say that such information about the current size of all outstanding issues of the relevant programme is NOT as essential for CPs issued by "classic" issuers (i.e. banks or corporations) because in that case the CP debt mixes up with all other types of debts (i.e. bonds etc..) of the relevant issuer.

At this moment, we certainly can access information about the current size of all outstanding issues of the ABCP programmes we invest on, but more often than not, we must ask for this particular piece of data to every programme sponsor and the refresh frequency is generally only on a monthly basis. We do not see any drawback in imposing on various ABCP sponsors the publication of the current size of their relevant programmes in a timely fashion and we think that such a measure would be desirable for all types of ABCP programmes, whatever their structures or maturities.

Another useful type of post-trade information would be the prices at which ABCPs traded, for what size and for what maturity. As for any other financial instrument, the "price discovery" process is a very relevant piece of information, especially to assess risks and achieve best execution. In that respect, the present situation is no worse for ABCPs than it is for other more "classic" CPs (ie issued by banks or corporations). Notwithstanding this, a daily publication of post-trade information relating to prices, sizes and maturities traded would be useful in our view provided that there is strict confidentiality about the buyers' names. A publication of such information immediately after the trade may not be achievable from a technical point of view and may also not be desirable from a confidentiality point of view, so it would probably be better on the next day.

*Q56 to 61: **Credit Default Swaps**: Which benefits and drawbacks of a post-trade transparency regime for CDSs? Would it be desirable for all types of CDSs, or not (e.g. not for single name CDS)? What post-trade information should be published? When should it be published; immediately after the trade?*

Information on most traded CDS are available but not on a regular basis. This can be improved if a central clearing organisation (DTCC, Euroclear etc) commits to post as many information as possible, concerning the volumes and traded spreads, using accessible media.

One of the reasons for large bid-offers on CDS also lies in the asymmetry of the product with respect to counterparty risk. A clearing house should be a way to cope with this problem.

For CDS of ABS, at the beginning of the crisis, derivative markets appeared as more liquid than cash markets – in particular the CDS market. However, today the CDS market's liquidity is shrinking rapidly because of:

- reduction of risks by some trading desks
- increasing aversion vis-à-vis counterparty risks, which will prevail until clearing chambers are set up
- distended arbitrage relationship with the underlying cash.

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