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Credit Derivatives The Two Day Course

DAY ONE

In the first day we lay the groundwork for credit derivatives: we examine the products, the markets, the concepts and the structures. We also talk about the related legal and accounting issues.

Welcome and Introductions

Participants introduce themselves to the group

Introduction to Credit Derivatives: Concepts and Structures
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Evaluating the Credit Derivatives Market and the Rationale for its Development

- Current and future potential of credit derivatives market
- Assessing the size of the market in terms of capacity and liquidity
- The size of the market and the distribution among product lines and underlying instruments
- Difficulties in developing a true "two way" market
- Evaluating the potential for a secondary market in credit derivatives
- How the Euro has impacted on the credit derivatives market
- Credit derivatives: the US experience
- The recent credit crunch and its implications on the market

Different Structures and Assessing their Risks to Ensure Successful Implementation

- Default Swaps & Options
- Total return swaps
- Credit linked notes
- Put credit spreads on asset swaps
- Credit spread notes
- Demystifying the risks: cross, equity, term structure, settlement, legal and basis risk

- Collateralized Debt Obligations CDO's: Collateralized Bond Obligations (CBOs) and collateralized loan obligations (CLOs)
- Downgrade options and their uses

Examples of sample terms sheets

- Examining specific terms sheets
- What is the use of each structure
- Why is someone purchasing the structure
- How is it created
- What are the benefits to the issuer

Convertibility products

- Suitable for hedging cross border risks
- The currency repatriation hedge
- Is this a credit derivative or is it a foreign exchange structure?

New products

- News from the field
- What are some of the most recent deals being done
- The role of the exchanges: the CME experience with the QBI index
- Credit enhanced convertible bonds

The credit spread

- Comparison: credit spread vs. corporate spread
- The credit spread curve and its meaning
- Connecting the credit spread, the recovery value and the probability of default
- What is the "current spread" as opposed to the "forward spread"
- The credit rating agencies and their role
- The credit transition matrix and its implications

Connecting Between Credit Derivatives and the Repo Markets

- Is it a credit derivative or is it a repo trade?
- Similarities and differences
- When to use each instrument

Where should the CD desk be placed within the bank

- We examine several possibilities
- Possible solutions arrived by different banks
- Advantages and disadvantages of the various approaches

Asia

- Asia before the crash
- How to deal with opaque terms sheets and loose disclosure requirements
- Real life experiences from the field
- Asia after the crash

- Is it the best trading opportunity ever? News from the field
- Sample trade ideas and strategies
- The nasty surprises awaiting borrowers
- Other emerging markets

Examining the Legal and Regulatory Issues Concerning Credit Derivatives
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Developments in Credit Derivatives Documentation and Legal Considerations

- Defining a trigger event - pitfalls for the unwary
- Post credit event payout mechanics
- Confidentiality and publicly available information
- Legal considerations
 - transferability
 - insider trading
 - insurance business
- Documentary formats
 - Credit default products
 - Total Rate of Return Swaps

Latest Developments Regarding Regulation Capital

- Impact of Regulatory Capital on credit derivatives
- Regulatory capital treatment of credit derivatives by:
 - BIS
 - Fed and OCC
 - Bank of England
 - SFA
- The industry's position
 - ISDA
 - LIBA/BBA

Applications of Credit Derivatives

Exploiting the Potential: Understanding the Concept of Credit Derivatives

- Defining credit derivatives
- Examining the advantages of credit derivatives for:
 - Addressing line constraints
 - Optimizing balance sheet use and portfolio diversification
 - Hedging credit exposure
 - Investment
- Role of the seller:
 - how to price credit derivatives
 - how to market them
 - how to hedge them
 - managing a book

Designing Credit Derivatives for the Benefit of the Investor

- The investor's role in structuring credit derivatives
- What are the structuring choices available?
- How does the issuance process work?
- Finding the correct risk/reward mix for each type of investor
- Determining the features that would appeal to the investor
- Addressing liquidity concerns
- Can the investor get out of the structure after they have purchased it?

Credit Risk Management Systems

- CreditMetrics by JP Morgan
- CreditRisk+ by Credit Suisse Financial Products
- CreditPortfolioView by McKinsey and Co.
- PortfolioManager by KMV Corporation
- Algo Credit by Algorithmics.
- Other models in development
- Advantages and disadvantages of the various models
- When is each model applicable?
- How do these models compare to each other and how are they accepted in the market

DAY TWO

Understanding Credit Derivatives as a Successful Tool for Credit Risk Management

- Using credit derivatives to manage and securitise credit risk
- Overcoming the problem of illiquid credit exposure
- Applying portfolio theory to credit risk management
- Successful use of credit derivatives to optimize bank loan portfolios
- Credit spread options as a commitment facility
- Mitigating cross-border risks with credit derivatives
- Comparing and contrasting credit swaps and securitisation

Practical Investment Applications for Credit Derivatives

- Calculating relative value: how does credit risk compare with other instruments?
- Uses of credit derivatives in investment:
 - Yield enhancement
 - Taking advantage of discrepancies in credit pricing across asset class barriers
 - Modifying credit risk allocation
 - Improving liquidity of core portfolio
 - Synthetic loan trading

Evaluating the Possible Limitations when Implementing Credit Derivatives

- What are the typical first few deals?

- How to get into more esoteric structures?
- What can you tell the risk manager in order to approve your deal?
- The concept of "fast track" in credit derivatives
- Diversification and managing a book
- Can special structures be booked "back to back"?

Investigating the Possible Uses of Credit Derivatives

- Managing the capacities of credit "buckets"
- Credit derivatives for optimizing balance sheet use and portfolio diversification
- Credit derivatives as an alternative to the syndicated loan market
- Applications of credit derivatives for the end user

Implementing Successful Strategies for Profitable Trading, Hedging and Arbitraging of Credit Derivatives

- Identifying the optimal dealing methods for credit derivatives:
 - Who are the key players?
 - Assessing the role of the inter-dealer broker
 - Monitoring the trends in the market
- Using credit derivatives for:
 - Hedging default risk
 - Hedging a loan portfolio
 - Hedging downgrade risk
 - Implementation of proprietary trading methods
 - Can you hedge interest rate risk with credit derivatives?
- Taking advantage of arbitrage and mis-pricing opportunities
- Managing the risks: liquidity, basis, residual and correlation risks

Day 2 - Pricing, Hedging and Analysis Workshop

Working in small teams, delegates will be presented with term sheets of various deals using different products, such as credit derivatives, CBO's etc. We will analyze each deal in terms of the following:

- Motivation - why would a someone sell the product and why would another party purchase it?
- What is the view expressed by entering into the deal?
- Assessing the major risks and rewards associated with each deal
- Pricing - how is this structure priced
- Sensitivity - how will the structure perform under various scenarios (parallel shifts, flattening or steepening of the yield curve etc.) Credit spread changes? What about volatility swings?
- Hedging - how can the parties entering the deal hedge their exposure?
- Alternatives - what other structures are there which offer similar behavior under various possible market conditions?

Some of the products covered

- Put Credit Spread
- Asset Swap Put Credit Spread
- Binary Credit Linked Note
- Credit Spread Collar
- Dual Currency Credit Spread Note
- Forward Spread Note
- Coupon Enhanced Credit Linked Note
- Basket Credit Linked Note
- Total Return Swap

Pricing, Valuing and Hedging Issues**Pricing of Credit Derivatives**

- Developing a framework for accurately pricing credit derivatives
- Pricing total return swaps
- Pricing credit spread products:
 - Term structure of credit spreads
 - Pricing mathematics
 - Credit spread forwards
 - Credit spread options
- Pricing default risk products
 - Pricing logic
 - Pricing default risk
 - Hedging models
- Estimating the recovery value
- Delta hedging

Determining the Probability of Counterparty Default

- A comparison of three approaches to default:
 - Flesaker et al
 - Black, Scholes & Merton
 - Longstaff & Schwartz
- Credit rating vs. the probability of default
- Credit enhancement strategies

Different Perspectives for Pricing Credit Derivatives

- Assessing the difference between buyer versus seller
- Trader's perspective:
 - Evaluating market liquidity
 - Pricing specific structures as opposed to a portfolio
 - Identifying risk/reward ratios
 - Market pricing approach
- End user's perspective

Course Ends

- Conclusions
- The future of the credit derivatives market

