

Credit Derivative Product Companies 2007 Sector Review and 2008 Outlook

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OUTLOOK OVERVIEW

This outlook reflects Moody's opinion of the performance of Credit Derivative Product Companies ("CDPCs") in 2007 and Moody's expectation of the performance of CDPCs in 2008. The outlook incorporates Moody's view of the competitive landscape, the market for CDPCs, as well as Moody's view on credit derivatives. In addition, this outlook will address any rating implications for Moody's-rated securities and counterparty ratings in the asset class.

¹ Suzanna Sava contributed data to this report.



2008 OUTLOOK

Overall, the ratings outlook for CDPCs in 2008 is stable. However, Moody's outlook may change if the rate of corporate defaults in 2008 exceeds expectations.

The volume of new trading by CDPCs in the near-term is likely to be subdued. Although currently wide Credit Default Swap ("CDS") spreads and somewhat diminished competition suggest that CDPCs may be strategically well placed to capitalize on prevailing market weaknesses, limited CDS trading activity and rising corporate defaults may offset these advantages in the first half of the year, or possibly longer. This may adversely affect equity returns but counterparty and debt ratings are expected to be stable, largely because CDPCs are continuation vehicles and they are structured with a significant equity cushion available for ongoing expenses including debt service. In addition, CDPC's ratings are linked to the CDPC's capital model and the capital model restricts trading where it would affect the CDPC's rating. Once CDS trading picks up, the market should provide favorable opportunities for CDPCs. Although Moody's expects ratings performance to remain stable in 2008; this outlook may change if the rate of corporate defaults is higher than expected since CDPCs are levered vehicles with synthetic exposure to corporate credit.

CDPC SECTOR

CDPCs are highly rated, stand-alone companies whose principal business consists of selling credit protection on single names or tranches of corporates, generally investment grade, via unfunded credit default swaps ("CDS.") Like other Structured Finance Operating Companies ("SFOCs"), CDPCs depend upon detailed, predetermined parameters to define and restrict their business activities and operations.

2007 ACTIVITY SUMMARY

COUNTERPARTY RATINGS EXPERIENCE RECORD YEAR

CDPCs emerged as a significant new asset class in 2007; Moody's rated a record number of CDPCs, assigning **Aaa** counterparty ratings to seven new vehicles. This amounted to more than double the number of CDPCs previously rated by Moody's. The launch of these new vehicles was generally unimpeded by subprime turmoil. Five of the seven CDPCs were assigned ratings in the second half of the year, of which three were in the final quarter. In addition, Moody's assigned provisional **Aaa** ratings to another two new CDPCs in December 2007.

It should be noted that while CDPCs are a relatively young asset class, the first CDPC was rated in 2002 and Moody's has been assigning counterparty ratings to structured finance operating companies, including derivative product companies or "DPCs" since 1989. In the last 20 years, approximately 50 counterparty ratings have been assigned to SFOCs, not including CDPCs.²

RATED VOLUME OF CDPC DEBT

In 2007, Moody's assigned final ratings to ten tranches of debt of three new CDPCs in 2007, and provisional ratings on four tranches of debt of two new CDPCs, totalling \$1.65 billion and ranging in rating from **Aaa** to **Baa2**. In addition, Moody's rated a further \$150 million of new debt issued by an existing CDPC to increase its capital base.

² See, e.g., Special Comment, Counterparty Risk and Capitalization for Derivative Product Companies, June 1994; Special Report, Rating Methodology: A Framework for Understanding Structured Financial Operating Companies, April 2005

Recent market turbulence and decreased liquidity have been an obstacle to new issuers trying to raise debt, particularly with auction rate notes, as well as a drain on CDPCs with auction preferred debt outstanding. CDPCs that launched after the onset of difficulties in the auction preferred market found that market closed to new issuances. Those CDPCs closed with financing either through equity or term debt.

CDPCs whose auction rate notes were subject to auction/remarketing were unable to roll the notes, with the result that the notes reset at a higher interest rate. This situation persists as of the time of writing this report. These higher interest rates were already incorporated into the capital model as Moody's rating assumes that the liabilities are bearing the maximum possible spread. Consequently, the disruption in the auction rate note market does not impact Moody's counterparty ratings or debt ratings of CDPCs that have issued auction rate notes.

PERMITTED ACTIVITY

The nine CDPCs rated to date are selling protection synthetically, principally on single names (three of the nine) and tranches of corporates (six of the nine). The two CDPCs which are provisionally rated also plan to write protection on corporate tranches. With very limited exception, CDPCs are not yet permitted to write protection on asset-backed securities. Some CDPCs are working on expanding their capital model to capture the risk of writing protection on asset-backed securities but this work is still in progress.

STABLE RATINGS IN 2007

Despite the market deterioration in 2007, CDPCs experienced stable ratings. No debt of CDPCs rated by Moody's was upgraded or downgraded during 2007 nor, for that matter, in any previous year. Furthermore, Moody's has never to date taken negative rating action on any CDPC. There are several reasons why CDPCs have been largely unaffected by subprime related turmoil.

- CDPCs are structured as continuation vehicles which do not terminate or collateralize based on marked to market positions or changes in the counterparty or debt ratings of the CDPC itself. Trading is contingent on the capital model showing sufficient capital. Certain parameters may trigger a cessation of trading but even in this case, there is no provision for a forced sale or termination of CDS.
- CDPCs are generally not permitted to sell protection on asset-backed securities nor, with limited exception, to hold them as their eligible investments, which has proved to be significant in avoiding exposure to subprime securities and the contagion in other asset-backed securities.
- CDPCs have generally upgraded the credit quality of their CDS portfolios.
- Spreads have quickly widened which has the benefit of increased premiums for protection sellers who have been able to execute new trades in the current market.
- Some CDPCs are structured so that upon a downgrade of the debt or counterparty rating of a CDPC, equity dividends and the junior management fee are suspended, incentivizing the manager to maintain the ratings, especially if the manager holds any equity in the vehicle. A further incentive to maintain the ratings is that the manager may encounter difficulty trading once the CDPC is downgraded.

It should be noted that CDPCs have a limited history, being a relatively new asset class. CDPCs have not yet experienced a full business cycle and accordingly, a review of rating transitions to date is limited to recent experience.

Moody's does not rate the equity of CDPCs and does not analyze their potential returns.

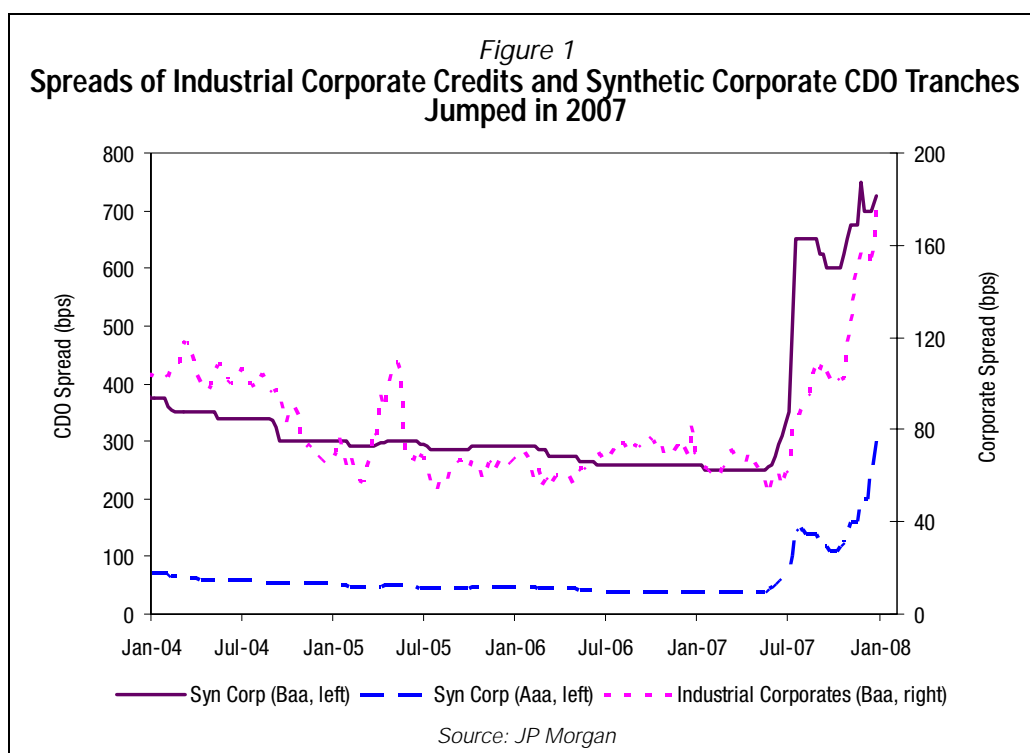
NEW ISSUANCE EXPECTATIONS

There are currently between 10 and 15 new CDPCs in the pipeline at various stages of Moody's analytical process. Moody's expects that about five of these may be assigned a definitive rating in 2008. Moody's currently does not have a significant number of new debt rating requests from CDPCs, reflecting generally unfavorable conditions in the new-issue market.

PERFORMANCE OUTLOOK

RELATIVE ARBITRAGE OPPORTUNITIES FROM WIDENED SPREADS

CDPCs may stand to profit from the extreme widening of spreads on CDS that occurred in 2007, as this may provide the vehicles with a relatively strong opportunity for spread income. While spreads on CDS widened considerably in the third quarter of 2007, CDS spreads on investment grade names more than doubled during the year. See *Figure 1*.



Decreased Competition

CDPCs may benefit from decreased competition from other sellers of protection. For example, some monoline insurers are unable to readily access the capital markets due to concerns over their subprime and CDO exposures. By contrast, CDPCs generally have capital available for new trades. Also, some sellers of protection have failed, such as certain commercial paper conduits. Furthermore, some providers of protection that post collateral have failed to post sufficient collateral, raising concerns about their reliability as providers of protection going forward.

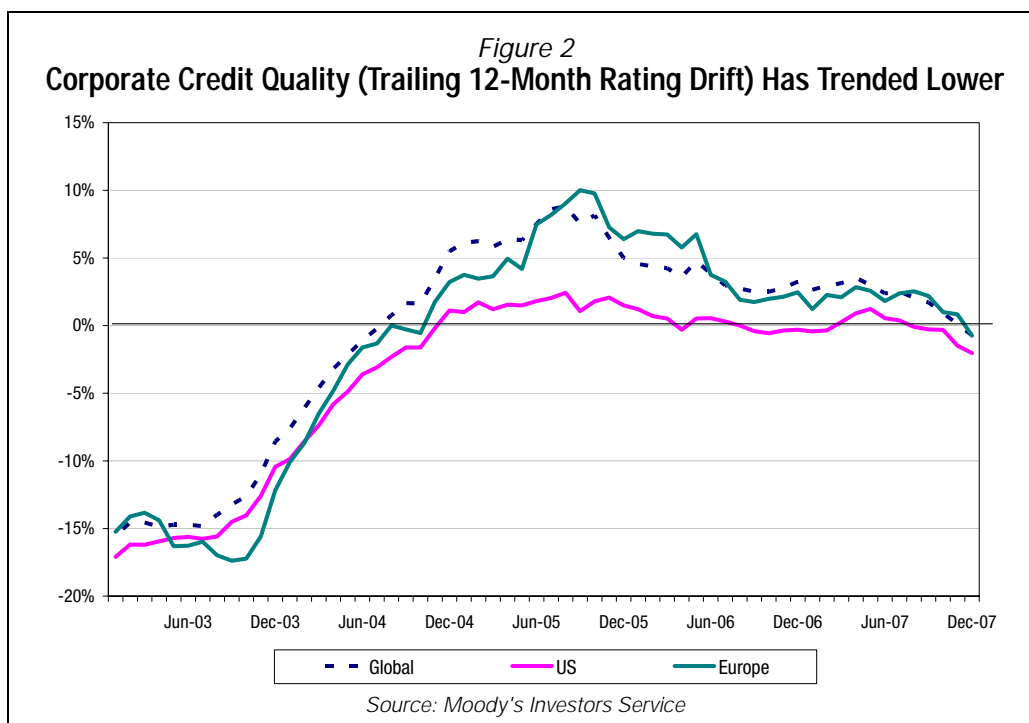
Challenge in Opening New Counterparty Lines

Looking into 2008, the challenge for new CDPCs is to find trading partners who are willing to open counterparty lines and start writing new business. Caution commensurate with uncertain times has made it more difficult for CDPCs to get prospective counterparties comfortable with understanding and

accepting model-based counterparty credit risk and counterparties who do not post collateral. At the same time, limited liquidity also continues to constrain CDS trading even among long-time market participants. Moody's expects a relatively slow pace of CDS execution in the first half of 2008, potentially easing somewhat later in the year. In rating a CDPC, Moody's does not assume any volume of future trading activity as the capital model assumes that the CDPC is in wind-down (with a cessation of trading) at each point in time.

Sharp Rise in U.S. Defaults Anticipated

Consistent with the predictions of a generally slowing U.S. economy, Moody's anticipates a sharp rise in U.S. corporate default rates in 2008. See *Figure 2*. Specifically, Moody's baseline forecast projects a trailing 12-month U.S. speculative-grade default rate of 5.2% by the end of 2008, up from just 0.9% in 2007. Moody's pessimistic forecast contemplates a speculative-grade default rate of 10-12% as seen during the 1990-1991 and 2001-2002 credit cycles. Moody's investment grade default rate forecast over one year remains low at 0.0466%. *Figure 2* shows that the 12 month trailing ratings drift (the difference between upgrades and downgrades relative to outstanding ratings) turned negative in the latter part of 2007.



OUTLOOK CONCLUSIONS

A record number of CDPCs launched in 2007 despite subprime turmoil and the pipeline for 2008 remains strong. Limited trading in the CDS sector is constraining CDPC activity and CDPCs are looking forward to an uptick in CDS trading and hoping to benefit from widened spreads. When liquidity in the CDS market improves, the newly launched CDPCs hope to become broadly accepted as trading partners. The widening of CDS spreads to date is causing CDPCs to show negative equity but CDPCs are continuation vehicles designed to withstand negative equity based on marked to market positions.

CDPCS RATED TO DATE

Year	Name	Tranche Name	Rated Amount	Rating
2002	Primus Financial Products, LLC	Counterparty Rating		Aaa
2003	Primus Financial Products, LLC	Perpetual NC-10 Floating Rate Cumulative Preferred Securities (Series I)	55,000,000	A2
2003	Primus Financial Products, LLC	Perpetual NC-10 Floating Rate Cumulative Preferred Securities (Series II)	55,000,000	A2
2004	Primus Financial Products, LLC	Subordinated Deferrable Interest Notes, Series A	75,000,000	Aaa
2005	Primus Financial Products, LLC	Subordinated 2005 Deferrable Interest Notes, Series A	75,000,000	Aa2
2005	Primus Financial Products, LLC	Subordinated 2005 Deferrable Interest Notes, Series B	50,000,000	Aa2
2005	Athilon Asset Acceptance Corp	Counterparty Rating		Aaa
2005	Athilon Capital Corp.	Counterparty Rating		Aaa
2005	Athilon Capital Corp	Senior Subordinated Deferrable Interest Notes Due 2035	250,000,000	Aaa
2005	Athilon Capital Corp	Subordinated Deferrable Interest Notes Due 2035	150,000,000	Aa2
2007	Athilon Capital Corp	Senior Subordinated Deferrable Interest Notes Due 2047	100,000,000	Aaa
2007	Athilon Capital Corp	Subordinated Deferrable Interest Notes Due 2047	50,000,000	Aa2
2007	Aladdin Financial Products, LLC	Counterparty Rating		Aaa
2007	Channel Capital Plc	Counterparty Rating		Aaa
2007	Channel Capital Plc	Class A Auction Notes	100,000,000	(P)Aaa
2007	Channel Capital Plc	Senior Capital Notes	50,000,000	Baa2
2007	Channel Capital Plc	Class B Notes	100,000,000	Aa2
2007	Channel Capital Plc	Class A Term Notes	150,000,000	Aaa
2007	Cournot Financial Products LLC	Counterparty Rating		Aaa
2007	Koch Financial Products, LLC	Counterparty Rating		Aaa
2007	Koch Financial Products, LLC	Floating Rate Subordinated Notes Due 2037	100,000,000	A2
2007	Koch Financial Products, LLC	Floating Rate Junior Subordinated Notes due 2037	50,000,000	Baa2
2007	NewLands Financial Limited	Counterparty Rating		Aaa
2007	NewLands Financial Limited	Class A Loan	50,000,000	Aaa
2007	NewLands Financial Limited	Class B Loan	75,000,000	Aa3
2007	NewLands Financial Limited	Floating Rate Notes Due 2022	250,000,000	Aaa
2007	NewLands Financial Limited	Class B1 Deferrable Loan	10,000,000	Aa3
2007	Quadrant Structured Credit Products LLC	Counterparty Rating		Aaa
2007	Quadrant Structured Credit Products LLC	Senior Subordinated 2007 Deferrable Interest Auction Rate Notes, Series A	300,000,000	(P)Aaa
2007	Quadrant Structured Credit Products LLC	Subordinated 2007 Deferrable Interest Auction Rate Notes, Series B	100,000,000	(P)Aa2
2007	Satago Financial Products Limited	Counterparty Rating		Aaa
2007	Satago Financial Products Limited	Deferrable Interest Preferred Perpetual Auction Rate Notes	65,000,000	(P)Aa3
2007	Satago Financial Products Limited	Deferrable Interest Auction Rate Notes due 2047	250,000,000	(P)Aaa

Doc ID# SF125640

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