

Structured Credit: Exploring the Diverse Developments and Upcoming Challenges in Global Credit Markets (an Investors' Perspective)



Presented by:

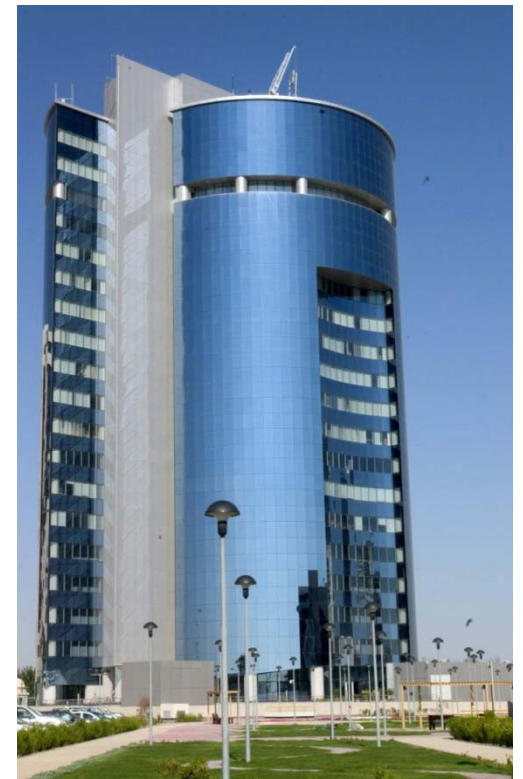
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Debt Capital Markets

Overview

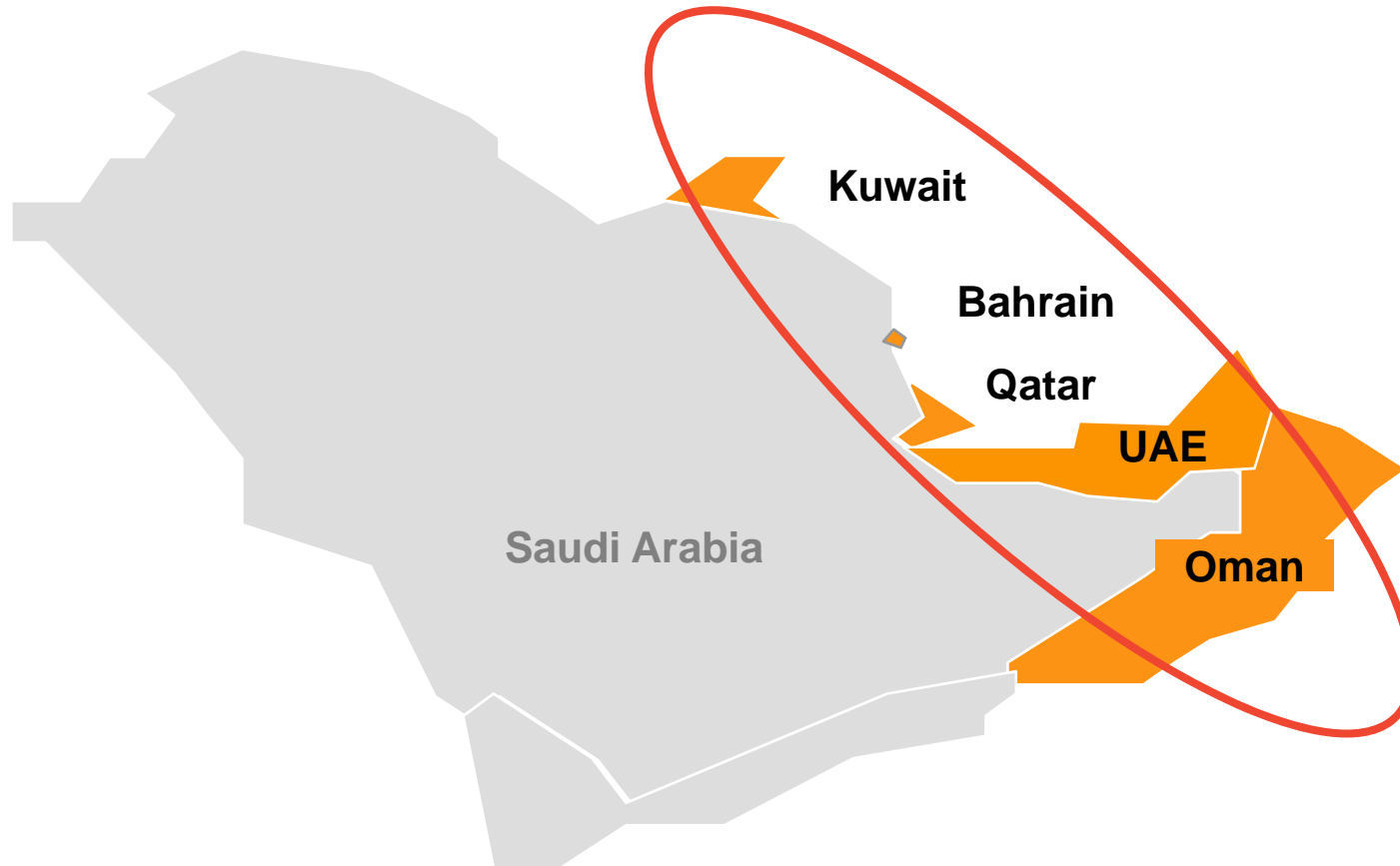
- **Introduction to al khaliji**
- Views on the Current Credit Market
- Building and Managing a Portfolio in Today's Market
- Looking Forward From Here

About al khaliji

- A new regional bank in the making
- Founded by a group of prominent investors from Qatar, UAE, Kuwait, Oman and Bahrain
- The aim is to become a universal bank
- The Bank is headquartered and started in Qatar with an initial Authorised Capital of USD 2 billion
- Our geographical presence is targeted towards the shareholders' countries with international expansion as a possibility at a later stage



Geographical Presence?



In its first expansion phase **al khaliji** aims to build a strong regional presence in five gulf countries ... the ultimate goal is to establish a financial institution that serves all five markets successfully.

al khaliji Vision Statement

Our Direction? Next generation banking from the Gulf

Our Discovery? Something exciting!
Something connected!
Something new!

Our Destiny? Putting the buzz into banking!



al khaliji Values

Cool

Streetwise, fashionable, smart, elegant
Composed, calm, level-headed

Bold

Brave, daring, courageous, adventurous,
striking, eye-catching

Swift

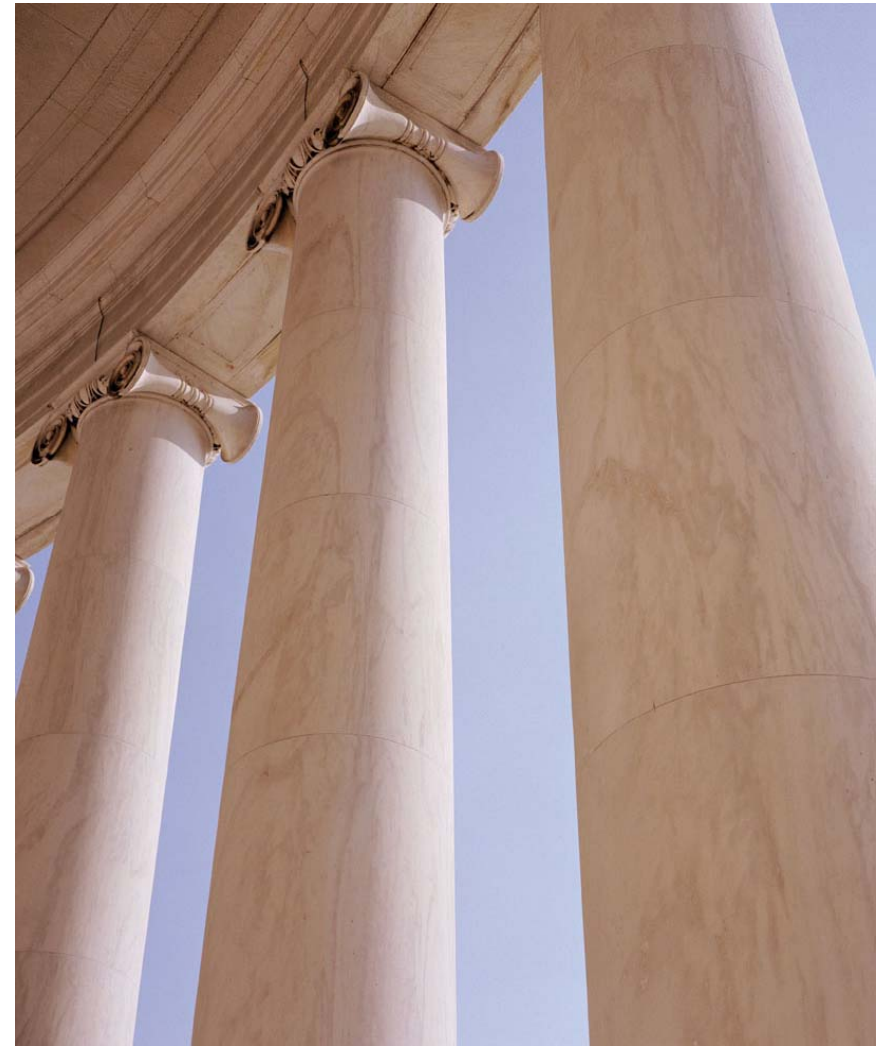
Quick, nimble, fast, nippy, efficient

United

One-team, co-operative, together, solid

Reliable

Dependable, honest, conscientious,
trustworthy, steadfast



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Structured credit is a key component of our investment program complementing our primary lending business

- The Bank has made a strategic decision to invest in structured credit as a significant driver of income in the short and intermediate term
- It remains a solid portfolio management tool by creating diversification in all aspects including geography, rating, and industry
- Excess liquidity and significantly lower spreads in the region provides investment opportunities outside of the region to gain greater margins in a diversified manner
- The current credit crisis, while largely catalyzed by structured credit, has also brought sanity back into the market in terms of simplifying structures, increased spreads to historic norms, and a hard look at where the weaknesses lie in the structured credit engine, particularly fiduciary responsibilities of banks and effectiveness of credit ratings
- Institutions with cash have enormous buying power in this market, especially in the next few quarters

Outlook on credit remains poor

- There appears to be no end in sight for spread widening
- Economic outlook, particularly in the US looks grim with more statistical indicators pointing to a recession potentially hurting corporate balance sheets
- Individuals remain highly levered and with unemployment appearing to tick up along with crashing housing prices, it is unlikely consumer spending will maintain at its current levels



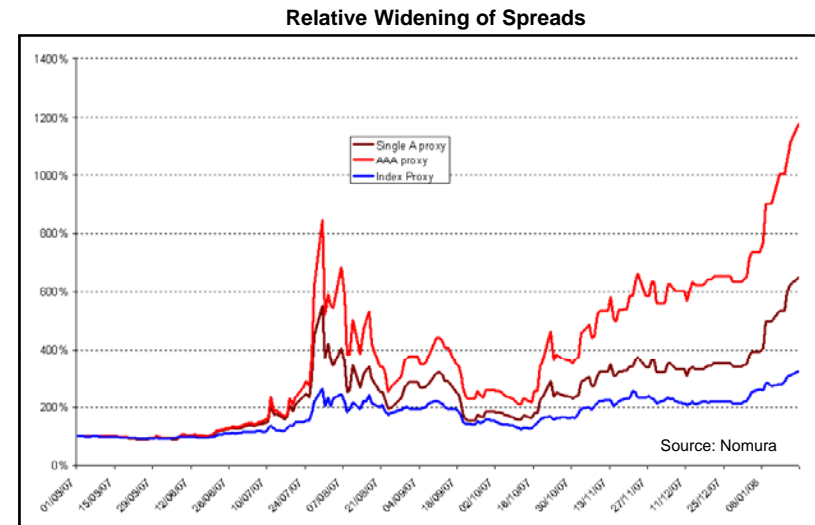
- While originally a liquidity driven spread widening scenario, it is increasingly looking like underlying creditworthiness is likely to be hit (particularly HY with default forecasts in the 4-5% range now)
- According to numerous bank research opinions, ABS CDOs appear unlikely to re-open before the end of the year and the CLO market still remains largely shut

Intervention is unlikely to prevent further short term deterioration

- Multiple Fed injections of capital, the opening of the auction window, massive rate cuts, and proposed stimulus package are unlikely to stop the US economy from entering recession
 - Historically, rate cuts tend to take 6 months to work into the system which is far too late
 - Separate surveys show stimulus check refunds will likely be used to pay down debt rather than for spending
 - Quick reduction in short term rates is increasing the likelihood of inflation and longer term rates are starting to tick up which means fixed term mortgage rates may actually rise rather than fall
 - Indicators such as the services ISM is showing retraction in corporate, even amid rate cuts
- The so-called decoupling of global economies seems less prevalent than once thought
 - Recent equity market movements in across Asia (particularly China and India) are showing that US bear markets still have huge impacts on Asian equities (and implicitly the growth potential of these economies)
 - While the GCC is still growing and showing resilience, it is unlikely the GCC will have much impact in keeping the global economy afloat since, as a whole, it is only 1% of the world GDP

However certain pockets of value are emerging

- With credit spreads nearing where they were at the Great Depression and the default outlook less serious than implied by credit spreads, there appears to be a pricing mismatch that can be arbitrated *over time* – the big disclaimer is the ability of investors to tolerate the volatility in the near term to capture this value
- Investors should pay close attention to the relative value that can be found in different sectors, geographies, and parts of the capital structure. These plays, depending on the outlook of the investor, have been in the past few months (though may change quickly):
 - Bank debt over corporate
 - US over Europe
 - Senior tranches over mezzanine and juniors
- Certain asset classes such as ABS CDOs should actually create enormous relative value opportunities in the secondary market except much of the existing investor base has decided to hold on to maturity given how low the price has gotten, which combined with a lack of new issuance, has meant that market has essentially stopped



The existing credit crisis is unlikely to have a serious adverse effect on GCC credit

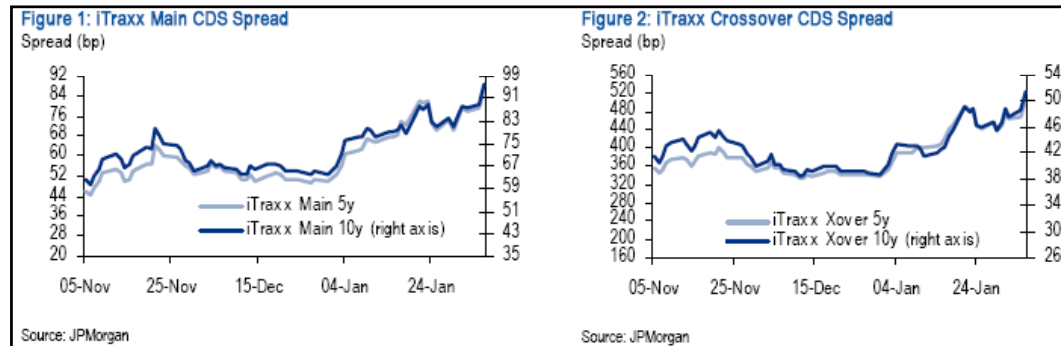
- At **al khaliji**, we believe high hydrocarbon prices will remain, even with an expected oncoming recession from the US – demand from other countries (eg, China) will pick up some of the slack, especially given resources such as coal are rising even faster
- The economic story of the GCC, real estate boom, massive influx of foreign labour, huge demand for services and infrastructure is mostly isolated from the world markets at this point, except perhaps for economies not driven by oil & gas and highly integrated into world financial markets
- GCC credits make up practically no exposure towards structured credit so there is no direct impact – this however may change as we are seeing some movement in MBS, particularly in the commercial side
- If anything, we expect credit investors to start looking into GCC exposures as an alternative and perhaps counter-correlated to external credit markets

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It is difficult to call a bottom but smart investors should start getting in now

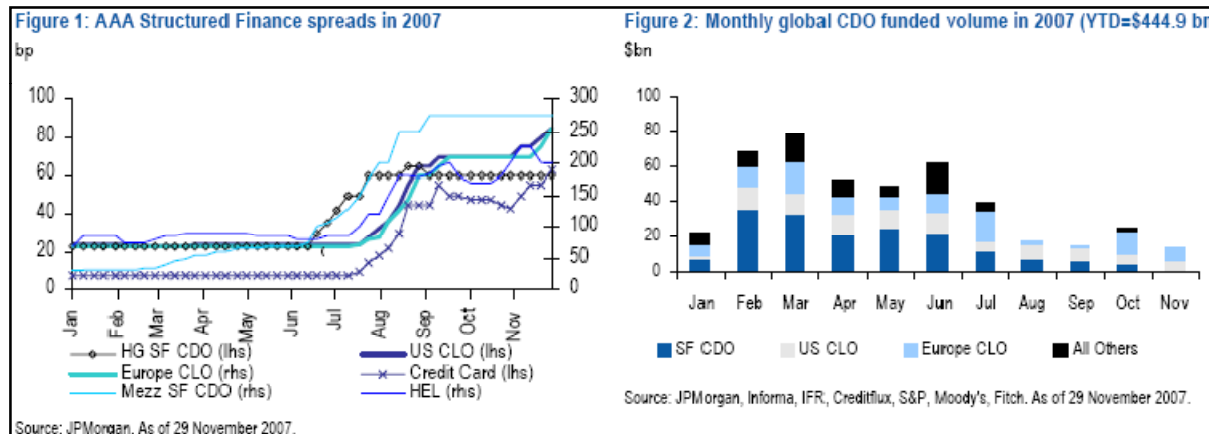
- Many bankers we have spoken to are expecting that when spreads tighten, they will tighten quickly as the available liquidity is waiting on the sidelines for the “right time” before rushing in
- While relative value exists, we believe as a broad market, assets are cheap enough now to start investing



- Most credit investors in the region should be focussed on income generating, intermediate-long term value rather than credit trading – active credit trading and bottom-fishing require access to deal and information flows that are not available to most banks in the regions

Liquidity is key and investors with capacity will have opportunities to acquire quality assets at low cost

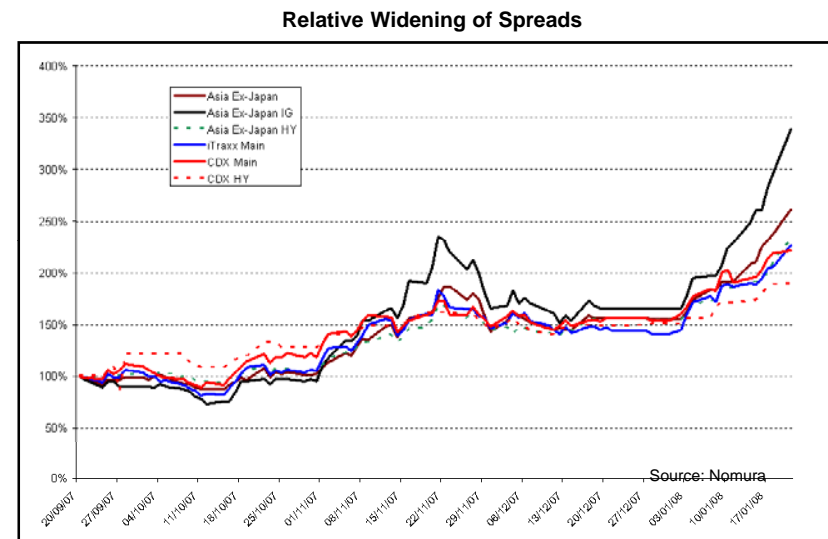
- With Street estimates of anywhere from \$250bn to \$400bn in write downs from CDOs, it is expected that the supply demand picture will be one-sided from all the investors who will be suffering from this
- Dozens of events of default that have already occurred on CDOs and potential collateral liquidation will allow for assets to be picked up at fire sale prices
- Structured credit spreads have widened dramatically since the credit crisis even while supply has dwindled



- For investors with a shorter time horizon, we are also seeing 3-year structures with wide spreads now for the first time showing how dramatic the change has been for structured credit

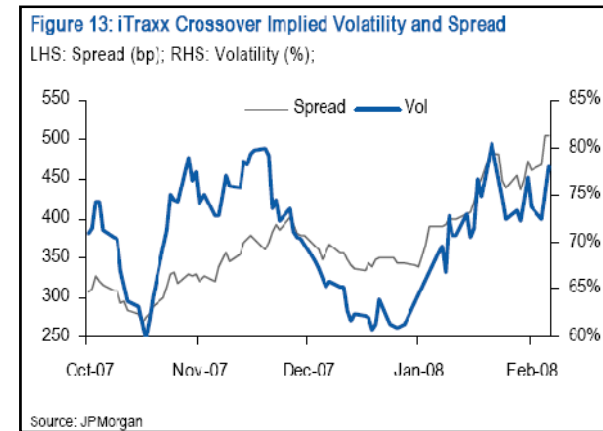
Invest in relative value assets but be mindful of recessionary forecasts and its effects on credit

- While not officially in a recession, the slowdown is incontrovertible and the view of economists and industry data largely point to a recessionary environment already
- Credit pricing seems largely to have priced in a moderate to serious recession where implied defaults, particularly on HY, is between 4-5% whereas the observed remains <1% - *does the market know something we don't know yet?*
- Although Asia is not expected to enter recession does the relative spread widening in Asia indicate that it is now a cheap asset... *or is the decoupling story a myth?*
- US consumer wealth effect of the 90's stock market bubble and the 2000's real estate bubble is now over – *where are they going to get the credit to keep the consumption-driven economy alive and where is the extra money coming from to pay for it all?*
- What happens when Baby-Boomers begin to withdraw money from the equity markets?



Volatility is a fact of life now but there may be ways to play it

- Volatility remains high by historic standards and the MTM impacts would be significant for investors
- High volatility benefits credit hedge funds / credit opportunity funds due to their ability to long/short credit
 - For wary investors in credit markets due to the current volatility, long/short funds also can generate decent absolute returns without a great deal of exposure (targets of 10-15% can be expected in funds today)



- For the very conservative investor willing to give up a certain amount of upside, principal-protected products such as CPPI structures are still being printed
- There are also a limited number of banks with mark-to-market management solutions that we have seen that have developed structures which gives investors exposure to structured credit without MTM volatility
 - These structures are best for investors looking for stable, income-generating credit portfolio rather than alpha generation

Regulations may be a barrier to some investors

- From looking through central bank guidelines across the GCC, there is little in the way of guidance and supervision for credit derivatives relative to the extent of direct regulation there is for other asset classes
- Some limits set for investments, although appropriate when they were created, may need to be revisited given the evolution of financial products, particularly in structured credit
 - Though designed initially to protect capital, limits now frequently hinder the ability to operate an investment book based on a risk-return framework
- Having a rules-based regime where there is lack of direct guidance on specific asset classes also makes constituent banks wary of entering certain type of transactions
- We have seen a case for banks on the leading edge of products and asset classes to choose their regulator carefully
 - Principles-based regulations (DIFC, FSA) tend to be more friendly than rules-based regimes in the ability for banks to innovate and take a more risk-based approach to investments and business

Funding remains an issue until the currency repeg/reval picture becomes clearer

- As most financial institutions in the GCC know already, the market is completely one-sided on the USD issue and it is extremely difficult to get USD funding due to the lack of an effective hedge market
- It is a confusing time with central banks, economists, and investors all projecting different outcomes on the reval vs. depeg issue, expectations on the extent of the reval, and lack of a consistent message as to how long the peg is to remain
- For those without USD liquidity, banks are still wary of giving large lines to do unfunded transactions

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BHDF=							
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BHD2ND=	2.51	3.01		BHD2N=	-10.1	-6.2	AMRA 08:28
BHD3ND=	2.65	2.95	AMRU :	BHD3N=	-18	-9	AMRA 08:28
BHD4ND=	2.63	2.93	AMRU :	BHD4N=	-34	-13	AMRA 08:28
BHD5ND=	2.62	2.92	AMRU :	BHD5N=	49	19	AMRA 08:28
BHD6ND=	2.50	2.80	AMRU :	BHD6N=	-99	-37	AMRA 08:28
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OMR2ND=	0.50	2.50	OIBI 08:21	OMR2N=	-132	-98	AMRU 08:31
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SAR1ND=	2.73	2.98	BSFJ :	SAR1N=	-7.0	-4.0	CALL 08:29
SAR2ND=	2.74	2.99	BSFJ :	SAR2N=	-30	-20	CALL 08:29
SAR3ND=	1.88	2.28	CALL 08:29	SAR3N=	-70	-50	CALL 08:29
SAR4ND=	2.79	2.99	SADD :	SAR4N=	115	80	CALL 08:29
SAR5ND=	2.77	2.97	SABB :	SAR5N=	-250	-195	CALL 08:29
SAR6ND=	2.73	2.93	SABB :	SAR6N=	-420	-315	CALL 08:29
SAR7ND=	1.40	1.60	AMRU 07:20	SAR7N=	-550	-500	AMRU 08:29

Quote: QARF=							
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QAR1ND=	0.41	0.91	BNPB :	QAR1N=	-61	-21	BBMC 08:29
QAR2ND=	0.34	2.35	CALL :	QAR2N=	-121	-56	BBMC 08:29
QAR3ND=	0.33	2.35	CALL :	QAR3N=	-171	-71	BBMC 08:29
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KWDF=							
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KWD1ND=	0.75	0.75	GBXX :	KWD1N=	-36	-18	CALL 08:31
KWD2ND=	1.50	2.25	CALL 08:31	KWD2N=	-74	-38	CALL 08:31
KWD3ND=	1.50	2.25	CALL 08:31	KWD3N=	-107	-53	CALL 08:31
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KWD7ND=	1.50	2.50	CALL 08:31	KWD7N=	-517	-206	CALL 08:31

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Credit markets will continue to be volatile – the key is to lock in spreads now and hold on tight

- Best case projections for the US economy and the recovery of housing to be earliest Q3 2008 with most banks considering most of 2008 a write-off – to an extent, most agree that this is largely priced in but unexpected negative news still triggers markets to be quite volatile
- Rating agencies are beginning to review ratings methodologies for CDOs with Fitch expected first in late March
 - A number of high rated issues are expected to be downgraded which may make it difficult for new issues to be printed until ratings certainty is more clear
- Where possible according to local regulations (this is *not the same* in every jurisdiction), AFS will always be favourable to HFT from a P&L perspective to avoid wild swings in earnings as have been seen with many international banks
- The markets are now allowing more flexibility than before in that there are shorter maturity structured credit deals printed (3-5 years now which makes sense given spreads are much wider) so the investors are no longer locked in to 7 and 10 year deals

Synthetic structures still provide the best opportunity compared to cash and ABS

- As we know, the ABS market is closed, ratings on these structures aren't worth much, and the underlying fundamentals are now weak on a macroeconomic basis
- The CLO market is slowly opening but it provides a difficult way for GCC investors to participate given the funded nature of these deals – FX risk still looms large
- Synthetic structures provide the best opportunity for large stable diversified portfolios (long only)
 - Underlying CDS market is very liquid and can be packaged or liquidated more easily
 - Pricing and valuation is much more transparent, particularly for MTM concerns
 - Investors, particularly in private deals, can specify exactly the parameters that the fund can be invested in without concern for supply of underlying assets
 - More easily done on an unfunded basis
- We believe a majority of structured credit portfolios in synthetics with a piece of alpha generating long-short funds is a good mix until both ABS markets open up as well as the FX picture becomes clearer

K.I.S.S. – there is little need now to create value from deeply complex and leveraged structures

- When markets were particularly tight, complex dynamic and leverage structures were created (eg, CPDOs) to generate moderate returns
- The market made sense with cheap funding from monolines and equity tranches particularly low risk due to historically low defaults
- However, wider spreads combined with a loss of super senior funding from monolines means that simpler structures can be created with less leverage while still paying decent returns higher up the capital structure – this should be the norm rather than an exception
- Unless they are active credit traders, most GCC investors should probably be in senior mezzanine tranches (investment grade) to generate decent income with lower risk
 - Debt holders, particularly those higher up in the capital structure now have a lot more power in transactions versus equity tranches due to the pullback of monoline and other funding sources
 - *This provides a particularly attractive opportunity for cash-rich GCC investors*

Choosing the right fund manager - back-to-basics

- Gone are the days of two guys and a Bloomberg terminal
- Smart investors should look for:
 - Core credit analytical skills
 - Sound credit processes within the fund
 - Strong operational and administration resource base
 - Access to deal flow
 - Track record of downgrades and defaults
- Be cautious of smaller fund managers as the recent lack of new deal flow has put many of the smaller managers on the brink of shutting operations

Examples of some deals we are seeing today

- Standard investment grade synthetic CDO – only investment grade underlying
- Investment grade synthetic CDO – ex monolines
- Venture capital CFO – structured like a CDO with multiple investment grade debt tranches
- Some CLOs
- Asian-only investment grade CDO
- A number of smaller credit opportunity funds to take advantage of short opportunities
- Funds structured with higher SROCs beyond requirements of rating agencies to provide cushion for possible methodology revisions



Thank You