

Provider Profile

As the deal gets more complex, the transparency disappears

Buy-side analytics provider CDO² is the subject of this week's Provider Profile.



Fittingly for a firm that deals in the specifics of pricing, CDO² was created with very specific aims. It was founded in early 2004 to provide a pricing service targeting structured credit investors and focussing on complex structured deals. Furthermore, CDO² was set up with the express aim of plugging the gap between the price that investment banks put on the deals that they market, and what their clients need: an independent validation of that price.

"A typical CDO² client might be a mid-sized European bank. They are a 'buy and hold' type client that has an appetite for more exotic structured credit deals. We work with many German banks in particular, as there is a regulatory need for an independent price for deals with these types of structures in Germany. We provide them with that additional level of comfort by supplying them with an independent pricing mechanism" says Gary Kendall, md and founder of CDO².

Gary Kendall

Perhaps surprisingly, the hedge fund market has, so far at least, not made so many enquiries about the CDO² service. Kendall explains: "Our clients are not in and out of the market quickly, they will look very carefully at a CDO, analyse its complexity and price it, and if they invest they will be in there for the medium term at least."

Hedge funds, in Kendall's view, adopt a different strategy. "The hedge fund sector trades simpler credit derivatives deals, such as single tranche and zero coupon CDOs; it's easier for them to do that, as they can get out of a deal quickly. It's very difficult, however, to model structured credit. We don't see them getting into the highly exotic CDOs," he says.

So when does an investor look for help from CDO²? A typical deal often includes an unequal weighting of names across a CDO or an unusual payoff. "Once you do this you find that you fall off the scope of traditional software to price the deal," claims Kendall. "CDS and index tranche trades are relatively straight-forward, with enough transparency and liquidity, but as the deal gets more complex, the transparency disappears."

Investors' desire to regain that transparency through CDO²'s service is driven by two key factors, according to Kendall. First, a deal structure, having usually first been agency rated, will need to be marked-to-market to comply with IAS39 accountancy regulations. Second, investors question whether the price they've been given by the issuing dealer is fair.

He explains: "Basically these guys see that they might be getting a poor deal and so need a third party to provide an accurate price on their behalf. The banks give them spreadsheets when marketing a deal, but such tools only go so far. These investors don't employ many quants so we fill that analysis gap. The more complex the deal, the more the investor wants an independent view."



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Investors' desire for third-party input could potentially antagonise the issuing banks and raise concerns that their own pricing services are being replaced, but the banks appear comfortable with the situation. "The sell side is happy for their clients to get an independent view, if it helps them invest. We even have investment banks using CDO², to get an additional view on a price," claims Kendall.

A typical client for CDO² might well have only a few deals on the go, explains Kendall, but naturally as the bank gains confidence and invests more in exotic structures, they always want to do better with each additional deal, and so more is demanded of the software tools used to do their pricing. "There are some additional tools out there besides what the investment banks offer. Bloomberg, for example, lets you price two or three deals, but sophisticated investors need a complete system," Kendall observes.

Pricing the highly complex structures now on offer to such investors requires more computing power than a desktop pc can provide. So CDO² has partnered with Sun Microsystems, to give its clients remote access to Sun's network of servers, which delivers grid computing.

Grid computing provides the vast processing power needed to run the thousands of Monte Carlo simulations required to value a structure; having Sun as a business partner has therefore benefited all concerned. "This approach works well for the banks as they pay for what they use on Sun. And because the system is networked, a work-group can be formed and they can see each other's deals," explains Kendall.

The use of a complex set-up such as this to price deals will serve the structured credit market well going forward as structural innovation will inevitably continue. At present, the explosion in the number and variety of CPPI products is a key focus for CDO².

"This is definitely the next big challenge for CDO². Credit CPPI today is where CDO squared deals were a few years ago. We hear that there's a lack of transparency out there, so it's a natural area for us to consider," says Kendall.