Developments in the Credit Swap Market

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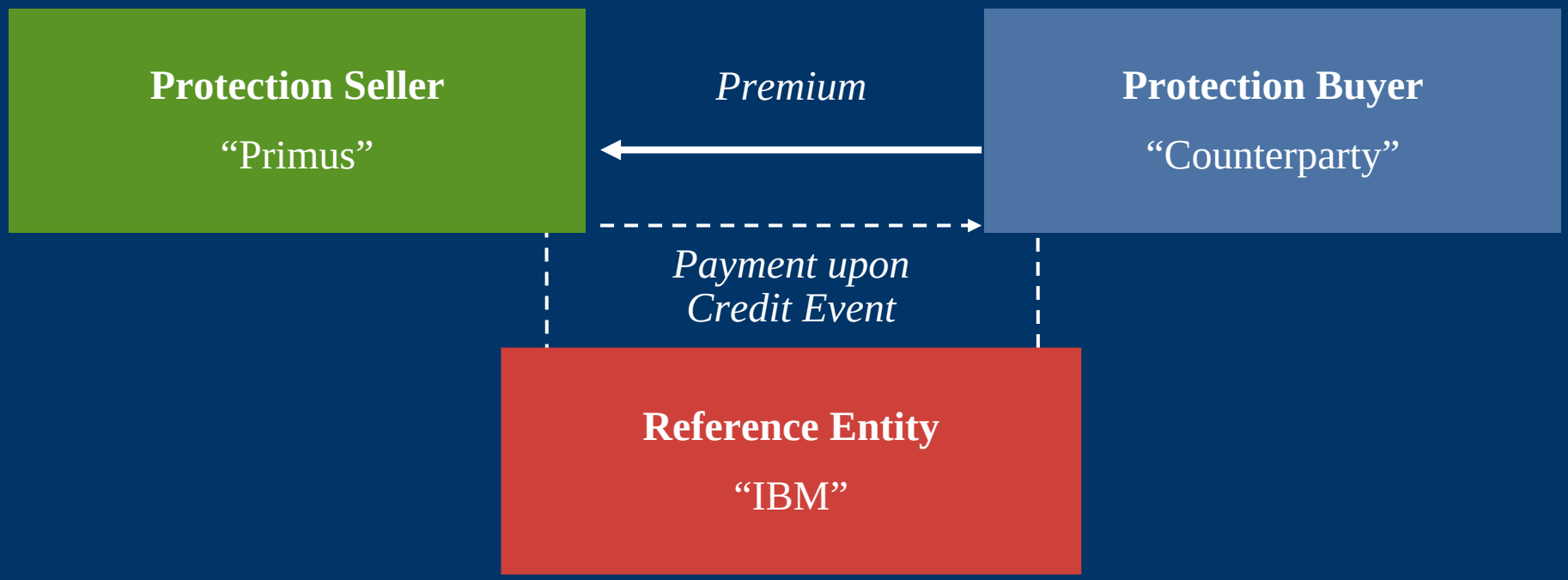
March 22, 2007

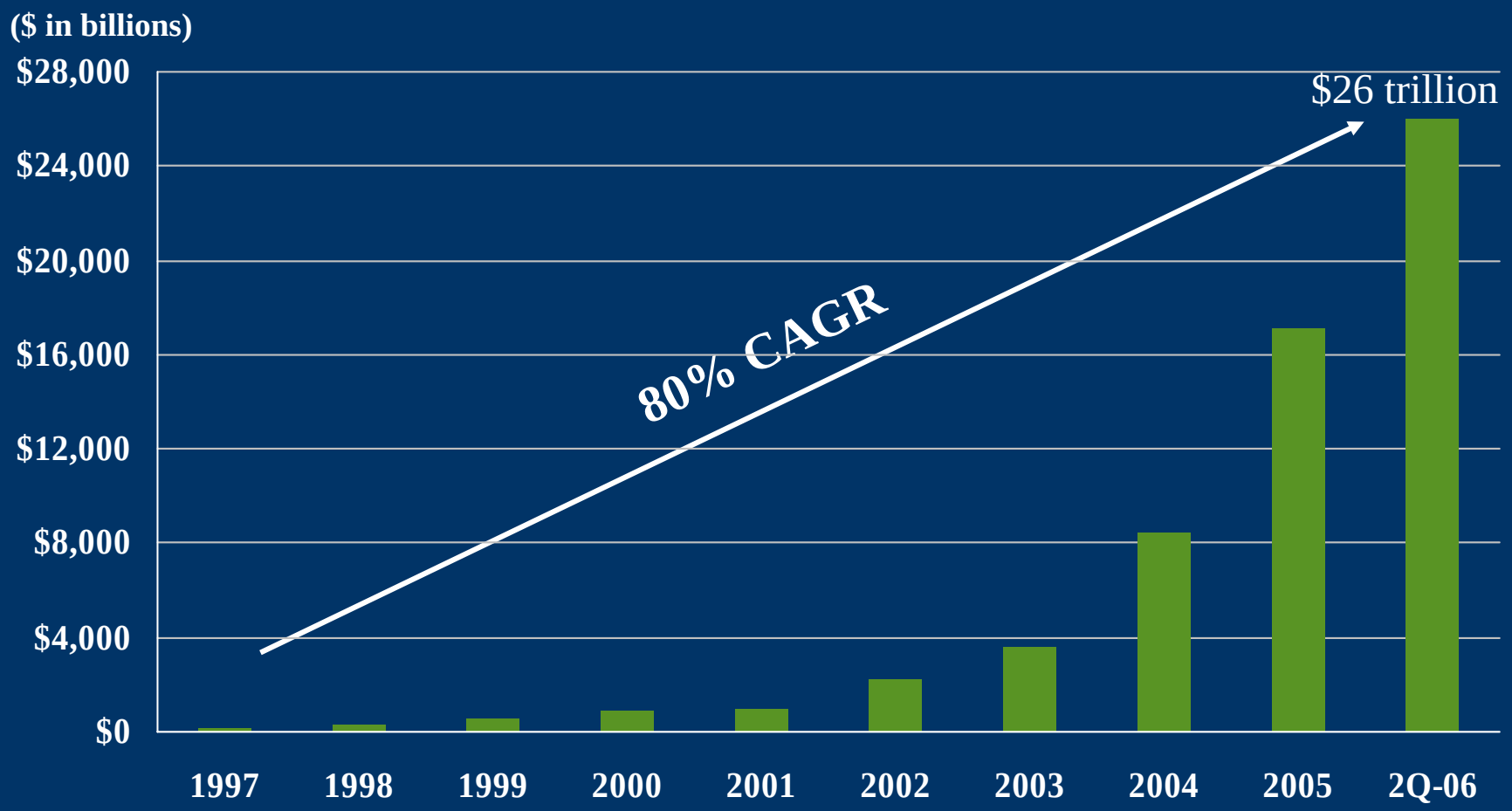
Credit Swap Market Overview

What is a credit swap?



Credit Swap Market Growth

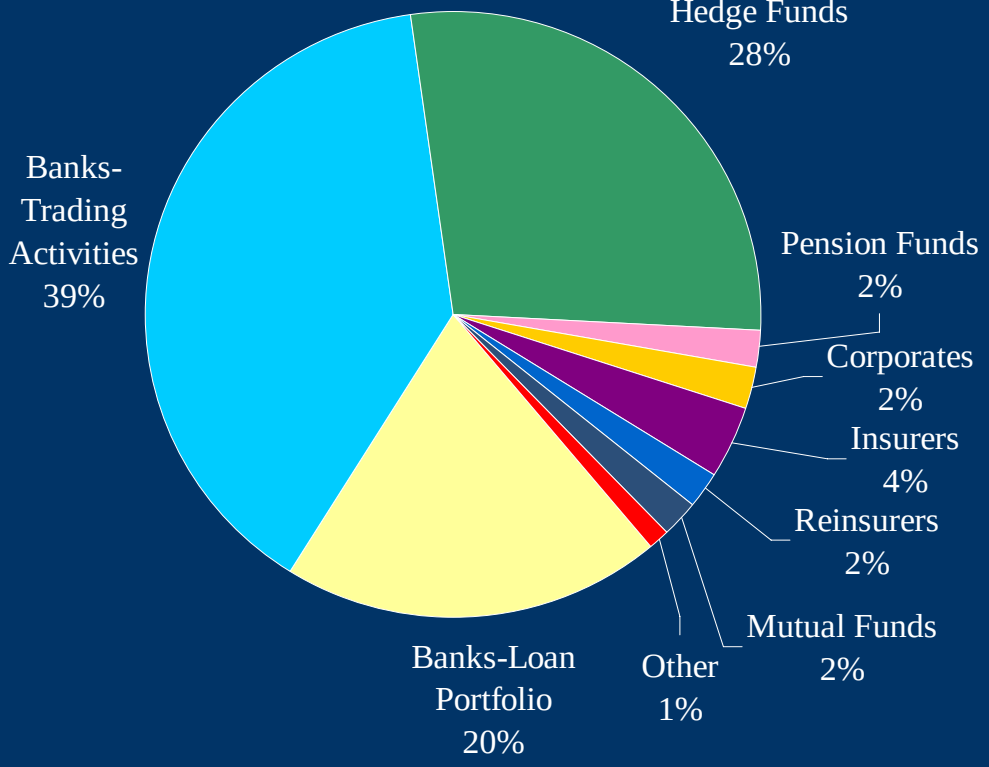
Global Credit Swaps Outstanding



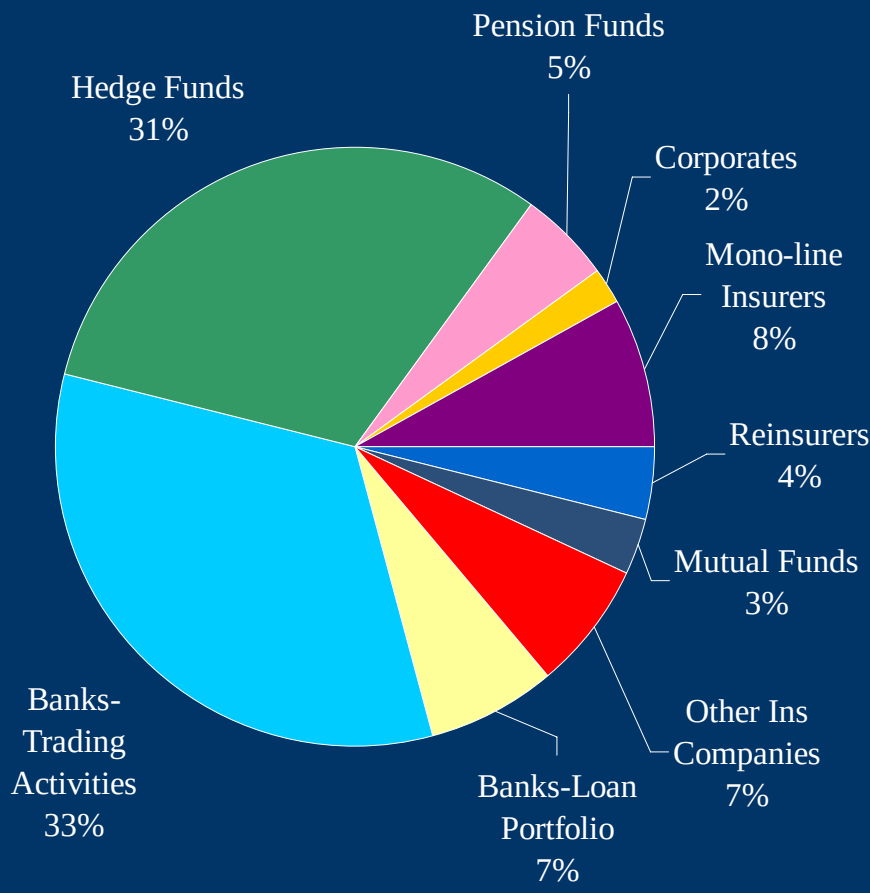
Source: BBA (1997-2000, 2004) and ISDA (2001-2006)

Credit Swap Market Participants

Protection Buyers



Protection Sellers



Source: Lehman Brothers Fixed Income Research High Grade - Credit November 2006

Risk Management

Credit and Operational Risks

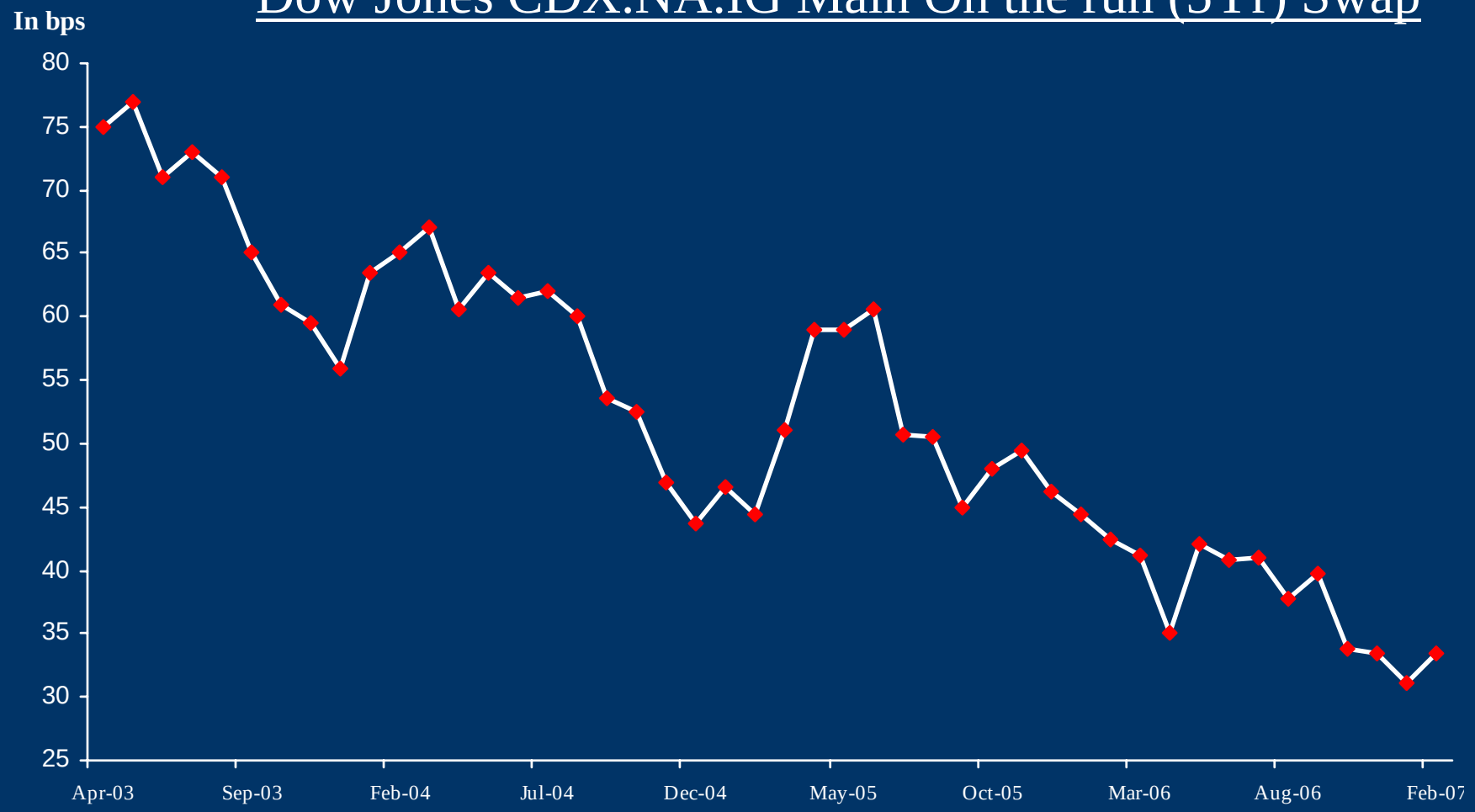
Legal and Operational Issues

- Legal contracts/ISDA masters
  - Enforceability and definitions
- Confirmations
  - Outstanding confirmation issue
- Settlement upon Credit Events
  - Cash versus physical settlement

Historical and Current Credit Market Environment

Credit Spread Trend

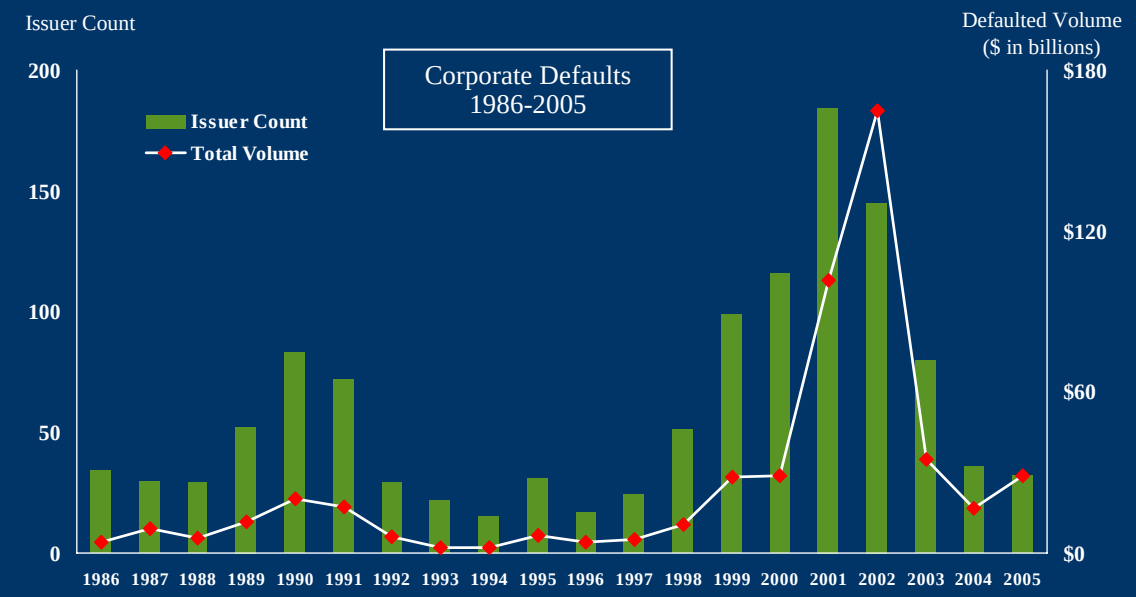
Dow Jones CDX.NA.IG Main On the run (5Yr) Swap



Source: JPMorgan

Primary Driver of Credit Spreads

Perceived Benign Credit Environment As Measured By Defaults



Liquidity and Search for Yield

Source: Moodys Default and Recovery Rates of Corporate Bond Issuers, 1920-2005 – January 2006

Source: Lehman Brothers Research – July 2006

Credit Risk Environment

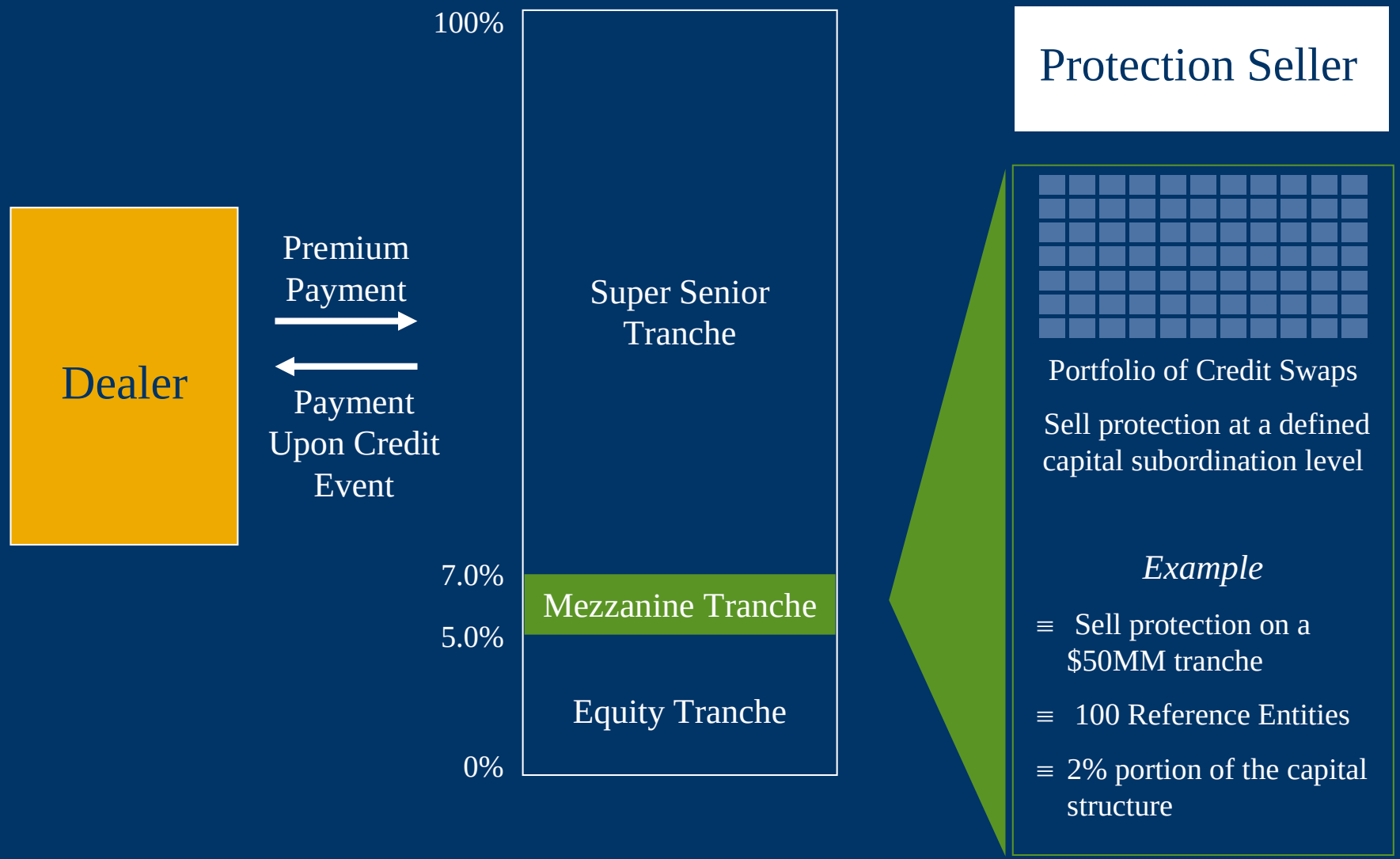
- Overall Economic Environment
  - Slowing growth
  - Increasing downgrade / upgrade rating actions
- Increasing Corporate Relevering
  - Leveraged Buyouts (LBOs)
- Increasingly Complex Structural Leverage

New Development:
Credit Swap Tranches

What Is a Credit Swap Tranche?

- Pool of underlying credit swaps
- Customized transaction
- Defined capital subordination
- Defined portion of the capital structure

How does a tranche work?



New Development:
Credit Derivative Product Companies
(CDPC)

What is a CDPC?

- ≡ AAA rated special purpose Operating Company
- ≡ Seller of credit protection
- ≡ Diversified portfolios and dynamic capital structures
- ≡ Targeted to generate attractive returns on equity

CDPC Requirements

- Counterparties
- Equity capital to meet capital model requirements
- Debt capital to enhance returns on equity
- Operating Guidelines – agreed with Rating Agencies
- Management team
- Operating platform

CDPC Competitive Landscape

- Primus Financial Products LLC – 2002
- Athilon – 2004
- Invicta Credit LLC – January 2007
- Other Potential
  - Newlands Financial
  - Pallium Investment Management
  - 6 to 8 credible groups

Conclusions

Conclusions

- Credit swaps market continues to grow rapidly
- New structures (e.g. tranches)
- New underlyings (e.g. ABS)
- New market participants (e.g. hedge funds, CPDC's, structured investment vehicles)