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*J.P. Morgan's Choudhry on Credit Derivatives (Transcript)*
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New York, Oct. 9, 2002 (Bloomberg) - Moorad Choudhry, Vice President of structured finance services for J.P. Morgan Chase & Co. in London, talks with Bloomberg's Terence Flanagan about the credit derivatives market, the growth in synthetic collateralised debt obligations (CDOs) and the outlook for the market in Europe and the U.S.

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FLANAGAN: Good morning, welcome to the Bloomberg Forum. My guest today is Moorad Choudhry. Moorad is Vice President in structured finance services for J.P. Morgan Chase in London. Moorad, good morning, thanks for coming in.

CHOUDHRY: Good morning, my pleasure.

FLANAGAN: First off, tell me a little bit about what it is you do. A lot of people may not quite understand. It's somewhat complex. What exactly do you do? What is your function at J.P. Morgan?

CHOUDHRY: Well, I work on the sales side of the department of structured finance services, part of the trust services arm of J.P. Morgan Chase Bank, based in London. And basically, we service the structured finance market - the London office will service the European market. And by structured finance, I mean debt market securitization products, asset-backed securities, mortgage bank securities, and the subject of most topical interest at the moment, collateralized debt obligations.

FLANAGAN: OK. Now, why have these instruments become so popular, in your opinion, over the last couple of years?

CHOUDHRY: Well, on the synthetic CDO side, which is really where the main focus is at the moment in terms of interest in - academic and media interest, that mainly reflects the flexibility of credit derivatives as instruments in their own right by using credit derivatives in a - and combining it with securitization technology. Originators of securitization deals are able to effect synthetic securitizations, which are much more flexible, or certainly can be tailored more flexibly to meet individual issuer and investor requirements, and because of this flexibility, we've seen many different variants of the synthetic CDO developed in the last 12, 18 months or so.

FLANAGAN: OK, now, what are some of these different variants we've seen developed?

CHOUDHRY: OK, well, if you take the first type. Basically, securitization was, previously, prior to credit derivatives technology being introduced, was a cash-based product. You would have a pool of assets, these can be bonds or loans, and these would be sold to a separate legal entity, a special purpose vehicle, the SPV. And these would then be - the SPV would issue the liability, issue the notes into the market, and what the originator has done is effected a true sale from its balance sheet onto the SPV. With synthetic CDOs, you don't have to undertake the true sale, you use credit derivatives to transfer the credit risk of these assets, these bonds or loans that are on your balance sheet, and that does the credit risk management for you without having to enter into the cash transaction.

Now, what we've seen - because of the flexibility of credit derivatives, is that different types of participants, like fund managers, are now using this technology and these instruments to enter into credit-type trading, or credit fund management on a synthetic basis, using credit derivatives.

FLANAGAN: OK, now are there developments in the European market that are different than the U.S. market, or do generally - do both move kind of together as far as the market evolving?

CHOUDHRY: Well, it's interesting. I think, generally, in debt markets as a whole, the U.S. is where everything happens first, and then that technology is transferred out into the rest of the world. But with synthetic CDOs, it would appear that the European market has actually developed these structures ahead of the U.S. market, and that's mainly because of the different legal jurisdictions that the European - the euro area operates under. In the U.S. market, you obviously have a homogenous legal jurisdiction and there is probably less, up to now, necessary demand to effect the synthetic securitization.

In Europe, because of the multi-jurisdictional aspects of it, using a synthetic approach enables originators to overcome some of the obstacles of doing this, and that's why we've seen, to answer your point, developments like the managed synthetic CDO and the hybrid CDO in the European market, ahead of us observing them in the U.S. market.

FLANAGAN: OK, now is there notional value you could put on the size of this market, and can we say how much it's grown in the last one, two, or five years?

CHOUDHRY: Well, it's certainly grown in terms of value, it's in the billions of dollars, but I couldn't give off the top of my head a value here. But it has grown quite phenomenally. If you were to look at a chart, I'm actually - the presentation I'm giving later today at the Wiz (ph) conference - if you look at the chart, you would see the growth doubling each year from about '96 onwards in terms of synthetic CDOs, and then, this year, probably tailing off a little, which reflects market conditions. And we'd expect to see that kind of growth again, I imagine, in the market as a whole over the next year again.

So the growth has been quite phenomenal in terms of synthetic CDOs and in the new types of participants that are entering into the market.

FLANAGAN: Now, the presentation that you're giving later today, what themes will you be talking about? Are they similar themes that we were talking about here, or what are the real key points that you'll be bringing up?

CHOUDHRY: Yes, essentially, what we're covering in overview fashion now. Basically, the flexibility of credit derivatives, I mean, the way one uses credit default swaps and total return swaps, as well as credit-linked notes, and combines that with securitization technology to effect the synthetic CDO. I'll be talking about that, and also, two case studies of some high profile deals that we've worked on as trustee and as servicer in the market. That's the Rebeco synthetic CDO, and the Jazz hybrid CDO as well.

So I'll be talking about those just as an informative lecture, in effect, so basically educating the rest of the market, people who aren't so familiar with these products, with what's going on in Europe.

FLANAGAN: OK, what types of market participants are there in these markets, and how has it been growing on both the investor and issuer side?

CHOUDHRY: Again, that reflects in its own way what's happening with the products and sales. There's basically a wider variety and more types of people entering the market. Initially, if you take static pool synthetic balance sheet CDOs where you had a bank at the originator, using credit derivatives to transfer it to credit risk or a part of its balance sheet, they would be commercial banks and the deal would be structured by an arranger.

As the technology and the variety of instruments has grown, we've seen fund managers, people who are specialists in managing corporate credits in the euro market, we've seen them enter the market and do the managed synthetic CDOs. You've seen, possibly, hedge funds coming in at some point, and we've seen the class of participants extending beyond commercial banks into fund managers and other type of fund institutions as well. And they're also employing this technology, now.

FLANAGAN: And if were to broaden out our discussion somewhat, just taking a look at overall trends in the credit market, we've seen credit spreads widen. There's been a certain real risk-aversion out there. Just wondering what factor, what impact, is this having on your market and what you cover and why is it happening like this?

CHOUDHRY: Well, certainly, yes, that's a good point. The CDO market in Europe, and I would imagine, worldwide, has been impacted by the slowing down of the economy generally, obviously, as one would expect. We've seen, as you said, corporate spreads widen. We've seen defaults in certain cash CDOs. We've seen downgrades in the liability side of synthetic CDOs, and the impact of that was, certainly in the start of this year, the market was a lot slower than at the same time last year. There were fewer deals coming to close, and investors were just a little more wary of new structures.

The impact - I think, the upside of that has been more and more investors are taking a bit more time to really get to know the product. I think there's been more of a demand from them that only people with a track record in effective and high-quality corporate credit fund management and in credit default swap - trading actually, credit derivatives trading, should be coming to the market with synthetic CDOs. And it's just resulted in more information being known and just a bit more wariness of the market, if you like. And this is a good thing in terms of going forward. Obviously, if you were holding paper of a CDO that's been downgraded or had a default in it, it's not such a great thing, but at least going forward people are more aware of what they're getting into.

FLANAGAN: OK, that leads me, Moorad, to my last question. What is your outlook for this market going forward? Do you see continued growth or will this be more restrained, shall we say?

CHOUDHRY: In the European market, I would say, because of the flexibility and the advantages of the product to the issuers and investors alike, I would probably say it picks up again. Once the economy is picking up, within the European market, I think you'll see more and more people on the issuer side, the originator side, realizing the value of using the synthetic approach as opposed to the cash approach in terms of ease of administration, lower cost, et cetera. And you'll see more investors, as they become familiar with the product, probably realizing that there is some value in it there for them.

I mean, we have to remember that a large number of parts of synthetic CDOs are very high quality, the super-senior piece on the default swap, the senior-rated note. They're very high quality and there is some value in there for investors, as well. So I would expect, as the economy picks up, we're going to see in the European market more issuance of these products, and also a greater number of participants coming in.

FLANAGAN: OK, we'll leave it there. Moorad, thank you.

CHOUDHRY: My pleasure, thank you.

FLANAGAN: I've been Terry Flanagan with the Bloomberg Forum. My guest today was Moorad Choudhry of J.P. Morgan

Chase's London office.

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