ISDA Goes West!
We were on the ground at the International Swaps and Derivatives Association’s San Francisco AGM Wednesday through Friday. Regulation and clearing were center stage.

See coverage, page 15 and at www.derivativesweek.com

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ISDA AGM
PROPOSED REFORM NOT TOO ‘UGLY’
The slew of proposed regulatory reform bills are not as bad as they could have been for the derivatives industry. That was a noticeable sentiment at the International Swaps and Derivatives Association conference in San Francisco last week as industry heavyweights gathered for the 25th AGM of the group.

Theo Lubke, senior v.p. at the Federal Reserve Bank of New York, characterized the current bills as “Goldilocks”—not too much and not too little. “The really ugly stuff is not in there,” said Ted MacDonald, treasurer of D.E. Shaw. “A lot of things are being left up to (continued on page 15)

VOL CONUNDRUM SOLVED?
An age-old problem that traders have encountered when trying to price options across different points in time using volatility estimates may have a solution from a team working for Paris-based financial markets software company Murex, which will publish rather than sell the formula. The firm’s head of global product development, who declined to be named because he is one of several who worked on the project, claims Murex’s solution will allow traders to more accurately price options between different maturity dates than before. (continued on page 16)

BOWLES BACKS NON-BANK LEVIES
Sharon Bowles, chair of the European Parliament’s influential Economic and Monetary Affairs Committee, backs the International Monetary Fund’s proposed global levies on non-banks in G20 countries. The levies would fund future bailouts, instead of taxpayers. The blessing of the influential policymaker will come as a blow to financial institutions operating in the E.U.

The IMF’s proposed tax—the revenues from which would held by the IMF—would consist of a flat value-added levy on the profits of all financial institutions and remuneration they pay out. Caught in the net would be players such as inter-dealer brokers, hedge funds (continued on page 16)

SEC’S HU LOOKS TO ADD TALENT
Henry Hu, a forecaster of the derivatives-driven crisis and head of the Securities and Exchange Commission’s new division overseeing risk, strategy and financial innovation, told Derivatives Week he has been deepening the unit’s bench of experts to stay on top of new and complex transactions. As the SEC’s self-professed “think tank,” Hu’s team has been working closely with Kenneth Lench, head of the enforcement division’s structured and new products unit. “I think Risk Fin has a huge amount of expertise in these particular products…We traditionally have investigated securities fraud and I think we are very good at that. But we can always use more forward thinking,” Lench told DW last week.

For the full interview with Hu, go to page 8

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At Press Time

Ag Bill To Snuff Out Muni Swaps?

A provision in the recently released Senate Agriculture Committee bill would impose a fiduciary duty on swap dealers transacting with municipalities and pension plans, and many industry players say this could destroy the already shaky market.

“It’s sort of like if you’re selling your house and you have a fiduciary obligation to the buyer; you’d have to concede to every request of the buyer,” said Michael Deck, co-head of municipal securities for the Securities Industry and Financial Markets Association. “The practical effect would be that it would create such a legal uncertainty and risk for dealers that all dealers would choose not to participate in municipal swaps.”

He said the provisions in the earlier Senate Banking Committee bill and House of Representatives bill provided workable alternatives, however. They would have required that swap advisors used by municipalities be regulated and then give the fiduciary responsibility to the advisor, not the counterparty. “You end up in a circumstance that’s workable, but provides a greater degree of protection [for munis] than they have under current law.”

Lawyers following the issue all said this is the first time that the law would give fiduciary duty to a counterparty instead of an intermediary. “They are being asked to do something that no party in a commercial transaction has ever been asked to do; and so that can only be to the detriment of all the participants in the market who benefit from the advantages that these transactions can bring to them when properly used,” said Larry Stromfeld, head of the municipal derivatives practice at Cadwalader, Wickersham & Taft in New York.

Fingers Point At Rating Agencies In Goldman Case

In the wake of the Securities and Exchange Commission’s complaint against Goldman Sachs, some market participants are asking why the rating agencies had not caught the poor quality of the portfolio sooner. “There’s very specific tranches of collateral being hand-crafted here—don’t the rating agencies have the ability to catch them?” asked one portfolio manager.

The SEC’s complaint alleges that Goldman arranged the ABACUS 2007-AC1 synthetic collateralized debt obligation at the request of Paulson & Co., which shorted the portfolio of residential mortgage-backed securities after influencing the selection of the portfolio to suit its interests. The lawsuit says Goldman led portfolio selection agent ACA Capital Management to believe that Paulson had made an equity investment in the transaction, when it had not.

The suit has led market watchers to wonder how the transaction had been so highly rated if it was of such poor quality. The A-1 and A-2 classes were rated Aaa and AAA by Moody’s Investors Service and Standard & Poor’s, respectively. Both classes are now rated Ca by Moody’s and D by S&P. “The rating agencies obviously rubber-stamped it,” said one broker. Then again, the entire market was chasing yield, he noted. “Everybody was reaching for garbage then. If a set-up was made an equity investment in the transaction, when it had not.

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Officials at Moody’s and S&P did not immediately respond to calls for comment. In a statement, Goldman said ACA selected the portfolio and that the bank “never represented to ACA that Paulson was going to be a long investor.”
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Basel III May See Funds Deal In More OTCs

Basel III proposals to increase capital charges for counterparty credit risk could give rise to unregulated entities such as hedge funds becoming market makers in the over-the-counter derivatives market, according to a report by Standard & Poor's.

Under Basel III, the existing dealers who make markets in OTC derivatives will have costly capital charges for not centrally clearing trades, according to Scott Bugie, managing director of financial services ratings at S&P in Paris. That means the more complex, bespoke OTCs, which cannot be cleared, could be offered by hedge funds which are not subject to those capital charges.

S&P believes the proposed regulatory capital charges under Basel III could be far higher than banks’ losses from counterparty risk exposure during the crisis. In 2008, less than 10% of bank losses were related to counterparty risk, but under Basel III firms would have to put up 20-25% of capital against any OTC trade.

The proposal, which is set to be implemented later this year, was being discussed by finance ministers at an International Monetary Fund meeting in Washington as DW went to press.

Euro Pols Call For 80% Clearing

E.U. politicians have called on the European Commission to require at least 80% of derivatives to be centrally cleared. The lawmakers want the requirement in the EC proposals to the Parliament’s Economic and Monetary Affairs Committee which are scheduled for June.

The proposals, which come in response to a legislative report on over-the-counter derivatives earlier this year by Werner Langen, member of the European Parliament for Germany (DW, 2/26), are likely to be scrutinized by clearing houses, who have warned the European Commission not to force inappropriate products for clearing.

Michael Hampden-Turner, a credit strategist at Citigroup in London, told Derivatives Week that it could be feasible that 80% of the derivatives market could be cleared, but warned that the process may take two years to be enforced. “The main thing is liquidity and that you have two-way pricing...where you have four or more market makers supplying prices to allow clearing houses to have a mark on each position,” he said. “There are also issues over setting up systems and giving IT training so that clearing houses can withstand huge volumes of trades and give banks the bulletproof solution they require.”

Other amendments to Langen’s paper call for European and non-European regulators to have access to data from trade repositories and clearing houses, and for the proposed European Securities and Markets Authority to have the power to ban naked credit default swap trading if necessary. "ESMA and the competent authorities [should have] a wide range of powers to effectively tackle dysfunctions in derivatives markets, e.g. banning naked selling of CDS or requiring physical settlement of derivatives...in order to stem speculation and avoid undue volatility," said Pervenche Beres, MEP for France, in response to the paper.

The Economic and Monetary Affairs Committee is holding a hearing on OTC derivatives regulation next Tuesday, with a focus
on end-user exemptions and trade supervision, before it submits its report to the European Commission and other global regulatory authorities. Speakers include Jean-Pierre Jouyet, chair of the Autorité des Marchés Financiers and Blythe Masters, head of global commodities at JPMorgan.

N.Y. CDS Bill Reaches Assembly
The New York state bill banning naked credit default swaps, where the user of the derivative has no economic interest in the underlying debt securities, and that would force the sellers of CDS to be licensed insurance carriers, reached the state assembly Wednesday.

The bill is primarily sponsored by state assemblyman Joseph Morelle (D-Rochester), who also chairs the National Conference of Insurance Legislators’ CDS taskforce, and is co-sponsored by 35 members of the 150-strong assembly. “Thirty-five is over a fifth of the whole body—that’s pretty sizeable,” Morelle told Derivatives Week. If the bill is voted on favorably by the insurance committee, the speaker of the assembly could assign the bill to other committees before it is finalized.

The 62-member state senate, which has received a draft copy of the bill (DW, 3/18), can act on the bill in parallel. Sen. Neil Breslin (D-Albany), chairman of the senate insurance committee, will likely push it through, according to Morelle. Democrats have the majority in both houses. Under state law, identical bills have to pass both houses before they go to the state governor for action, so any amendments will be taken in simultaneously in both houses.

Morelle said there will be no delays to consider developments on derivatives regulation at the federal level. “We’ve been working on [this] for a couple of years, and we’ve said from the beginning that we are going to move in a thoughtful way,” he said. “Congress is woefully behind. There are too many still asking fairly simplistic questions…They seem focused on taking their anger out on election-day rhetoric.” So far, only the language recently released by the Senate Agriculture Committee would appear to preclude states from regulating swaps in the way the New York bill proposes, because it addresses end user insurance laws specifically.

A central tenet of the New York bill is that CDS should be regulated as insurance, something that has been hotly debated in the past. Many industry players say that CDS is not insurance because the buyer does not have to suffer a loss to be paid out, whereas Morelle contends there is almost no way to describe CDS without using the word ‘insurance.’ In addition to halting the sale of CDS where there is no material interest in the underlying debt corresponding to the swap, his bill seeks insurance-sector like reserving requirements for all CDS market makers.

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People & Firms

Equity Bigwig Departs UBS

Makram Fares, head of equity derivatives distribution at UBS in London, resigned last Monday, reportedly to join Nomura.

Fares was behind the build out the firm’s portfolio sales and trading team, including hiring Oliver Hesse from Citigroup as head of European sales for portfolio trading. William Kennedy, head of European equities at UBS in London, to whom Fares reported into, was not available for comment at press time.

Senior Rates Trader Departs HSBC

Ian Phung, a senior emerging markets interest rates trader at HSBC in Hong Kong, left the bank two weeks ago. He reported to William Shek, who runs the emerging markets rates trading desk in Hong Kong. Phung is tipped for a rates trading spot at a European bank.

BBVA Sales, Trading Chief Departs

Shawn Riley, head of equity Asia sales and trading at Banco Bilbao Vizcaya Argentaria, has left the firm. He was based in Hong Kong and joined in 2007 from Nomura where he was an equity trader (DW, 9/21/07). The firm has hired a replacement who will head up trading, said a person with knowledge of the situation, declining to comment further.

Ex-CIBC Credit Staffer Joins Broker

Sabrina Schittone, a senior structured credit saleswoman formerly with CIBC World Markets in London, has joined brokerage firm Yorvik Partners in a similar role. She left CIBC in 2008 but her whereabouts over the last year could not be gleaned. In her new role at Yorvik, she will report to Simon Mullaly and Lars Lemonius, joint founders.

Ex-Goldman Credit Salesman Tipped For CS

David Ezra, a senior credit salesman formerly with Goldman Sachs who joined London brokerage Mint Partners last month (DW, 3/11), has left and is reportedly set to join Credit Suisse in a new role.

He was hired by Mint to form a structured credit and illiquid bond sales desk. It could not be determined why he left and Tim Valmas, managing director at Mint in London, was not available.

It is understood Ezra will join Credit Suisse in the next few weeks in a senior role covering sales into France. He will report to Nick Kyprios, head of European credit sales.

Pru Unit Creates Quant Role

Prudential Fixed Income, a unit of Prudential Financial, has hired Bjorn Flesaker to lead its quantitative modeling effort. In the newly created role, Flesaker heads up quantitative research and the team that develops investment strategy models for clients. He comes to the firm from Bloomberg, where he worked as a credit derivatives business manager and before that as a senior member of the quantitative research group. At Pru he reports to Arvind Rajan, head of quantitative research and risk management in Newark, N.J.

Calyon U.S. FI Sales Chief Leaves

Robert Popowski, the U.S. head of fixed income sales at Crédit Agricole Corporate & Investment Banking, formerly known as Calyon, has resigned. Calls to a Calyon spokeswoman and Popowski were not immediately returned and information on his destination or any replacement could not be learned.

ICAP Pockets GFI Exec For Inflation

Interdealer broker ICAP has hired Phil Barker, a senior v.p. in property derivatives at GFI Group in New York, to oversee its fledgling inflation derivatives desk. Barker left GFI in January and joined ICAP earlier this month in the newly created role, reporting to Dan Flannery, president of ICAP Securities.

A spokesman for ICAP declined to comment, as did Barker. Market watchers said the firm is already a leading broker in Treasury inflation-protected securities, or TIPS, and has been harboring a desire to expand into inflation derivatives for some time. One observer added that Barker’s experience and contacts in property derivatives would serve him well in inflation derivatives, because the two markets are well correlated. Before GFI, Barker had a trading background and was the global head of precious metals trading at Royal Bank of Canada.

BNP Taps JPMorgan FX Structurer

BNP Paribas has added Vasilis Koutsafitis from JPMorgan as a director in its fx and interest rates structuring group in New York.

The hire is part of the firm’s push to become a top five player in fx; it is currently in the top 10. “That requires firing on every cylinder and being involved in every aspect of foreign exchange, including exotic currencies, hybrids and prime brokerage activity,” said George Nunn, managing director in fx and rates structuring, to whom Koutsafitis reports.

Koutsafitis joined April 5. He had previously spent three years at JPMorgan as an fx options structurer in New York, most recently at the v.p. level.
Asia Pacific

NDFs Price In More Yuan Appreciation

The non-deliverable forwards market has been pricing in greater yuan appreciation against the U.S. dollar on the back of increasingly strong indications that China will deppeg its currency from the dollar and subsequently allow its currency to strengthen over time.

Twelve-month USD/CNY non-deliverable forwards were trading at CNY6.6 last week, whereas a month ago spot was CNY6.7.

Li Daokui, an advisor at the People's Bank of China, said on Friday that China had reached a consensus on adjusting its exchange rate. The yuan will likely be allowed to appreciate gradually with a wider trading bandwidth and enjoy "more flexibility over the medium and long term," he said. His comments were backed up by China's President Hu Jintao, who said that China will adopt a floating exchange-rate system.

CS Preps Excess Participation Notes

Credit Suisse is set to launch a new equity structured product for institutional and wholesale investors in Australia called the Investment Accelerator.

It allows for excess participation in a single stock or basket of stocks as long as the performance of the underlying is positive over the life of the note, typically three to five years. To get the excess participation, however, the investor has to surrender the dividends on the underlying stock or stocks. If the performance of the underlying is negative, the investor's participation is capped at 100%.

Investors have the option of getting exposure to major stocks in the U.S., Australia, Hong Kong and Singapore, for example. A spokesman for the bank declined to comment on the structure.

Nomura To Grow Indian Sales

Nomura plans to bulk up its fixed income, currency and commodities sales force in India. Dhiren Mehta has been hired from Citigroup to head up FICC Indian sales and direct the push. Mehta, who worked at Citi for 16 years, will start in the newly created position in about two months.

Exact numbers for the build-out could not be determined. The firm has already announced it is increasing headcount in Asia Pacific fixed income sales by 125 (DW, 1/14).

At Nomura Mehta will report to Neeraj Gambhir and Nitin Jain, co-heads of fixed income in India, and regionally to George Sun and Samir Bhandari, who oversee fixed income sales for Asia Pacific ex-Japan. Mehta's last role at Citi was as a director of emerging markets credit trading. A spokeswoman for Nomura declined to comment.

HK SFC To Stand Firm On Retail

The Hong Kong Securities and Futures Commission is set to largely brush aside pleas from the market for restraint on its proposals on unlisted retail structured product regulation.

The sell-side had until the end of December to respond to the regulators proposals it published in September last year. The SFC will confirm by the end of the second quarter its plan but it recently prepped the International Swaps and Derivatives Association that it had little intention to move far on the topics, say people made aware of the situation.

Key areas of contention include the disclosure of commissions by intermediaries, the introduction of a cooling off period and strict collateral requirements for special purpose vehicles used in the sale of a number of structured products. “The SFC has listened hard to our concerns but appears it has chosen to ignore them,” said one lawyer in Hong Kong. “Apart from a few minor legal points, it seems the SFC isn’t moving too far.”
Henry Hu, head of the Securities and Exchange Commission’s new division overseeing risk, strategy and financial innovation, told Derivatives Week he has been working closely with other SEC units, such as enforcement, and that he is deepening the unit’s bench of experts to stay on top of new and complex transactions. The interview, by Managing Editor Katy Burne, also features Adam Glass, the division’s co-chief counsel.

KB: What is the job of the new division exactly? Will you be recommending new standards, or enforcing them too?

HH: Risk Fin offers a multi-disciplinary approach across the full range of SEC activities. As you know, the SEC has long operated in large part through four divisions: corporation finance, enforcement, investment management, and trading and markets. We’re the first new division at the SEC since 1972—since before the emergence of the modern derivatives revolution.

We provide input as to all new rules adopted by the SEC—whether or not related to risk or financial innovation—as well as work with the enforcement division and other offices with respect to their activities. In terms of adopted or proposed rules, we’ve been involved in such matters as money market funds and asset-backed securities. In terms of enforcement matters, we’ve been helping in such litigation as the current insider trading case involving credit derivatives.

We have experts in the economic, legal and public policy implications of the complex new financial products being crafted on Wall Street. But perhaps more significant than this, our division is working behind the scenes when new, interdisciplinary insights or specialized expertise could be helpful to decision-making at the SEC. Such insights or expertise can be helpful, for instance, in addressing financial regulatory reform. SEC Chairman Mary Schapiro and others have referred to Risk Fin as the SEC’s think tank.

KB: How much of Risk Fin’s resources will be allocated towards studying or monitoring derivatives activities?

AG: We have certainly been involved in considering questions relating to legislation that would bring over-the-counter derivatives into the regulatory fold, as well as questions on OTC derivatives under existing law. One of the reasons for creating Risk Fin was to add the skills of those who’ve engaged in OTC derivatives transactions, have written about such transactions, or otherwise have knowledge in this area to the SEC’s toolkit.

KB: Will you work in liaison with other units within the SEC, other U.S. governmental agencies, or even international regulators?

AG: There is extensive cooperation with other divisions/offices within the SEC and other financial regulators, here and abroad.

KB: Can you expand on your hiring goals for the unit as it relates to derivatives expertise?

AG: We are continuing to look to hire across the seniority spectrum. These could be people with Ph.D.’s in, say, economics, finance, or statistics. They might be rookies, hired straight out of graduate school, or chair-holders with tenure. We will also hire people with market expertise who may not have Ph.D’s. Last but not least, we are looking for college graduates with deep math and computer coding skills and a few years in the financial markets.

KB: Are you looking for more legal experts?

HH: Adding to the SEC’s existing bench of people with non-traditional skill sets can be helpful with respect to the entire range of SEC policymaking, rulemaking, enforcement, and examination activities. With Risk Fin’s creation and initial staffing, there are now some more experts in the economic, legal, and public policy implications of modern financial innovation. Here on in, I think that Risk Fin’s hiring is likely to skew heavily to those with highly quantitative backgrounds, such as Wall Street finance professionals or economics/finance academics.

KB: Some have blamed the whole of the financial crisis on derivatives, in particular credit default swaps on subprime, and others have said that the OTC derivatives market aggravated the crisis, but was not the root cause. What’s your view?

AG: The causes of the financial crisis are complex and manifold. Things like irrational exuberance, excessive faith in the ability of markets to self-correct, subprime lending in the U.S., and the fragility of the interbank repo market may have been some of the factors. Personally, I suspect that CDS on subprime may have intensified the damage from the subprime bubble, both by prolonging it and by raising the gross (but not net) exposure of the financial markets to subprime.

KB: Professor Hu, you warned in a 1993 article about the risk of derivatives contributing to a financial crisis. What did you say then? And do you believe derivatives could cause another financial crisis?
HH: I do not want get into causation issues here. I do believe that the clearinghouse arrangements and increased transparency of the general sorts being considered in Congress can contribute to reducing the systemic risk concerns posed by derivatives.

But that Yale Law Journal article, ‘Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism,’ suggested certain factors can cause sophisticated financial institutions to take undue risks and make other errors as to complex financial products. The article also offered certain regulatory responses.

For instance, it discussed cognitive biases such as the “availability effect” and the tendency to ignore low probability-catastrophic events. It also focused on highly asymmetric compensation structures, which are especially worrisome if the risks are opaque and arise years later. It also showed the significance of financial “science” departing in fundamental ways from, say, physics. It discussed how “inappropriability” effects that cause under-investing in scientific basic research can cause capital market participants to under-invest in understanding complex financial products.

As for regulatory responses, it proposed, for instance, the creation of a centralized, governmental informational clearinghouse relating to derivatives. This article came up both in my Congressional testimony in 1998 relating to the collapse of the hedge fund Long Term Capital Management and, prior to my arrival at the SEC last year, my Congressional testimony relating to American International Group and the global financial crisis.

KB: Regulators the world over are trying to rein in the OTC derivatives market. Is there a danger of over-regulation to the point that users of derivatives for legitimate risk management purposes may be harmed? For example, with capital charges that make it prohibitively expensive for end users to hedge?

HH: In fashioning regulation in this area, it is important to consider not only the systemic risk and other issues associated with derivatives but also the risk management and other benefits that can flow from derivatives. A balance is involved.

KB: Do you think the industry has achieved a lot through self-regulation already, for example by reducing confirmation backlogs, and standardizing CDS for clearing? Or do those steps only scratch the surface, so that more of a push is needed from regulators?

HH: There is no question that operational risk has been reduced in the credit derivatives market. But it should be pointed out that sustained regulatory pressure was critical. Some functions markets perform best, while some functions regulators perform best.

KB: You have written, with University of Texas Professor Bernard Black, about “empty creditors” and “empty voters.” How should the concept of the empty creditor hypothesis be addressed?

HH: In 2007, I coined the term “empty creditor.” One example of an “empty creditor” would be a creditor who has the control rights flowing from a loan agreement or bond indenture but, because of credit default swap holdings has no economic stake in the borrower’s survival. The term “empty voter” was coined in a co-authored 2006 article. Roughly speaking, an empty voter is a person who has substantially more voting rights than his or her economic stake would normally justify. That is, his votes have been “emptied” of a corresponding economic interest.

These phenomena are examples of “debt decoupling” and “equity decoupling.” Corporate governance, “debt governance, ” and systemic risk issues can arise. Derivatives Week readers wanting more information can, for instance, look at my April 2009 Wall Street Journal op-ed or the 2008 University of Pennsylvania Law Review and 2008 European Financial Management articles. I should emphasize that all these were written prior to my coming to the SEC.

KB: Some argue that central counterparty clearing concentrates risk, when the purpose of it is supposed to be to reduce risk by having clearing members be exposed only to the risk of the clearinghouse, rather than other market participants. What is your view?

AG: As the primary regulator for all securities clearing agencies in the U.S., the SEC has substantial experience with the regulation of clearing. The U.S. has both concentrated (in the equities and listed equity options markets) and decentralized (in the commodities options and futures markets) clearing models. The SEC realizes the importance of risk control in clearinghouses.

"Here on in, I think that Risk Fin's hiring is likely to skew heavily to those with highly quantitative backgrounds, such as Wall Street finance professionals or economics/finance academics."

—Henry Hu, SEC's Division Head
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Gaining Perspective On CDS Liquidity

On the day when KfW wired EUR300 million to the defaulted Lehman Brothers, it became clear that a new regime for risk control and counterparty risk assessment was imminent. No longer could the middle office operate in an end-of-day or end-of-week environment while the front office operated in real-time. This article illustrates how an institution can significantly enhance its ability to actively manage counterparty credit exposure by using credit default swap information provided by the Credit Market Analysis (CMA) independent CDS data service. It will also introduce CMAs market activity indicators, which provide information that is not contained in CDS pricing, but which can have a significant and valuable impact on counterparty credit assessment.

The Evolution of Counterparty Credit Risk Assessment

For a long time, counterparty credit assessment was largely outsourced to the big three credit rating agencies and was subject to a rather static approach in its implementation. Recent credit market turmoil exposed some potential shortcomings, however. Credit ratings alone simply did not satisfy the increasing need for enhanced transparency and near real-time risk monitoring. Their long credit evaluation cycles could not provide a timely and responsive flow of relevant information to market participants who had found themselves holding large exposures on rapidly deteriorating credits. So institutions that needed an up-to-the-minute picture of credit risk began to look beyond the rating agencies for other methods to assess their credit and counterparty exposures.

In pursuit of a more timely and accurate assessment of their credit and counterparty risk, institutions turned their attention to credit derivatives. Here the strength of individual credit is evaluated on a near real-time basis and opinions are backed by the capital exposure of those who buy or sell exposure in the reference credit. While the limited outstanding debt notional in the corporate bond market often mitigate its pricing efficiency, the CDS market, with its ability to write protection on gross notional that are multiples of the reference entity's outstanding debt, became the natural venue for firms who needed a responsive and reliable source of credit assessment information.

Understanding CDS

Due to the over-the-counter nature of the CDS market, the ability to access reliable pricing data and trading information is a challenge for market participants. In contrast to exchange-traded markets, the mechanics of CDS data collection plays a significant role in the value of the information that may be extracted from CDS market data.

While genuine transactional data (so called “Level 1” pricing) is available for only a very limited number of single name credits, trading in a majority of single-name credits occurs with very little recording. Although a few CDS data vendors provide aggregations of book and record figures, these figures lack a direct connection to CDS front-office activity. Assessment of the reference credit then relies on using CDS pricing alone, without transparency on the underlying market activity. So “Level 3” data may not say much about the market's perception of the underlying entity's probability of default. “Level 2” CDS pricing data is available from CMA, and is originated close to real time from market makers.

In order to fully comprehend the market dynamics surrounding specific reference entities, it is important to monitor the price of protection in conjunction with information on the size and scale of market activity around a particular credit. By monitoring sudden drops or rises in market interest in a given credit, one can gain a much better understanding of how CDS market players are reacting to new information. More importantly, one can gain this understanding in the early stages of credit deterioration, or optimally, prior to it. As we will demonstrate with a few examples below, levels of market activity can be much more reactive to new information than price levels and can provide a leading indicator of future price movements. Alert signals can also bring a counterparty's name to the attention of the risk managers.

Monitoring CDS Using Quoting Patterns

It is challenging to obtain a timely source of CDS transactional history, containing both price and liquidity information. When trying to track CDS trading activity, we must therefore rely on data that is closely related to trading patterns. The measures presented in this article, are based on patterns of information flow between CDS market makers and investors. We suggest that by looking not only at what prices are being quoted, but by looking at how often, and to how many counterparties a given credit is being quoted, one can effectively monitor levels of market interest in a particular entity.

In order to analyze the CDS market quoting patterns, we use market activity indicators sourced from our dataset. The remainder of this article demonstrates how CMAs CDS price and market activity indicators can enhance market monitoring.
processes as well as active counterparty credit risk management.

**Market Activity Indicators**

In contrast to other CDS data providers, CMA's dataset is collected directly from the trading desks of buy-side CDS market participants. Based on this market data, CMA produces intraday and end-of-day consensus pricing for the entire liquid CDS market.

CMA's market activity indicators reflect various dimensions of market makers’ quoting patterns. We assume market makers will provide indicative quotes more frequently and to a wider range of clients when facing increased trading activity in a particular reference entity. Even if the consensus price of CDS protection remains generally unaffected, increased quoting activity may signal that a larger segment of the market has begun to take a view on, or an interest, in the underlying credit.

Let's take a closer look at two examples of a quoting pattern that can be used to draw inferences about a specific reference entity or a sector of reference entities. These examples should demonstrate how significant changes in quoting patterns could have raised institutions' attention to possible issues with the reference credit.

**1. When did the CDS market get interested in Lehman?**

Both examples illustrate the use of the “Quoting Frequency” (QF) indicator. QF specifies how many price quote aggregations have been produced by contributors in a day. Each trading desk contributing data to CMA does so only if a particular CDS contract is quoted by multiple market makers within a day. Based on these quotes, an aggregation is produced. With each additional price level update from one of the market makers, or from an additional market maker, a new aggregation is produced, increasing the Quoting Frequency. The QF is therefore positively correlated with the number of indicative price updates received by CMA's clients from their market makers.

We assume that the CDS market follows normal supply and demand dynamics. Market makers will therefore quote prices more frequently if there is a higher buy-side interest in obtaining or providing protection on a given credit.

In Figure 1, the proxy for market interest (QF: a solid red line) and the protection price (five-year CDS contract price: a black dotted line) are plotted for the senior unsecured debt of Lehman Brothers. Lehman's five-year CDS price was stable until mid-2007. Following Bear Stearns' announcement on subprime-related losses in July 2007, Lehman's CDS spiked above 50 bps for the first time, indicative of the rising concerns of credit market participants. But was this the first moment when the CDS market started to sit up and take notice of Lehman?

No. The QF indicator signalled a sharp rise in the market’s interest in gaining protection on Lehman six months ahead of its CDS price hike. The sharp rise in QF coincided with losses announced by HSBC in February 2007. We may speculate that CDS market participants were sensitive to the implications of the HSBC announcement for other financial firms with large sub-prime exposures. Hence they became actively concerned about the credit standing of these firms and began to research and examine CDS protection.

The implications the announcement had on individual credits becomes more obvious when looking at Figure 2. While the QF indicator for Deutsche Bank remained stable after Jan. 2007, Lehman's QF spiked five-fold, a pattern also repeated for Merrill Lynch and Morgan Stanley. During the following two years, these three firms either went bankrupt, sought emergency rescue, or accepted multiple capital injections from the private and public sectors.

This data suggests that a sizeable portion of the CDS market began to anticipate the risks related to the sub-prime market as early as February 2007. By identifying the escalating CDS market

<table>
<thead>
<tr>
<th>Fig. 1</th>
<th>Number of Quotes per Day vs Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lehman Brothers 5Y CDS</td>
<td></td>
</tr>
<tr>
<td>Quotes per Day (left axis)</td>
<td>Mid Price (right axis)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Fig. 2</th>
<th>Daily CDS Quote Frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selected Financials</td>
<td></td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>Merrill Lynch</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Fig. 3</th>
<th>Price of Protection</th>
</tr>
</thead>
<tbody>
<tr>
<td>5Y CDS on Selected Financials (in bps)</td>
<td></td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>Merrill Lynch</td>
</tr>
</tbody>
</table>
activity in those names, a client monitoring CDS market activity indicators would have had a head start in analysing the underlying motivation and addressing relevant counterparty exposure.

Further breakdown of the market activity indicators by maturities would have shown a substantial increase in the QF levels for non-five-Year maturities over the first half of 2007. This suggests that market participants were choosing contracts with maturities specific to their existing exposure in order to hedge that exposure, rather than taking a speculative view on the affected credits.

2. Greece
In order to provide a more recent example, we have chosen to analyse the CDS data on Greek sovereign credit. For some years Greece has experienced severe difficulties managing its fiscal position, resulting in a massive level of national debt. Most recently there have been concerns regarding Greece’s ability to refinance its debt in public markets and concerns that it would need to seek the support of either the E.U. or the International Monetary Fund. Intense media scrutiny of Greece’s fiscal position started in early December as the price of Greek government bonds began plunging. As a result, many institutional investors exposed to Greek sovereign credit suffered substantial losses.

In Figure 4 we can see how the protection price for Greece (the gray line) started gradually rising in early November, slowly reacting to the first news about the EU’s concerns about Greece’s debt problems. However, a much clearer picture about CDS market reaction over the period of November is provided by the QF indicator (the solid black line). We can see that QF for contracts on Greece rose five fold through the nine days (Nov. 10-19) after the first news on EU’s concerns were made public. The QF rose from 477 quotes a day, to an enormous 1529 quotes a day. In Figure 5 we can see that through this period quoting activity increased around Germany as well, as it had indeed for most of Eurozone countries. However, Greece saw the biggest increase in QF levels by a significant margin, followed by Portugal. Notice that QF levels on countries outside eurozone, such as Poland, remained unaffected.

Fig. 5

The QF figures suggest that substantial market interest in Greece and other eurozone countries developed during the week prior to Nov. 19. Over the two or three weeks following Nov. 19, we can observe further widening of the basis between Greece and Germany CDS spreads in Figure 5. Note that the Greece/Germany basis can be seen in Figure 4 as well. The period was concluded with a substantial widening of the bond yield basis in early December.

We can conclude that the QF figures provided an early and strong signal on the changing market perception of eurozone credits, particularly Greece, as early as on Nov. 19. This change of perception was most clearly seen around countries with high debt to GDP ratios. However, it took almost three weeks until the CDS spread for Greece broke through the 200bp level and started rocketing towards 400. During the three weeks leading up to Dec. 9, any investor monitoring signals from the CDS market could have taken the opportunity to assess the magnitude of the issues that Greece was starting to face, draw relevant conclusions, and apply active measures to mitigate the increasing risk of credit deterioration.

Conclusion
In order to track CDS market activity in individual credits, we chose to analyse CDS market quoting patterns using data sourced from CMA’s unique dataset. Through a combination of CDS price data and market activity indicators, risk managers can develop a more complete risk profile of specific reference entities.

CMA’s data can help identify changing market interest in a given credit by highlighting changes in CDS quoting patterns, before these changes translate into price movements. The examples of Lehman Brothers and Greece demonstrate how these market activity indicator changes provided additional signals on those entities before a significant price shift took place.

Monitoring these changes can trigger early warning signals, leading to a qualitative review on the underlying reference entity.

This Learning Curve was written by Michal Koblas, head of quantitative research for CMA.
Foreign Exchange & Credit Derivatives Markets

Exotic Dollar/Yen Plays Surface

A handful of six-month discrete one-touch options hit the market early last week in anticipation the U.S. dollar will continue to strengthen against the yen. The options surprised market watchers, who note the hedge fund buyers usually opt for more vanilla one-touch options, although they are more expensive, offer a greater possibility of receiving a pre-agreed premium when the barrier is reached.

Discrete one-touch options also have one barrier, but they can only be triggered on a number of predetermined fixing days, at which point if the Federal Reserve Bank of New York sets the closing exchange rate beyond the barrier, there is payout. They are cheaper than one-touch options since there is a lower probability that the barrier will be touched given that there are fewer days for the barrier to be triggered, so end-users try to use them whenever they think the chances of that happening are high. The options, which were struck on Monday and Tuesday with spot around JPY92, had upper barriers set at around JPY98. Payouts and premium rates could not be gleaned. By press time, the yen had weakened to JPY93.2.

One currency option trader in London told Derivatives Week that funds began to execute the trades on the back of the news that Goldman Sachs had been charged with civil fraud by the U.S. Securities and Exchange Commission, causing investors to turn to safe-haven currencies, such as the yen. “The yen gained on the back of this, but people knew that it was short term and that a discrete one-touch option on the pair was a cheap and effective way of locking in a tasty premium,” he said.

Olivier Korber, currency options strategist at Société Générale in Paris, who expects spot on the pair to hit JPY100 by September, was not surprised by the uptake in discrete one-touch options as investors look for a cheaper way to lock in a profit, although he added that there were even cheaper alternatives. “We are advising a call spread over a one-month or two-month period, which is even cheaper,” he said. “However, if you are looking to gain more leverage over a longer period, then you should go for the one-touch option.”

Hans Redeker, global head of fx strategy at BNP Paribas in London, said that over the long term the market is preparing for a weakness in the yen to continue. “The country has a huge debt burden and is stuck in deflation, while it will also have to raise taxes so that it meets bond repayments, which will negatively impact the yen.”

Greek CDS Break 600bp

Five-year credit default swaps on Greece gapped out dramatically Thursday to a record 601 basis points from a close of 485.7bp as it emerged that the level of the country’s debt was worse than first feared.

Eurostat, the E.U.’s statistic office, revised Greece’s 2009 deficit to at least 13.6% of gross domestic product from 12.7%. On the news, Moody’s Investors Service downgraded its rating on Greece’s debt to A3 from A2, warning of further downgrades in the near term.

Despite the move in CDS levels, trading was muted. One CDS trader in London, who was quoting CDS on Greece at 650bp, told Derivatives Week that the levels were expected to hold at 500bp as news surfaced that yields on the country’s bonds had reached 10.1%. “If that wasn’t enough, then you had the Eurostat news in the afternoon, followed by the [Moody’s] downgrade and people rioting in the country over the economic situation … it’s just panic stations all round,” he said. “If we don’t hear of some good news soon, you could have the CDS trading past 750bp by Monday morning.”

Peter Chatwell, a fixed income strategist at Credit Agricole CIB in London, agreed that CDS on Greece could widen further, and that the lack of clarity on when an E.U. and International Monetary Fund rescue package would be activated was driving CDS on other European sovereigns wider. Five-year CDS on Spain for example, whose fiscal deficit is also under scrutiny, reached a new record high of 175bp from a close 171bp, according to CMA DataVision.

“Greece has to do something that shows the market that it is committed, such as getting access to a bridging loan for example, which will stem the flow of fear,” said Chatwell.
Market Data

**Equity Data**
This table reports current levels and one-week changes of at-the-money implied volatilities at 3-month and 12-month tenors for eight equity indices in the U.S., Europe, and Asia. For comparison, we also list 3-month and 12-month historical volatilities based on daily returns in the underlying indices.

<table>
<thead>
<tr>
<th>Index</th>
<th>3M ATM</th>
<th>1-wk chg</th>
<th>12M ATM</th>
<th>1-wk chg</th>
<th>3M Hist</th>
<th>12M Hist</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>16.3%</td>
<td>0.0%</td>
<td>19.8%</td>
<td>0.7%</td>
<td>13.6%</td>
<td>17.7%</td>
</tr>
<tr>
<td>Eurostoxx 50</td>
<td>19.4%</td>
<td>0.5%</td>
<td>22.0%</td>
<td>0.9%</td>
<td>18.9%</td>
<td>21.4%</td>
</tr>
<tr>
<td>FTSE 100</td>
<td>18.5%</td>
<td>0.7%</td>
<td>18.6%</td>
<td>0.6%</td>
<td>18.6%</td>
<td>20.3%</td>
</tr>
<tr>
<td>Nikkei 225</td>
<td>19.2%</td>
<td>0.5%</td>
<td>21.2%</td>
<td>0.6%</td>
<td>18.6%</td>
<td>20.3%</td>
</tr>
<tr>
<td>Hang Seng Index</td>
<td>21.0%</td>
<td>-0.1%</td>
<td>23.1%</td>
<td>0.1%</td>
<td>19.6%</td>
<td>25.0%</td>
</tr>
<tr>
<td>KOSPI 200</td>
<td>17.8%</td>
<td>0.7%</td>
<td>19.7%</td>
<td>0.3%</td>
<td>18.0%</td>
<td>19.2%</td>
</tr>
<tr>
<td>Hang Seng China Enterprise Index (HSECI)</td>
<td>26.4%</td>
<td>0.0%</td>
<td>28.6%</td>
<td>0.2%</td>
<td>25.3%</td>
<td>29.1%</td>
</tr>
<tr>
<td>Taiwan Taidex Index (TWSE)</td>
<td>19.6%</td>
<td>0.6%</td>
<td>20.7%</td>
<td>0.3%</td>
<td>19.0%</td>
<td>20.9%</td>
</tr>
</tbody>
</table>

**Emerging Markets FX Vol Values**
This table shows a Principal Components Analysis of the richness or cheapness of 3-month at-the-money volatility of various emerging market currencies relative to each other and history. (USD as a base currency in all cases, and two years of data used in the model).

<table>
<thead>
<tr>
<th>Currency</th>
<th>z-score (model vs market</th>
<th>Value model (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>PLN</td>
<td>1.46</td>
<td>14.79</td>
</tr>
<tr>
<td>CZK</td>
<td>1.15</td>
<td>12.36</td>
</tr>
<tr>
<td>MYR</td>
<td>1.15</td>
<td>7.52</td>
</tr>
<tr>
<td>HUF</td>
<td>1.08</td>
<td>14.21</td>
</tr>
<tr>
<td>IDR</td>
<td>0.68</td>
<td>9.14</td>
</tr>
<tr>
<td>MXN</td>
<td>0.53</td>
<td>10.44</td>
</tr>
<tr>
<td>CLP</td>
<td>0.28</td>
<td>12.61</td>
</tr>
<tr>
<td>KRW</td>
<td>0.13</td>
<td>14.21</td>
</tr>
<tr>
<td>BRL</td>
<td>-0.30</td>
<td>13.73</td>
</tr>
<tr>
<td>TRY</td>
<td>-0.52</td>
<td>11.02</td>
</tr>
<tr>
<td>TWD</td>
<td>-0.76</td>
<td>5.75</td>
</tr>
<tr>
<td>ZAR</td>
<td>-0.82</td>
<td>14.54</td>
</tr>
<tr>
<td>IDR</td>
<td>-0.87</td>
<td>8.21</td>
</tr>
<tr>
<td>ILS</td>
<td>-1.34</td>
<td>6.94</td>
</tr>
<tr>
<td>SGD</td>
<td>-1.38</td>
<td>4.90</td>
</tr>
</tbody>
</table>

Source: Société Générale Cross Asset Research

**G10 FX Vol Values**
This table shows select G10 FX at-the-money forward implied vols that are exceptionally rich or exceptionally cheap relative to historical volatility. Risk premium is the ratio between implied and realized vol. It shows the best buys (below 1.0) and the best sells (above 1.0).

<table>
<thead>
<tr>
<th>Currency Pair</th>
<th>Expiry</th>
<th>Implied Vol (%)</th>
<th>Realised Vol (%)</th>
<th>Risk Premium</th>
<th>1w Var</th>
<th>1m Var</th>
</tr>
</thead>
<tbody>
<tr>
<td>AUD/USD 2Y</td>
<td>12.5</td>
<td>22.1</td>
<td>0.6</td>
<td>-6.2%</td>
<td>-10.4%</td>
<td></td>
</tr>
<tr>
<td>EUR/SEK 2Y</td>
<td>7.2</td>
<td>11.3</td>
<td>0.7</td>
<td>1.4%</td>
<td>-0.3%</td>
<td></td>
</tr>
<tr>
<td>NZD/USD 2Y</td>
<td>13.9</td>
<td>20.8</td>
<td>0.7</td>
<td>2.4%</td>
<td>-2.9%</td>
<td></td>
</tr>
<tr>
<td>USD/CHF 2Y</td>
<td>4.9</td>
<td>6.9</td>
<td>0.7</td>
<td>6.7%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>USD/NOK 2Y</td>
<td>13.6</td>
<td>19.7</td>
<td>0.7</td>
<td>4.2%</td>
<td>-2.6%</td>
<td></td>
</tr>
<tr>
<td>EUR/GBP 6m</td>
<td>10.6</td>
<td>7.3</td>
<td>1.5</td>
<td>5.9%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GBP/USD 1m</td>
<td>12.0</td>
<td>8.2</td>
<td>1.5</td>
<td>36.4%</td>
<td>44.1%</td>
<td></td>
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<tr>
<td>EUR/NOK 3m</td>
<td>7.2</td>
<td>4.8</td>
<td>1.5</td>
<td>5.1%</td>
<td></td>
<td></td>
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<tr>
<td>USD/JPY 1m</td>
<td>11.9</td>
<td>7.6</td>
<td>1.6</td>
<td>19.0%</td>
<td>27.7%</td>
<td></td>
</tr>
<tr>
<td>EUR/NOK 1m</td>
<td>7.2</td>
<td>4.8</td>
<td>1.5</td>
<td>2.1%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Société Générale Cross Asset Research

**Europe CDS Movers**

<table>
<thead>
<tr>
<th>Name</th>
<th>Weekly Spread Chg (bp)</th>
<th>2 Week Spread Chg (bp)</th>
</tr>
</thead>
<tbody>
<tr>
<td>EMI Group Ltd</td>
<td>-132</td>
<td>-157</td>
</tr>
<tr>
<td>Hellenic Rep</td>
<td>81</td>
<td>68</td>
</tr>
<tr>
<td>Brit Asys plc</td>
<td>39</td>
<td>39</td>
</tr>
<tr>
<td>Box Comercial Portugues SA</td>
<td>59</td>
<td>59</td>
</tr>
<tr>
<td>Box Espirito Santo SA</td>
<td>82</td>
<td>82</td>
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</table>

**ABX Index Movers**

<table>
<thead>
<tr>
<th>Market ABX-HE-AAA 07-02</th>
<th>44.20</th>
<th>2.55</th>
<th>5.73</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market ABX-HE- AA 07-02</td>
<td>5.34</td>
<td>0.28</td>
<td>0.45</td>
</tr>
<tr>
<td>Market ABX-HE-A 07-02</td>
<td>4.56</td>
<td>0.88</td>
<td>0.18</td>
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<tr>
<td>Market ABX-HE-BBB 07-02</td>
<td>3.50</td>
<td>0.04</td>
<td>0.20</td>
</tr>
<tr>
<td>Market ABX-HE-BBB- 07-02</td>
<td>3.50</td>
<td>0.04</td>
<td>0.20</td>
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</tbody>
</table>

**Asia CDS Movers**

<table>
<thead>
<tr>
<th>Name</th>
<th>Spread</th>
</tr>
</thead>
<tbody>
<tr>
<td>ALL NIPPON Aews CO LTD</td>
<td>165</td>
</tr>
<tr>
<td>TAISID Corp</td>
<td>160</td>
</tr>
<tr>
<td>Kajima Corp</td>
<td>172</td>
</tr>
<tr>
<td>ACMOD CO LTD</td>
<td>220</td>
</tr>
<tr>
<td>Taheyo Gem Corp</td>
<td>422</td>
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</table>

**CDS Index Movers**

<table>
<thead>
<tr>
<th>Name</th>
<th>Weekly Spread Chg (bp)</th>
<th>2 Week Spread Chg (bp)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market iTraxx Europe Series 13 Version 1 5Y</td>
<td>81.16</td>
<td>5.62</td>
</tr>
<tr>
<td>Market iTraxx Europe Crossover Series 13 Version 2 5Y</td>
<td>411.44</td>
<td>7.02</td>
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<tr>
<td>Market iTraxx Europe HVol Series 13 Version 1 5Y</td>
<td>118.77</td>
<td>7.23</td>
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<tr>
<td>Market iTraxx Europe Senior Financials Series 13 Version 1 5Y</td>
<td>98.23</td>
<td>7.76</td>
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<tr>
<td>Market iTraxx Europe Sub Financials Series 13 Version 1 5Y</td>
<td>156.00</td>
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<td>Market CDX.NA.IG.14-V1 5Y</td>
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<td>Market CDX.NA.IG.HVOL.14-V1 5Y</td>
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<td>Market CDX.NA.HY.14-V1 5Y</td>
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<td>Market CDX.EM.13-V1 5Y</td>
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<td>Market iTraxx Japan Series 13 Version 1 5Y</td>
<td>90.86</td>
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**Loan CDS Index Movers**

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<thead>
<tr>
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<th>2 Week Spread Chg (bp)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market LCDX Series 14 5Y</td>
<td>180.22</td>
<td>0.28</td>
</tr>
<tr>
<td>Market iTraxx LevX Senior Series 6 5Y</td>
<td>103.87</td>
<td>0.05</td>
</tr>
</tbody>
</table>

**North America CDS Movers**

<table>
<thead>
<tr>
<th>Name</th>
<th>Spread</th>
</tr>
</thead>
<tbody>
<tr>
<td>Radian Grp Inc</td>
<td>694</td>
</tr>
<tr>
<td>MBIA Inc</td>
<td>971</td>
</tr>
<tr>
<td>Assur City Mun Corp</td>
<td>343</td>
</tr>
<tr>
<td>Assur City Corp</td>
<td>545</td>
</tr>
<tr>
<td>Std Pac Corp</td>
<td>370</td>
</tr>
</tbody>
</table>
ISDA 25th Annual General Meeting

The great and the good of the industry descended on The Fairmont atop Nob Hill in San Francisco last week for the annual International Swaps and Derivatives Association AGM. As you’d expect the drumbeat of regulation could be heard everywhere and there was a fair bit of reviewing the market’s role in the meltdown. Managing Editor Katy Burne and Reporter Eleni Himaras filed the following reports:

PROPOSED REFORM

(continued from page 1)

the [Securities and Exchange Commission] and the [Commodity Futures Trading Commission].”

Stephen O’Connor, managing director at Morgan Stanley, referred to “the good, the bad and the ugly” within the legislation. He dubbed clearing the good, mandatory clearing the bad, and the potential fallout of getting the solution wrong, the ugly. “Any institution connected to every trade on the market is by definition too big to fail,” he said.

There is frustration with the fact credit default swaps are still being starred as a culprit in the crisis. Conrad Voldstad, ceo of ISDA, noted the rhetoric against CDS has gotten worse in recent weeks because lawmakers feel emboldened by the success of health care reform. Another concern was the criticism the industry is getting for not working fast enough to reduce risk. “Just because you regulate it a certain way, doesn’t mean it can be done,” said Athanassios Diplas, global head of systemic risk management and global credit training at Deutsche Bank, of forcing customized trades onto exchanges when that is not always the appropriate remedy. —Katy Burne & Eleni Himaras

Treasury, Industry Butt Heads

The stark divide between regulators and major derivatives dealers was palpable Thursday morning when ISDA officials’ comments clashed with those of Neal Wolin, deputy secretary of the U.S. Treasury.

Bob Pickel, executive vice chairman of ISDA, maintained that dealers want clearing and are making significant progress toward getting more instruments eligible for CCPs and expanding access for more users. Athanassios Diplas, global head of systemic risk management and credit trading at Deutsche Bank, added that it is a myth that dealers don’t want clearing. “There are a lot of benefits for dealers to clear, and that’s why we have put so much resource behind it.”

But Wolin accused the dealers of stalling. “To state it bluntly: the large OTC dealers simply do not have a sufficient incentive to speed up the process of standardization,” he said. “Large dealers profit too handsomely from the current system in which they have far more information and far more leverage than other market participants.”

There was similar tension on the prospect of exchange trading for OTCs, which regulators believe will improve costs for end-users and transparency. Shortly after Pickel laid out ISDA’s framework of ISDA’s efforts on the disclosure front, Wolin hit back that while he welcomed those commitments, “They are not enough.” Many industry officials believe exchange trading will hurt liquidity and that there is already enough transparency between end-of-day prices from clearinghouses, data repositories and real-time trading screens. But Wolin countered that more derivatives, certainly all standardized OTCs, should be traded on exchange. “We believe that it imposes no undue burdens.”

Buyside Hesitant On Clearing

Buysiders bemoaned the pressure being heaped on them to clear their over-the-counter contracts, noting that while in principle they believe in the benefits, such as improved portability of trades, in practice it is proving costly and disruptive.

Quite apart from the out-of-pocket costs involved in clearing, Ted MacDonald, treasurer at D.E. Shaw, said a major downside is the uncertainty over how much capital needs to be committed over the life of a trade. “If we do a five-year CDS [right now], we know the amount of capital we have to commit to that trade for five years. But the clearing house reserves the right to change the initial margin,” he said.

Others highlighted the legal risks, given that the solution is yet to be tested in a meaningful way. Stuart Spodek, managing director at BlackRock, said for the additional costs, asset managers need to be able to show clients a demonstrable benefit. “Many of us are [far along] on the path of researching and exploring the potential of clearing…and net net it’s probably good. But we must recognize that we are just moving risk from one place to another.” Bill De Leon, global head of risk manager at PIMCO, agreed that fiduciary duty was a big point of debate. “When we move to CCPs we want to make sure the protection afforded to our clients is better than the existing ones…There is a chance, not that we expect it, that something happens and we are in a worse position for our clients.”

For more coverage of the event, head to wwwderivativesweek.com
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The firm presented the solution for the first time at the MathFinance conference in Frankfurt last month and has had positive feedback since then from quants at a roster of dealers. A teaser is scheduled for publication in quant magazine Wilmott next month and an academic paper will follow in the summer.

Joining the dots between maturity dates is called interpolation by mathematicians. Up to now it has been challenging because the accepted method for volatility interpolation has been different for each market, be it equity or currencies, and because for each date there are several possible strikes. “Nobody gets it quite right,” said the Murex official, who has held several senior trading positions, including heading up European fixed-income derivatives trading at Citibank. “No-one agrees how to interpolate over time. You could do a straight line between [maturities], but there are many different methods.”

The Murex solution is a new mathematical formula. Instead of interpolating using two different measurements for delta, showing the change in the value of the option when there is movement in the underlying, Murex used a measure of probability showing the likelihood of the options being in the money at the relevant expiry dates. Traders have historically disagreed not just about interpolation methods, but also about whether to base delta on changes in the spot or forward markets, but probability is not as contentious a concept.

“It's an issue that a lot of traders and quants have been worried about for the last few years,” explained Uwe Wystup, ceo of independent consultancy MathFinance and a former quant at Commerzbank. “It's important for trading to have a methodology for having option volatility smiles between tenors...for a smoother transition from one point to another. They have thought about this and come up with a very smart, intelligent solution that works across assets.” —Katy Burne

BOWLES BACKS
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and derivative boutiques. The levy would eventually be changed depending on how risky the operations of those firms are. That risk issue will be hashed out at the next G20 meeting. The firms, however, argue their businesses do not pose a risk to financial stability and that they are being unfairly punished by regulators despite not being a cause to the financial crisis.

“This is not a punishment, this is a forward looking measure...where there is risk of a future bailout, especially on a cross-border basis,” Bowles told Derivatives Week. She said that it would be difficult to exempt any financial institution from the levies, arguing that all financial institutions can affect the stability of the financial services market. “Everybody says firms such as hedge funds were not at fault in the recent crisis, but look at their role when Bear Stearns went down and the recent event involving Goldman Sachs,” she said.

Bowles’ Committee, along with the European Council and Michel Barnier, Commissioner for internal market and services at the European Commission, will be consulted before a levy or tax can be implemented in the E.U. Barnier yesterday also pledged his support for the levy, as did French Economy Minister Christine Lagarde and U.K. Chancellor of the Exchequer Alastair Darling. Canadian Finance Minister Jim Flaherty, however, quashed hopes of global coordination on the levy, arguing that it could spur further excessive risk taking by firms because they’ll be looking for ways to make up the profit shortfall.

Non-bank officials maintain their respective firms do not create systemic risk. Alex McDonald, ceo of the Wholesale Markets Brokers’ Association in London, said in reference to interdealer brokers, “This levy should be applied to firms that create systemic risk...IDB’s do not create systemic risk, they are merely agents who introduce two sides in a transaction.”

“Boutiques operate wholesale and off limited balance sheets so systemic risk creation is severely limited.” added Paul Morgan, founder of boutique derivatives and securities dealer Conduit Capital Markets in London, in reference to boutiques. “This levy should therefore not be applied to this group.”

Econ and the European Commission are to discuss the IMF’s proposals over the next few weeks, while the IMF will present its proposals to G20 finance ministers at a summit in Toronto in June. That is when a timeline would emerge for the levies.

—Rob McGlinchey

Events

The Global Association of Risk Professionals will be hosting its annual European Risk Congress on June 8-9 at the Renaissance London Chancery Court Hotel. Topics to be discussed include over-the-counter derivatives regulation and remuneration. Email events@garp.com for more information.

Quote Of The Week

“Everybody says firms such as hedge funds were not at fault in the recent crisis, but look at their role when Bear Stearns went down and the recent event involving Goldman Sachs.”—Sharon Bowles, chair of the European Parliament’s influential Economic and Monetary Affairs Committee, on why all financial institutions should be subject to the International Monetary Fund’s proposed levies on profits and remuneration [see story, page 1].