

DERIVATIVES BRIEFING

Derivatives – A Global Review

According to figures announced by the BIS, trading in exchange-traded derivatives actually fell in the last quarter of 2005, mainly due to seasonal factors (interest rate contracts have historically tended to fall off at year ends). The year-on-year growth was however high – at 22%.

In the exchange-traded markets, trading on the 3-month EURIBOR contracts on Euronext.liffe has soared as strong signs from the UK economy have altered dealers' perceptions of the future of short-term interest rates. Trading in these contracts has been running at a level US\$30trillion a month. Other areas of growth have been in the index derivative markets as managers and dealers alike look to provide more portfolio protection for themselves as the demand for long-dated bonds has outstripped supply, forcing them to look at derivative contracts in order to match their liabilities.

In the OTC markets several trends are emerging. The boom in Credit Derivatives continues unabated – further fuelled by the emergence of multiple solutions for clearing the confirmation backlog that are now entering the market place (see overleaf). New products are also being mooted – both the CME and Eurex have recently announced that they will be marketing Credit Default Futures in the near future, and many hybrid cash-synthetic CDOs (Collateralised Debt Obligations) based on US Asset Backed markets are coming out every month.

In the commodity markets, volumes on international exchanges rose in the last quarter of 2005, mainly because of a huge 47% rise in precious metal (specifically gold and copper) derivatives. This has been driven mainly by Japanese investors who have been using these contracts to diversify their portfolios as the Yen has declined.

Prospects for derivatives in the UK specifically look more than rosy despite the recent market "adjustment" in the commodity and emerging markets – indeed the rise in market volatility (as tracked by the Vix Index in the US) has actually meant a distinct rise in the trading of variance swaps as hedge funds in particular look to make bets on market movements. Thus as more and more traditional long-only managers look to diversify their offerings and comply with the opportunities provided for in Basel 2, UCITS 3, IAS39 and other regulations. Increasingly therefore managers are looking to manage their risk more effectively, match their liabilities, and compete with their peers using derivative contracts of all flavours.

Business Trends

LDI

Following pressure from Investment Consultants and Actuaries, and as the UK Pensions market crisis looms ever larger, more and more managers are following the mantra of Liability Driven Investing. In a paradigm shift away from the search for relative returns Managers are now attempting to match their fund liabilities, and as a result the demand for long-dated and Index-Linked Bonds has outstripped supply, driving yields lower and forcing managers to look at other forms of protection and liquidity – such as those offered by derivatives products such as Inflation Index Swaps and other Index derivatives that can be used to manufacture synthetic bonds.

Software Providers

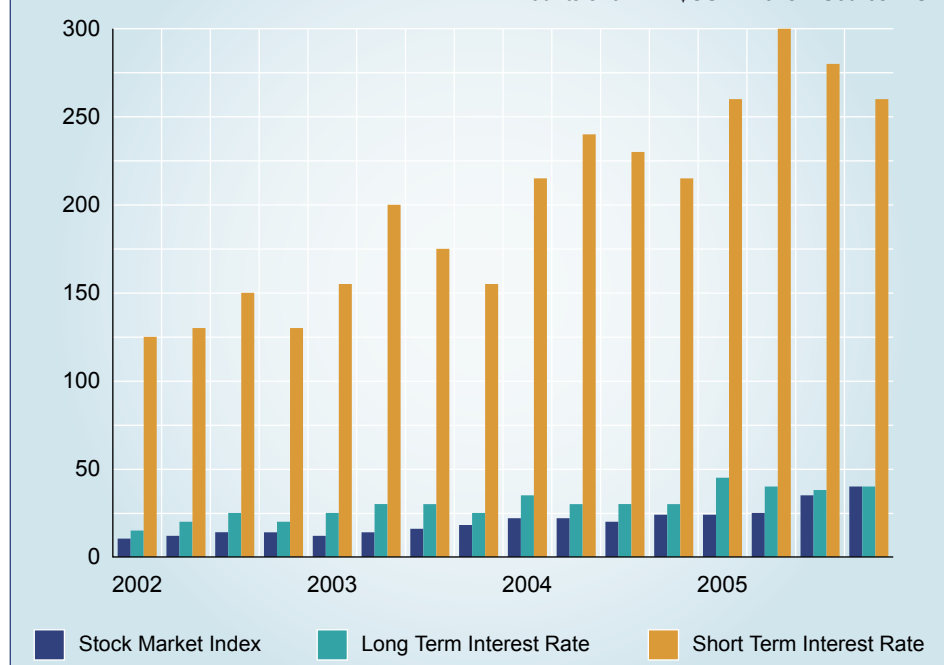
The larger buy-side front office OMS providers are rapidly trying to keep up with the product marketplace by enhancing their systems to cover derivatives and are creating links to the various exchanges and services involved the arena such as links to Tradeweb, Euronext, Market Axxess, Markit, Swapwire, DerivServ and the use of messaging protocols such as FIX and FpML. We are seeing a number of sell-side systems entering the buy-side arena as the space begins to evolve.

Collateral Management

The servicing industry is evolving to match the changing requirements of the traditional asset manager. In the last year most of the larger custodians have announced and implemented plans for derivative servicing – with products designed to aid managers to track and report on collateralised derivative transactions, to value OTC derivative products and to provide collateral custody and liquidity management. This will assist fund managers in mitigating their increased credit exposure and will improve their derivative trading cost effectiveness by providing services that are not currently core competencies in asset management firms.

Turnover of Exchange Traded Futures & Options

Amounts shown in \$US Trillions – Source BIS



Citisoft Solution

Citisoft has a wealth of consulting experience in the Derivatives arena. We deliver to our clients the benefits of that specialist expertise through advice and assistance across a number of services, including:

- Full system selection service – from RFI – RFP – Workshops – Implementation
- Project Management
- Industry Research and Business Analysis
- Deep domain knowledge of front office trading and risk management systems for derivatives

Citisoft consultants can also demonstrate expertise in the following:

- Fixed Income exotics
- Asset and Mortgage Backed securities
- Credit Derivatives
- Interest Rate Swaps
- Inflation Swaps
- Total Return Swaps
- Spreadlocks
- Futures and Options
- Energy Contracts
- Commodity trading
- DMA
- ECNs

Citisoft Published Articles

Members of the Citisoft Hedge Fund and Derivative Practice are widely quoted in the following national and trade press:

- Financial Times
- FT Mandate
- FT Digital Business
- STP
- Funds Europe
- Hedge Fund & Investment Technology
- Financial I
- Financial News
- Global Investor

Copies of these articles are available on request from the contact number below.

OTC Markets – Post-Trade Processing

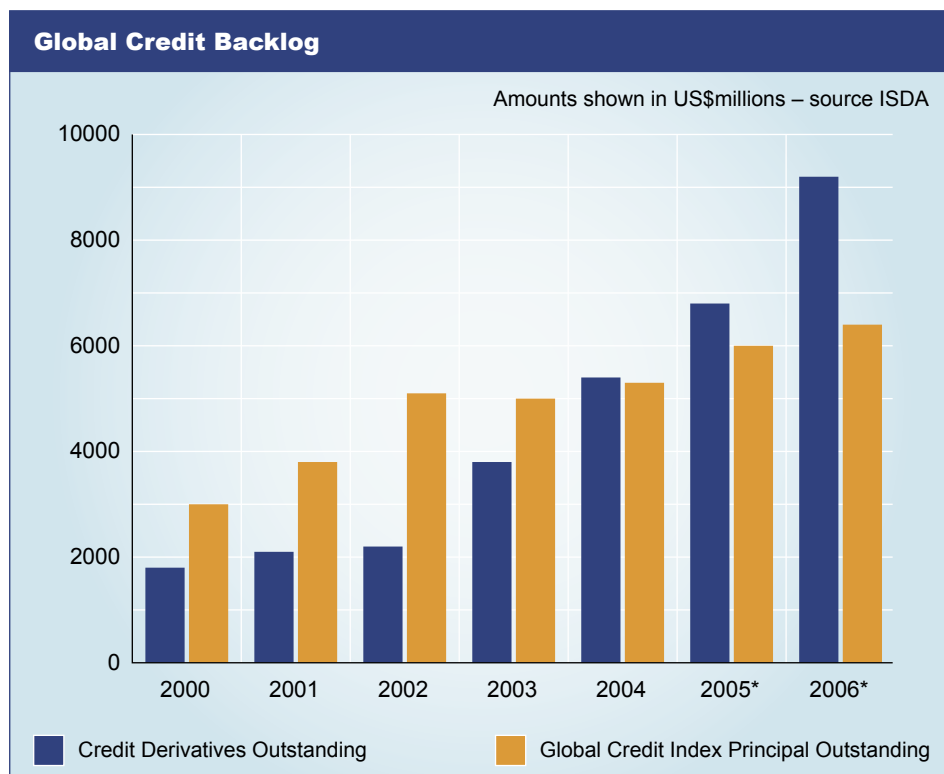
Despite the recent booming credit derivative markets there has long been a black cloud darkening the horizon of market participants – namely that back offices around the world are struggling to keep up with the plethora of trade confirmations in this complex market. To add fuel to the fire there is also a secondary market for novations (when one side of the deal wishes to leave the contract prior to maturity) further adding to the complexity of operations.

Last year regulators around the world attempted to address the issue. In the UK the FSA took a consultative approach with participants – in the US the Federal Reserve called in the major players and issued a proposal including adherence to ISDA’s Novation Protocol. On both sides of the Atlantic the measures were widely welcomed and agreement was reached as an industry to reduce the backlog as soon as possible.

Since then the servicing industry has moved quickly to assist by automating the post trade processes. The Depository Trust and Clearing Corporation (DTCC) has signed up large numbers of participant firms to its Deriv/SERV matching and confirmation service. It currently leads the pack with established links to exchanges such as TradeWeb and Market Axess, and other providers such as T-Zero (who provide trade messaging and workflow connectivity) and Thunderhead (who provide software to investment managers to manage the document creation, automation, and workflow of these complex contracts). Also in the mix however are Swapswire, who provide matching services, and are also linked to Tradeweb as well as to Bloomberg’s SwapTrader system. Most recently, Markit, the firm that is rapidly becoming the industry standard in Credit Default pricing, has acquired Communicator, a New York-based provider of automated systems for OTC derivatives trade processing.

Other areas of the industry are also looking to consolidate to give cross-industry standardisation. MarketAxess, the electronic trading platform used by many large participants, has incorporated Markit’s RED database to ensure that all players know the correct reference entity details and obligations as well as functionality that enables counterparties to check that sufficient credit lines and documentation are in place. These trades may then be sent to Deriv/SERV for matching and confirmation. Similarly Creditex, another e-trading credit platform, launched T-Zero in the summer of 2005 – giving them their flexible derivatives affirmation tool that allows users to link to dealers, trading platforms and the DTCC by capturing and transmitting trade information over to back and middle office systems.

The good news is that market participants appear to be taking a holistic, industry-wide view of the potential solutions to the OTC issues faced. The totality of these redesigns should therefore put the market in good stead and allow for the continued expansion in volumes together with proper operational control and lower costs.



For more information please contact Sean Sprackling, +44(0)20 7776 1111 or by email: sean.sprackling@citisoft.com
No. 1 Frederick’s Place, Old Jewry, London EC2R 8AE