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CROSS-ASSET ORG TROUBLES DEUTSCHE BANK

Deutsche Bank is the latest firm on the Street struggling to please and hold on to senior staffers after merging its equity and debt derivatives. **Johan Groothaert**, senior equity derivatives head in London, has taken an extended holiday and is reportedly set to leave Deutsche Bank in London. That follows a spate of credit derivative departures at the firm (DW, 2/24).

Groothaert has held several senior roles at the firm, including most recently co-head

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MORGAN STANLEY LOSES CLUSTER OF STRUCTURED STAFFERS

Morgan Stanley has lost a clutch of structured credit officials in Asia and Europe. The resignations appear unconnected and some see them as typical of the annual post-bonus merry-go-round. But a concentration of London departures may have left the structured credit desk in Europe underweight. **Jerome Anglade**, head of structured credit marketing in London, referred calls to the press office, which had nothing to say.

As first reported on DW's Web site last Tuesday, **Aditya Rana**, head of credit derivative

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AIG TO FIRE UP HONG KONG DESK; CREDIT, CDO IN THE CARDS

AIG Financial Products is setting up a cross-product derivatives desk in a planned operation in Hong Kong. "We see a lot of potentials in Greater China," said an official. The firm has a long-running Japanese business, for which it launched a structured private placement desk in Tokyo by hiring a team from **JPMorgan** last year (DW, 4/8).

Aditya Rana, executive director at **Morgan Stanley** in Hong Kong, will establish a

(continued on page 12)

ISDA Singapore

CASH SETTLEMENT GAINS MOMENTUM; FEARS PERSIST ON READINESS

Pressure from regulators and the looming likelihood of a big auto default is giving momentum to a credit-default swap cash settlement draft. Operations and legal teams have not yet signed off, however, so last week's **International Swaps and Derivatives Association**'s annual general meeting in Singapore was abuzz with talk of the double-edged sword: risking untested back-office systems by speeding ahead, or incurring **Federal Reserve** wrath by transferring operational resources away from improving confirms—last year's hot potato—and onto developing cash settlement.

(continued on page 7)

At Press Time

BarCap Fund Sales Pro Quits

Laurent Ichard, director and head of equity derivative sales to hedge funds in London, has left **Barclays Capital**. Ichard, who joined the firm just under a year ago from **JPMorgan**, was on gardening leave and could not immediately be reached and it could not be determined if he has taken another role elsewhere. He reported to **Andrew Stonely**, who declined comment.

Several officials close to Ichard tipped him for a move to **Lehman Brothers**, which hired a group of his former JPMorgan colleagues last year (DW, 2/18/05). **Axel Kilian**, head of European derivative sales, declined comment.

BofA Equity MD Exits

Jon Orseck, managing director in the equity financial products group at **Bank of America** in New York, has left the firm. **Melissa Fox**, spokeswoman, confirmed the departure and said Orseck led the equity-linked solutions team, reporting to **David Moran**, managing director and head of structured sales for the equity financial products group. Orseck's responsibilities have been divided among the team and there are no immediate plans to replace him.

Further details of his possible destination could not be ascertained, but market buzz links him to **Managed Risk Advisors**.

Fitch To Launch Price Tool

Fitch Ratings is testing and planning soon to launch a service providing market risk pricing and analysis for synthetic collateralized debt obligations. The Web-based initiative, called Risk Analytics Platform for Credit Derivatives—or RAP CD—will offer similar services to those Fitch offers for credit risk, said **Kimberly Slawek**, group managing director, at Fitch's Global Synthetic CDOs and Credit Derivatives Conference last Wednesday.

It will include marked-to-model prices and market risk reports, similar to credit ratings and presale reports, as well as Fitch's CDO pricing model, third-party CDO pricing models, underlying components for calculations of pricing models and a deal database. Slawek declined to comment on a target release date.

Deutsche Bank Taps Citi Nordic Salesmen

Deutsche Bank has poached two derivative marketers from **Citigroup** to meet increased demand for business in the Nordic region. **Harald Lofgren** joins as director and **Knut Kobberstad** as v.p. in the Nordic debt capital markets and corporate coverage group in London.

Hakan Wohlin, managing director and head of Nordic and Netherlands DCM and corporate coverage in London, said the new roles will focus on corporate, agency, municipalities and sovereign derivative origination across asset classes.

At Citi, the pair focused on fixed-income derivative marketing to Nordic corporates and reported to **Antonio Cacorino**, head of European corporate derivatives, who could not be reached. **Jeremy Hughes**, spokesman for Citi in London, did not comment on the departures or a replacement by press time.

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RBC Brings On Board Structured Product Marketer

RBC Capital Markets has hired **Paula Pandolfino**, a former credit marketer at **Barclays Capital** and **Deutsche Bank**, as a director to lead distribution of structured products into Italy. Reached at RBC where she started last Monday, Pandolfino said she is working across asset classes, including credit and rates, and reports to **Avril Pomper**, head of credit derivatives marketing in Europe. Pandolfino left Barclays close to a year ago and took time out to travel before joining RBC.

CMBX Volumes Disappoint

The commercial mortgage-backed securities index, which started trading March 7, has so far produced disappointing results. Traders would not say how much volume they expected to see on the CMBX, but agreed the first week of trading fell short. Trades March 10 were estimated at no more than USD500 million, boosted by a USD200 million AAA trade, and this is compared to more than USD1 billion on the ABX its first day of trading.

Traders noted, however, they did not expect CMBX volumes to rival the ABX, which since Jan. 19 has seen more than USD12 billion. This is because residential mortgage-backed securities, which make up the ABX, are a bigger market and comprise 65-80% of the collateral in ABS collateralized debt obligations compared with CMBS. “Still, I think people were disappointed,” a trader said.

Forward-Starting Noise Fails To Kick Start Issuance

Chatter on the Street about the growing popularity of synthetic forward-starting collateralized debt obligations has yet to materialize into public deals being printed. Credit players say many institutional investors who have only recently starting taking views on credit defaults and correlation are not yet sophisticated enough to also take views on the timing of defaults, so dealers are holding off to gauge appetite. “They [investors] like the idea of locking in spreads and the boosted returns, but they need educating,” said one structurer in London.

Forward-starting CDOs have set tongues wagging on both sides of the Atlantic because the credit curve of the structure is steeper, and therefore pays a higher spread, than that of a current transaction of the same rating (DW, 1/27). One strategist said when the direction of the credit cycle becomes clear, meaning the market will be clearer on the timing of defaults, investors may then begin to see the value of the structure.

JPMorgan Adds City Illiquids Pro

JPMorgan has signed up derivatives broker **Kieran O’Connor** to source illiquid assets for its Northern European derivatives marketing team. Reached at JPMorgan, O’Connor declined all comment. **Sarah Oppler**, spokeswoman in London, said he is a v.p. reporting to co-heads of the desk **Ian Wilson** and **Marc Badrichani.** Both were off the desk and could not be reached by press time.

Before JPMorgan, O’Connor ran his own multi asset-class brokering business called **Cortin Capital**. He is the second recent addition to the financial institution derivatives marketing group following **Raymond de Kuiper**, who landed this month from **Morgan Stanley** (DW, 3/10).

ABX, CMBX Combined Tranching Mooted

Problems tranching the existing ABX and CMBX indices has led asset-backed pros to pitch the idea of combing the names in the two indices. The ABX and CMBX have too few underlying names and ratings differences to tranche right now, although tranching—which would allow for asset-backed correlation trading—is the holy grail of the synthetic indices. So traders are debating the merits of combining similarly-rated names from each index into joint tranches. An advantage is that there would be more names and more variety, but the situation is not straight forward as the two sectors also have different assumptions and maturities. “It will be challenging and we’re not there yet,” said one trader. “But we’re looking at everything.”

CDS On CDOs Of ABS To Pop

Credit-default swaps on tranches of collateralized debt obligations referencing asset-backed securities are expected to grow strongly. A few sizable trades have been done already, traders said, most involving hedge funds going long a CDO and short its AA through BBB mezzanine tranches. The creation of standardized definitions and confirmation documents by the **International Swaps and Derivatives Association** and an inter-dealer working group is set to work as a catalyst for further ABS correlation trades to take off.

The ISDA documents will be modeled on the pay-as-you-go form for CDS on residential and commercial mortgage-backed securities and are expected to be completed by the end of the year. Right now, existing documentation is being tweaked to allow deals to go ahead, but ISDA and members of the working group said they are hoping a document with the possibility of customizing individual trades on specific asset classes will lead to greater liquidity.

Merrill Adds To Big Apple Corp Desk

Merrill Lynch reportedly has hired **Hamish Cameron**, a director at **UBS**, and **Michael Ondruska**, an associate at **Morgan Stanley**, to add to its derivatives solutions group in New York. The hires follow the addition of **Mona Abraham** last month (DW, 2/24). The two have not yet started, but are said to report to **Greg Glickman**, head of corporate derivatives solutions, who declined comment.

Kris Kagel, UBS spokesman, said Cameron was a director in fixed income derivative marketing to corporate clients, reporting to **Michael Davidson**. He has not yet been replaced. **Mark Lake**, Morgan spokesman, said Ondruska left the firm last year. **Terez Hanhan**, Merrill spokeswoman, did not return calls.

RBC Touts Second High-Grade ABS CDO

RBC Capital Markets has hit the road with a USD1.5 billion high-grade collateralized debt obligation, which allows it to substitute deteriorating credits. The synthetic transaction is the second from the firm's principal finance arm, **RBC Principal Finance**, which has collateralized the portfolio with loan and debt obligations and residential-mortgage-backed securities rated A3 and above.

Rob Pomphrett, head of the structured product syndicate in London, said Logan II was structured on the back of investor appetite for its predecessor Logan I. The first USD2 billion deal closed September last year. Unlike the first deal, RBC Principal Finance has the right to substitute deteriorating underlying credits. "There is more ability for them to defensively manage," he noted.

The full capital structure is being pitched to banks and insurance companies globally with six classes of notes rated Aaa down to Baa2 being offered. These pay 40-45 basis points over three-month LIBOR through to 700-750 bps over three-month LIBOR respectively. The senior notes will also be offered in yen, Canadian Dollar and euro and the equity piece can also be priced as principal protected notes. The transaction will be priced at the end of March 27 and close a month later.

Knock-In Variations Hold Sway In Reverse Converts

Variations on reverse convertible bonds are holding investor interest in one of the most popular retail structured products of last year, officials said last week at the **Structured Products Association** conference in New York. With rising interest rates and increasing volatility, the most significant interest from investors is for knock-in protection, said **John Tessar**, product manager at **LaSalle Bank**.

Reverse convertibles are the opposite of convertible bonds. The very short-term, high-yielding notes are tied to a single underlying stock and return a coupon if the stock closes at or above an initial strike price and shares if it closes below the initial price. Knock-in features allow the investor to receive the coupon even if the stock closes below the strike price as long as it never touches or falls below a knock-in price. If it touches the knock in, the feature disappears and returns stock like an unprotected reverse convert.

Tessar said reverse convertibles are now dwarfing principal protected notes. **Kevin Mahon**, senior v.p. at **Countrywide**, said he saw volume double last year. "Everyone wants to be in this market."

User Strategy

Babson To Manage First Synthetic, Investment-Grade CDO

Babson Capital Management is bringing its first synthetic investment-grade structure to market. Until now, the USD95 billion firm has managed only CDOs collateralized by leveraged loans or high-yield debt. This transaction synthetically references a USD2billion (or EUR2 billion, depending on the currency invested) pool of corporates which has an average rating of BBB plus. Babson will manage the portfolio throughout the life of the seven-year deal.

Called Avon Ridge, it has been arranged by **SG Corporate & Investment Banking**. Officials from Babson could not be reached by press time and reasons for the manager entering the synthetic arena were unclear. Structurers from SG were traveling and not available for comment. Investment in Avon Ridge is being offered through six classes of USD270 million and EUR50 million of floating-rate, credit-linked notes linked to be issued through an offshore special purpose vehicle.

The transaction is expected to close next month and the notes have been given preliminary ratings by **Standard & Poor's** ranging from AAA through to A minus. Its target investors, notional and pricing could not be determined.

Asia Pacific

Credit Trading Funds Spring Up In Asia

Funds trading credit derivatives in the region have been gaining momentum in recent months on the back of the more developed market. For instance, **Tribeca Global Investments**, the hedge fund arm of **Citigroup**, has been setting up a credit derivatives trading unit in recent months in Singapore and hired **Aashish Ponda**, credit derivatives structurer at **UBS** in the Lion City, to spearhead the effort. Market insiders said the fund will look at trading default swaps as well as credit-linked notes and may potentially manage CDOs. Ponda declined all comment.

UBS' **Dillon Read Capital Management** in Hong Kong is also expected to rev up its activity in the regional credit markets, noted officials, as the former principal finance group in UBS was recently spun off. "A lot of players traded out of other offices, but the credit market is becoming liquid enough to allow for dedicated operations," said a fund manager, explaining that he expects additional entrants to pop up in Asia this year. New York-based **Amaranth Group** has also been expanding its presence in Asia, noted market participants.

A credit head at a bulge-bracket house said he also expects default-swap activity to pick up on the back of the growing number of private leverage financing deals in the region. Funds could purchase credit protection to hedge such transactions, he noted.

Japan Credit Spreads Tipped To Widen

Credit derivative houses are welcoming the possibility of wider credit spreads this year in Japan, on the announcement two weeks ago the central bank is ending its quantitative-easing regime. The **Bank of Japan** has changed its policy of flooding the market with cash and for the first time disclosed an inflation range, meaning that in the longer-term rates could move above zero. As a result market officials said this could trigger a move above the severely tight spread levels seen over the past few years, which have been responsible for slower levels of growth than other CDS markets.

"I expect to see some healthy spread widening this year," said **Shun Cajot Yoshida**, credit structurer at **BNP Paribas** in Tokyo. Yoshida noted that wider levels will attract more interest for domestic CDOs. The CDO market in Japan has tended to focus on overseas structures that offer much higher yields.

"We're already starting to see more punters in the market," said a credit head at a U.S. house in Tokyo, explaining that some participants, such as overseas hedge funds recently started buying protection on Japanese names in expectations of wider levels. He continued that spreads could widen out by 20-30% over the course of the year.

BofA Trading Honcho Joins Nikko Citi

Nikko Citigroup has recruited market veteran **Tony Kay**, head of credit derivatives trading at **Bank of America** in Tokyo, for a senior trading role according to market officials. **Yoshito Matsuura**, head of credit derivatives at Nikko in Tokyo, declined all comment. Kay was the talk of the credit market when he joined BofA from UBS, where he was the head of non-Japan Asia credit trading, for a compensation package in 2002 that set the bar for the region (DW, 8/19/02). A fluent Japanese speaker, Kay could not be reached by press time. **Sal Amery**, head of credit derivatives at Bank of America in Hong Kong, to whom Kay reported to, declined comment.

Korean Regulators Ease CDO Rules

The **Bank of Korea** has eased guidelines surrounding collateralized debt obligation deals sold locally and this is expected to speed up transactions. Credit officials in Seoul said in the last few weeks the B.O.K. has changed from a case-by-case approval process for CDOs to having firms just register a completed transaction with the regulator.

"The B.O.K. has been looking at these types of deals for a long time—they've got a firm grip on this now," said a marketing head at a bulge bracket house in Seoul. He continued that previously the approval process took about a month, so the move should give firms much more regulatory comfort to issue CDOs, which have long been eyed suspiciously in the country, given the memory of Asian financial crisis which impacted creditworthiness across the region. The primary interest in credit investment products has stemmed from insurance companies, which have been investing in more and more complex transactions, such as asset-backed security CDOs.

Officials at the B.O.K. in Seoul declined all comment.

ISDA Singapore

*The **International Swaps and Derivatives Association** held its AGM in Singapore March 14-16. Some 600 attendees headed to the Shangri-La Hotel to hear about the growing potential of the emerging Chinese and Indian derivative markets. Managing Editor **Elinor Comlay** and Reporter **Matt Tremblay** filed the following stories (for additional coverage go to* DW's *Web site).*

CASH SETTLEMENT

(continued from page 1)

ISDA put to delegates a proposal to cash settle all index, tranche and single-name trades over USD100 million through a netting process dependant on dealers electronically submitting trade and counterparty details to a third party. The draft is ambitious because previously the association has only handled one-off index CDS settlements. It also complicates the task because it looks to tackle credit risk by limiting netting to counterparties which already have trade relationships.

Kimberly Summe, ISDA general counsel, admitted there are a host of hurdles to cash settlement and called on delegates for help answering questions posed by the draft. There was little immediate response as lawyers, dealers and back office staffers digested Summe's suggestions and questions. A significant potential worry she highlighted is the possibility the organization called on to process and net the trades could be seen as an exchange or a clearing system—which may create more regulatory obstacles.

A key concern of delegates also is that the proposed system may further separate the small fish from the big, with small players being forced to shell out for expensive access to an over-the-counter settlement provider and less-sophisticated users potentially being put off altogether. All delegates, however, agreed solving the cash settlement problem is this year's highest priority for the trade association. "This has to be the main focus of the industry," said **Mike Pohly**, managing director and head of North American credit trading at **Morgan Stanley**.

China Takes Limelight

The high population and savings rates and the opening of its markets this year made China the focus for many delegates. **Tricia Bowden**, managing director and senior counsel at **Goldman Sachs** in Tokyo, said, "The pace of regulatory change and development in China is breath-taking." She said ISDA has been in dialogue with the regulators and is hopeful the first cross-currency swap is not far away.

Ralph Liu, chairman of **Advanced e-Financial Technologies** in Corona, Calif., walked participants through the first domestic RMB interest-rate swap in the market which he structured earlier this year between **China Everbright Bank** and **China Development Bank**. He further spelled out arbitrage opportunities for local participants between banking rates controlled by the central bank and rates from a trading book that are determined by something close to a market mechanism, noting this should spur growth for a domestic interest-rates market.

Participants noted an explosive boom in trades won't happen overnight but international firms are now positioning themselves for further market liberalization and have for instance been buying stakes in local banks. "It's a multi-year project," said **Jonathan Moulds**, head of international markets at **Bank of America** in London and ISDA chairman.

Speakers said attention on the nation is not over-blown: **Michael Rees**, ceo of wholesale banking at **Standard Chartered Bank** in the Lion City, noted 150 years ago China and India were the major global economies while the emerging markets for instance included the U.S. "It's more appropriate to talk about their re-emergence," he said.

Bank Internal Org Tipped To Change

The speed of development of derivative structures and the increasing range of investors getting into the instruments has banks questioning how they organize internally. But, no consensus is emerging on the correct model, according to panelists.

Mark Brickell, ceo of **Blackbird Holdings** and former ISDA chair, put the question of whether there would be any business changes to the panel but did not get a detailed answer. **Kenneth Tremain**, head of North American interest-rate trading at **Citigroup**, said his group has looked into developments in equity and fx and expects to see changes in the way Citi sells to clients. But, he noted it is still in the early phases of the analysis.

Justin Kennedy, managing director in pacific equities Asia at Citi, added the trend for merging credit and equity desks is also connected to product development. He noted, "The various players seem to be adopting different business models: there does not appear to be a one-size-fits-all answer." He added, "It will probably be a couple of years before we are able to discern what the most appropriate way of meeting the challenge is."

ISDA Singapore (cont'd)

Economic Derivatives Gain Ground

Economic derivatives—used to take a view on forthcoming data releases or hedge market reaction to data news—are catching on, said **Richard Rosenberg**, global head of economic derivatives at **ICAP**. Speaking on a panel about innovations, he said the instruments have existed for some years, but received a boost when the **Chicago Metals Exchange** started clearing trades in September.

The instruments can be vanilla or digital options or forwards on data releases such as European inflation or non-farm payrolls and are bought through an auction process, run by ICAP. Plans are afoot to launch a U.S. CPI auction this spring, and other instruments will likely follow as interest builds, said Rosenberg.

Gaming Bill Clouds Indian Outlook

India's emerging swaps and options market may face a potential obstacle in the form of a draft gaming bill suggesting derivatives are wagers. The language of the bill could encompass derivatives because the outcome of the instruments depends on "a future uncertain event." **Akash Mohapatra**, director and senior legal counsel for Asia at **Deutsche Bank**, noted it is still in bill form and ISDA has submitted comments. He is hopeful it should hear something in the next few months.

The uncertain status of market-access products in the country is also bugging dealers, as the dispute between the **Securities and Exchange Board of India** and **UBS** over an equity market crash and know-your-customer requirements drags on. SEBI has now taken UBS to the supreme court (DW, 10/28) and Mohapatra said it could be 12-18 months before there is a decision. During this time, he added, SEBI is unlikely to clarify its know-your-customer rules, leaving dealers looking to issue market-access notes uncertain as to what SEBI wants.

Asia Starts To Export Equity Exposure

A major shift on the equity front is Asia turning from a net importer of equity underlying from other regions for derivative contracts to being a net exporter. **Justin Kennedy**, managing director in Asia-Pacific equity derivatives at **Citigroup** in Hong Kong, told attendees this has in part been driven by the craze for BRIC (Brazil, Russia, India and China) products from investors in Europe and the U.S. "If someone doesn't know what that stands for they must have been asleep in '05," he intoned.

Other key equity derivative developments in the region include a deep variance swap market, dividend swaps, exotic retail warrant products, synthetic convertible bonds and aggressive short-dated structured trading products for private banking clients.

In a documentation panel, **Tim Hailes**, managing director and associate general counsel at **JPMorgan**, noted the region's equity business has had a boost from new documentation in the past year. For instance, Asia's variance swap docs are now ahead of Europe, which is also lagging the U.S. too.

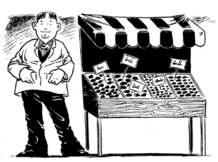
Seen 'N' Heard

• **Gregory Zerzan**, who joined the trade association last week in the new role of counsel and head of global public policy, threw a thought into the leftfield which triggered some lively break-time conversation. "Some of you may be shocked to hear that here in Singapore talking about derivatives we are actually talking about the betterment of humanity," he said. Over coffee, delegates pondered just how seriously Zerzan was taking his new job.

• Do it like you mean it. In a rather unlawyerly tone, **Edward Murray**, partner at **Allen & Overy**, bemoaned the fact the U.K. Takeover Panel barely took notice of ISDA's input on disclosure requirements. "They were only really consulting because they were required to for their own rules." His lawyer hat was only temporarily misplaced, as he quickly asked, "Was that controversial?"

• **Bob Pickel**, ISDA ceo, was interrupted by a chirping sound from the back of the room. As the whole hall turned round, a bird flew center stage and during the next speech made by **Teo Swee Lian,** deputy managing director at the **Monetary Authority of Singapore**, it continued to flit around the room. With some delegates' heads following the bird like a tennis ball in play, Teo did an admirable job of maintaining others' attention. The bird failed to reappear after lunch, leading some delegates to wonder whether it really was chicken they had just eaten.

• Brokers and party animals **ICAP**, annual organizers of ISDA's biggest knees up, were caught short by the opening of Singapore's Ministry Of Sound in December. Local taxi drivers were keen to inform delegates it was the Lion City's top venue—sadly, ICAP didn't get the news on time and this year and were left hosting a party at the city's now second-best venue, Phuture at ZOUK.



Foreign Exchange & Credit Derivatives Markets

Emerging Mart Options Overtake Majors

Emerging market option trading outstripped volumes traded on G7 currencies last week after a jump in volatility across central European currencies raised player interest. The activity was boosted by the prolonged low volatility environment, and therefore less attractive speculative trading opportunities, across the major currency crosses.

In addition, the Icelandic krona has held its spot on the options radar since it fell 10% in 36 hours last month and was downgraded by **Fitch Ratings** (DW, 2/27). The krona is often bundled in with emerging market moves because it is dealt by the same traders.

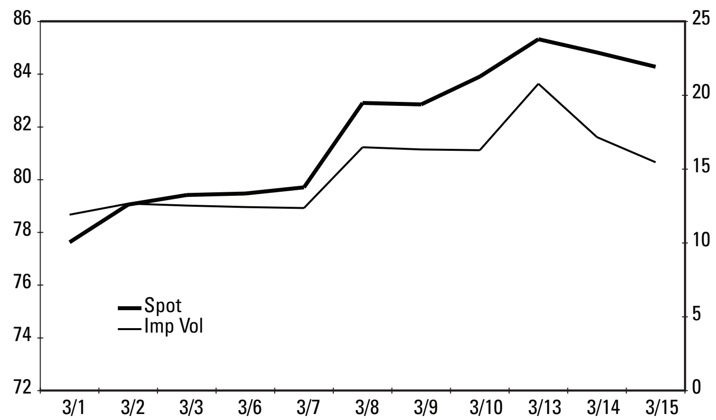
Adrian Hughes, currency strategist at **HSBC** in London, attributed the rise in volatility to the market doing a u-turn on emerging market risk taking. "There was a large plunge in risk appetite and a change to risk aversion, causing positions to be liquidated," he noted.

In line with the shift, traders said one-month implied volatility skipped up on euro/krona, which rose to 20.7% on Monday from 16.2% the week before and the euro/Hungarian forint, which rose up to 7.8% from 7.5% over the same period. In spot, the euro gained ground on the krona to ISK85.32 on Monday from ISK79.71 the week before and also appreciated steadily against the forint to around HUF261 from HUF254 the week before.

Another traded noted activity in U.S. dollar/Turkey new lira options with players snapping up new lira puts. He said the options with one-month expires were most common with strikes around TRY140. On Thursday spot was trading around TRY133.

"There is starting to be wider views on emerging markets than a few months ago," said one official, who also noted options trading on crosses such as euro/Brazilian real and dollar/real. "A few months ago people weren't separating the good from the bad countries, everything was good because the yield was ok," he said.

EUR/ISK Spot & One-Month Implied Volatility



Source: **JPMorgan**

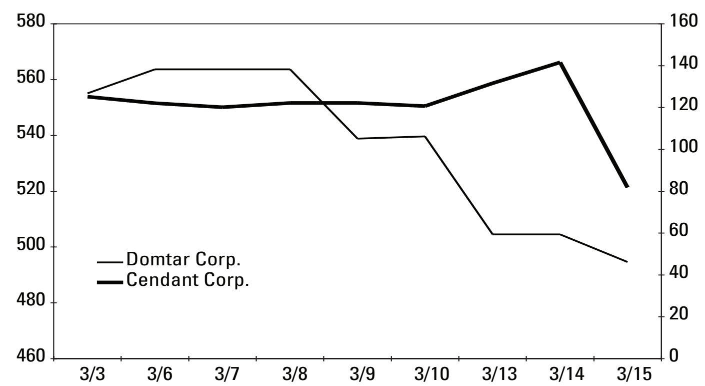
Indices, Names Draw Tighter Ahead Of Roll

The price of protection on North American credit-default swap indices, as well as component names, drew in broadly last week ahead of this week's bi-annual CDX roll. Indices tighten on the way into every roll, traders said, but the CDX and underlying were tighter than usual. "We're seeing a huge amount of selling going into the roll," said one New York trader. "It just feels like people don't want to be short."

Players were particularly interested in selling five-year protection on **Cendant**, a leading provider of real estate, rental car, timeshare and travel services, rated Baa1 by **Moody's Investors Service** and BBB+ by **Standard & Poor's** and **Fitch Ratings**. Spreads pulled in more than 50 basis points in just a few days last week, traders said. The selling craze followed the company's announcement of a new USD2.38 billion credit facility and issuance of USD1 billion in senior unsecured bonds to reduce asset-backed debt. But, it was also part of a general tightening. **Domtar** traded 50 bps tighter Thursday and **Georgia Pacific** 20 bps tighter.

Spreads on the seven- and 10-year CDX drew in overall, but the price of protection on the 10-year 3-7% tranche widened on several big trades. **Deutsche Bank** and **JPMorgan** were reported to be buying protection in that tranche to hedge combination notes, traders said. "Normally it would come in tighter," said one New York trader of the tranche. "It's a little messy this time because there have been some structured products out there that are causing the 3-7% to move up."

Five-Year Credit Protection On Cendant Corp. & Domtar Corp.



Source: **JPMorgan**

L E A R N I N G   C U R V E ®

Implied Correlation For Pricing Multi-FX Options - Part 2

Implied Correlation Of FXRs With Different Denominating Currencies

For the valuation of exotic options written on FXRs with different denominating currencies, the formula (6) cannot be used. This is the case, for example, for a barrier option on two FXRs, where one FXR determines how much the option is in or out of the money at maturity and the other FXR is related to the barrier.

The underlying FXRs for this option may have different denominating currencies. This example is easily generalized to barrier options with more than two FXRs, i.e. some FXRs determine the payoff while other FXRs are knock-in/knock-out indicators. The FXRs linked to the barrier and FXRs in the payoff may have different denominating currencies.

There are closed-form solutions for some barrier options in the case of two FXRs assuming constant parameters in (1). In the case of time-dependent parameters or more than two FXRs, numerical procedures are used to price barrier options. In either case, the correlation is required for option valuation.

Below we derive the implied correlation between FXRs with different denominating currencies via implied volatilities of all related FXRs.

Consider four different currencies i , j , k , m and find the implied correlation $\rho_{i/j,m/k}$ between $Y_{i/j}$ and $Y_{m/k}$ as follows.

$$Var(Y_{i/j}) + Y_{m/k}) = (\hat{\sigma}^2_{i/j} + \hat{\sigma}^2_{m/k} + 2\hat{\rho}_{m/k,i/j}\, \hat{\sigma}_{i/j}\hat{\sigma}_{m/k})T \tag{7}$$

The variance of $Y_{i/j} + Y_{m/k}$ can be written as

$$X_{m/k} = X_{i/k} \,/\, X_{i/m} = > Y_{m/k} = Y_{i/k} - Y_{i/m} \tag{8}$$

In the absence of arbitrage

$$Var(Y_{i/j} + Y_{m/k}) = Var(Y_{i/j} + Y_{i/k} - Y_{i/m} =$$

$$= T(\hat{\sigma}^2_{i/j} + \hat{\sigma}^2_{i/k} + \hat{\sigma}^2_{i/m} + 2\hat{\rho}_{i/j,i/k}\,\hat{\sigma}_{i/j}\hat{\sigma}_{i/k} - 2\hat{\rho}_{i/j,i/m}\,\hat{\sigma}_{i/j}\,\hat{\sigma}_{i/m} - 2\hat{\rho}_{i/k,i/m}\,\hat{\sigma}_{i/k}\,\hat{\sigma}_{i/m}) \tag{9}$$

Thus, the formula (7) can also be written as

Calculating the correlations in the above equation using the "currency triangle" equation (6) and equating (7) and (9) we obtain

$$\hat{\rho}_{m/k,i/j} = \frac{\hat{\sigma}^2_{i/k} + \hat{\sigma}^2_{m/j} - \hat{\sigma}^2_{j/k} - \hat{\sigma}^2_{i/m}}{2\,\hat{\sigma}_{i/j}\,\hat{\sigma}_{m/k}} \tag{10}$$

This equation allows us to find implied correlation between $X_{i/j}$ and $X_{m/k}$ using implied volatilities $\hat{\sigma}_{i/j}$ and $\hat{\sigma}_{m/k}$ of these FXRs and implied volatilities of cross FXRs, $\hat{\sigma}_{i/k}$, $\hat{\sigma}_{m/j}$, $\hat{\sigma}_{j/k}$ and $\hat{\sigma}_{i/m}$. Equation (10) reduces to (6) if denominating currencies in $X_{i/j}$ and $X_{m/k}$ are the same, i.e.. $m = i$, $\hat{\sigma}_{i/i} = 0$.

Discussion

Equations (6, 10) are still valid for the relationship between $\hat{\rho}\,(T_1,T_2)$ and implied volatilities $\hat{\sigma}\,(T_1,T_2)$ over future time period $[T_1,T_2]$ and is also valid for the relationship betweeninstantaneous correlation $\rho(t)$ and instantaneous volatilities $\sigma(t)$. The value of a barrier option depends on the time-structure of volatilities and correlations. Using observed implied volatilities for different maturities T_n, n = 1,2... the implied volatilities over future time periods $[T_n,T_{n+1}]$ can be found as usual via

$$\hat{\sigma}^2(T_n,T_{n+1}) = [\hat{\sigma}^2(0,T_{n+1})T_{n+1} - \hat{\sigma}^2(0,T_n)T_n]/(T_{n+1}-T_n)$$

and equations (6, 10) can be used to find implied correlations $\hat{\rho}\,(T_n,T_{n+1})$ over those periods. The instantaneous volatilities $\sigma_{i/j}(t)$ can be extracted from (2), assuming some functional form, and used in (10) to find instantaneous correlations $\rho_{i/j,m/k}(t)$. These can be used in Monte Carlo or other numerical procedures to get better estimates of barrier option prices. The easiest approach is to assume piecewise constant functions of time. Then instantaneous volatilities and correlations are just forward implied volatilities and correlations over corresponding time periods:

$$\rho_{i/j,m/k}(t) = \hat{\rho}_{i/j,m/k}(T_n,T_{n+1}); \quad \sigma_{i/j}(t) = \hat{\sigma}_{i/j}\,(T_n,T_{n+1})$$

for $t \in (T_n,T_{n+1})$. Other functional forms for time-dependence can be used as well.

It is important to note that calculating correlations

Derivatives Week is now accepting submissions from industry professionals for the Learning Curve® section. For details and guidelines on writing a Learning Curve®, please call **Elinor Comlay** in London at 44-20-7303-1738, **Matthew Tremblay** in Hong Kong at 852-2912-8097, or **Abigail Moses** in New York at 212-224-3640.

via implied volatilities allows for the transfer of the correlation risk of the multi FX option into volatility risk in all underlying FXs. This is because option price becomes dependent on FX volatilities only when correlation is calculated by (6) or (10).

One of the consequences of model (1) is that the implied volatility is independent of strike, while the observed implied volatility usually exhibits strike dependence, the so-called volatility smile. Thus, in the presence of smile, the pricing of multi-asset options assuming model (1) and correlations (6, 10) cannot be consistent with all implied volatilities observed for different strikes. Under model (1), one can make pricing consistent with, for example, at-the-money implied volatilities—for all available maturities— by using ATM volatilities to find instantaneous time-dependent volatilities and correlations in the way described above. The pricing can be made consistent with volatility smiles of option underlying FXRs by considering more complicated models. For example, the multivariate extension of a state-dependent volatility model where time dependent $\sigma_{i/j}(t)$ and $\rho_{i/j,m/k}(t)$ in model (1) are assumed to be time and state dependent functions $\sigma_{i/j}(X_{i/j},t)$ and $\rho_{i/j,m/k}(X,t)$ respectively. Although in this case $Var(Y_{i/j}) \neq \hat{\sigma}^2_{i/j} T$, equation (10) is still valid for the relationship between instantaneous correlations and volatilities. Thus, after marginal calibration of $\sigma_{i/j}(X_{i/j},t)$ using observed implied volatilities, one can find instantaneous state-dependent correlations using (10). Solution and calibration of such model is quite complicated and is beyond the scope of this article.

*This week's Learning Curve was written by **Dr Pavel Shevchenko**, at the **Commonwealth Scientific and Industrial Research Organisation**—Mathematical and Information Sciences, in Sydney, Australia.*

Markets

Five-Year Credit-Default Swap Levels

March 15, 2006

U.S.

Name	Current Mid	Change On Week	Change On Two Weeks
American Express	21	-1	1
American Express	19	0	0
AOL Time Warner	47	-5	-1
Bear Stearns	23	0	0
Citigroup	13	1	1
Disney	25	-1	-1
Federated Dept. Stores	33	0	-2
Ford	915	-30	-10
Ford credit	490	-30	-30
General Electric Cap Corp.	15	0	0
GMAC	405	-65	-90
Goldman Sachs	21	0	0
Hertz	230	-14	-3
Hewlett Packard	17	0	0
IBM	15	1	1
Lehman Brothers	23	0	0
Morgan Stanley	21	0	0
Philip Morris	57	-3	-3
Wal-Mart	10	0	0

Europe

Name	Current Mid	Change On Week	Change On Two Weeks
DaimlerChrysler	59	-1	-2
Volkswagen	34	1	0
J Sainsbury	30	1	1
Marks & Spencer	42	1	0
France Telecom	44	-1	-2
Deutsche Telekom	42	-1	-2
Telecom Italia	52	-2	-1
Vivendi Universal	45	3	3

Asia

Name	Current Mid	Change On Week	Change On Two Weeks
British American Tobacco	41	1	4
Amcor	50	-1	-1
BHP Billiton	20	-1	-1
Fujitsu	29	0	1
Hutchison Whampoa	39	1	3
Mizuho Bank	16	1	0
NEC	33	1	2
Qantas Airways	46	0	0
Sony	28	0	3
Telstra	36	0	1
Toshiba	33	1	4
Australia	2	0	0
China	18	1	1
Japan	4	0	0
Korea	22	0	0
Malaysia	26	1	2
Philippines	192	-6	2
Thailand	42	2	4

North America	Current Mid	Change On Week	Change On Two Weeks
CDX.NA	39.75	-2.38	-2.50
CDX.NA.HY	241.04	-9.80	-8.62
CDX.EM	104.00	-14.00	8.00
Europe	**Current Mid**	**Change On Week**	**Change On Two Weeks**
iTraxx Main	34.50	-0.75	-1.00
iTraxx Crossover	250.00	-8.00	-4.00
iTraxx High Vol	68.50	-2.25	-3.50
iTraxx Sub Financial	21.75	-0.50	2.00
Asia	**Current Mid**	**Change On Week**	**Change On Two Weeks**
iTraxx Japan	25.71	0.41	0.88
iTraxx Asia	38.26	0.37	1.25
iTraxx Australia	29.57	-0.22	-0.09

This data is updated every Wednesday; Values expressed are in basis points.

Source: **JPMorgan**

MORGAN STANLEY

(continued from page 1)

sales and structuring in Hong Kong, has been tapped by **AIG Financial Products** to establish a CDO structuring effort for Asia (see page 1). In London, **Tony Venutolo**, executive director in structured credit marketing, is gone and may be moving to **SG Corporate and Investment Banking**.

One recruiter said the effect will be miniscule because the team, although smaller than other bulge bracket houses, is more niche-focused and entrepreneurial.

The departures come after London-based **Chris Boas**, head of correlation trading, resigned last month and **Rodrigue Afota**, a senior structurer, left in December to do credit structuring for **IXIS Corporate & Investment Bank** in Paris. Boas is expected to join hedge fund **Citadel**. In addition, **Ryan Chan**, a v.p. in credit structuring, is reportedly moving to **UBS.** He declined comment on his new employer when reached on his cell.

Spokesmen for SG CIB and UBS either couldn't be reached or didn't know anything.

—Laura Cochrane & Matt Temblay

CROSS-ASSET

(continued from page 1)

of structured equity and global head of retail marketing and structuring. **Stephanie Smart**, spokeswoman for Deutsche Bank, and Groothaert, reached on his cell phone, both declined comment. It could not be determined if he will take another role at the firm on his return or move elsewhere.

Like rivals **Merrill Lynch** and **JPMorgan**, Deutsche Bank merged its derivatives businesses over a year ago and now seems to have floundered on the same political problems as its U.S. rivals which sparked high-level departures. The German firm announced a further reorganization in November which set up a combined cash equity and derivatives group, with Groothaert and **Serge Marquie**, global head of equity strategics in New York, appointed to co-head structuring. It also last month unwound its cross-asset structured sales teams in Asia to split again along asset-class lines (DW, 2/3). Market reports are that Groothaert's group lost out in the course of this restructuring.

Groothaert is well regarded in the market and is attributed with being a key driver in creating a retail equity-linked business at Deutsche Bank which rivals—and in some regions betters—industry monolith **SG Corporate & Investment Banking.** "They have built an excellent franchise in many markets," said one rival equity head. Another added, "[Groothaert] has an impressive reputation and I have a very high respect for what he has achieved." He noted prior to Deutsche Bank, Groothaert was responsible for setting up a similar business at Merrill Lynch.

Rivals also noted, however, the continued growth of **Deutsche Asset Management**'s retail structured product business, and several said it has not been clear if this is run in competition or harmony with the investment bank's structured product group. DeAM last year hired a group of senior sellside **ABN AMRO** staffers to build its structured retail business (DW, 7/1).

—Elinor Comlay

AIG

(continued from page 1)

CDO structuring effort for Asia, as was first reported by *DW*'s Web site Tuesday. Market officials familiar with the situation said Rana will join in the coming weeks to oversee the credit and CDO structuring effort for the region. Rana worked at Morgan Stanley for over a decade in rates and credit derivatives, most recently heading up credit derivative sales and structuring for the region. He did not return messages placed to his mobile phone by press time. **Robert Breden**, head of Asian investment grade trading and structuring at Morgan Stanley in Tokyo, did not respond to messages by press time.

—M.T.

Calendar

Euromoney Seminars is holding its third annual China Derivatives Summit at the InterContinental Pudong Shanghai, on April 27-28. To register, call +852 2842 6912.

Quote Of The Week

"If someone doesn't know what that stands for they must have been asleep in '05."—**Justin Kennedy**, *managing director at* ***Citigroup****, on the craze in equity derivatives for Brazil, Russia, India and China (BRIC) products (see story, page 8).*

One Year Ago In Derivatives Week

Collateralized debt obligation managers were concerned about tight spreads and were looking to hedge widening risk by trading CDO tranches against one another or against credit derivatives indices. [The spread environment remains tight and relative-value trades of all kinds have been used to pick up returns as well as protect against eventual widening.]

