Fixed Income LEADERS SUMMIT

THE FILS REPORT #3
NOVEMBER 6-8 2018

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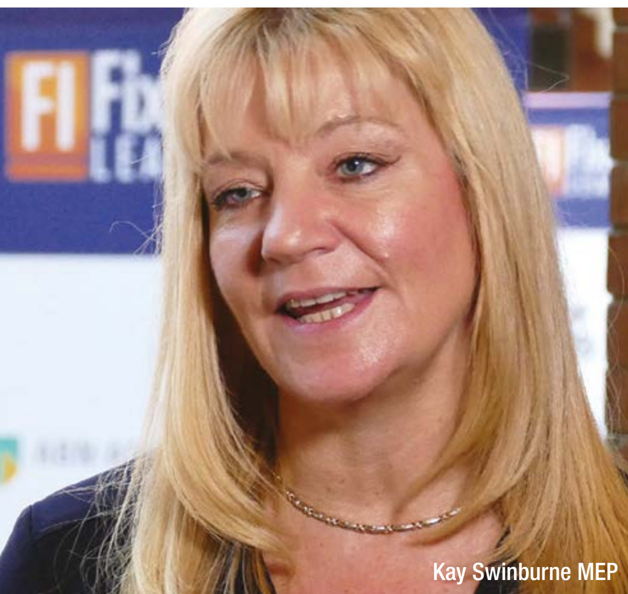
THE OFFICIAL NEWSLETTER OF THE FIXED INCOME LEADERS SUMMIT 2018

Swinburne: Traders should beware of radical change in Europe



Kay Swinburne MEP

Brexit will mean that politics will take precedent over principal, when setting policy in Europe, warned Kay Swinburne MEP, speaking at the Fixed Income Leaders' Summit in Amsterdam.

"We need to consider the changes that will take place in the European Union (EU) and to the EU's institutions. The European Parliaments elections are a good starting point," she said.

In May 2019 the EU elections will likely trigger a new and very different parliament with a greater emphasis on fringe political parties. In the current parliament, these groups typically vote against legislation regardless of its content.

"In the new parliament this type of tactic could return with numbers that make a difference," she said.

If this were to continue into the new parliament, Swinburne said one of two scenarios could emerge. Either they could block the passage of all legislation reducing the overall legislative output of the EU, or they could coordinate their activities.

Although they have not in the past Swinburne warned, "They could manage to deliver very radical agendas, across all legislation, not just those [in finance]."

The change in staff of EU institutions will also likely impact the direction of EC legislation, while there is also huge potential for change within individual EU member states, Swinburne said. The Italian budget and the new leadership within Germany will have a direct impact in the directions of financial legislation.

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1 ▸ This will mean that a MiFID II review will be written off for at least the first six months of the new European parliament, with topics like taxation taking uptime in the agenda. However the fundamental work of MiFID II will be affected.

"I don't know how many of you have heard of the 'Investment Firms Review', but it is already reclassifying what we understand to be an investment firm under MiFID II," she said. "Fundamental changes are already taking place to the legislation."

The reason this type of work is taking place behind closed doors right now is directly motivated by Brexit, which she said is the single biggest driver for 'MiFID III' type changes. The opinion that the UK would move away from existing European rules was quite wrong, she argued.

"When you think about the effects of Brexit and what impact it could have on MiFID, it is the EU 27 which will likely move away in a piecemeal fashion from MiFID II than the UK would ever think of," Swinburne said.

Most relevant to the fixed income markets would be changes where the UK had most heavily influenced MiFID II, she further asserted. The UK was also always an advocate for a more limited set of instruments asset to be subject to pre-trade and post trade transparency rules in the fixed income markets and an advocate for fair competition between firms within Europe's capital markets.

"The UK insisted there were rules around non-discriminatory access to clearing," she said. "Without the UK applying competitive pressure, I would not be at all surprised if the current exemption to this rule is made permanent." ■

QUOTES OF THE DAY

"In ten years' time, my way of working is going to be obsolete. I need to help my traders to ensure their skillsets are still relevant in ten years' time."

Oscar Kenessey, NN Investment Partners

"We owe our clients the privilege that we will go the extra mile for them. I don't think we do anything for the sake of it, we're simply doing it to get the best outcome."

Lee Sanders, AXA Investment Managers

"You can't ignore the fact that every other government bond market in Europe has an extremely low rate, and Italian yields are at historically high levels for the country. That looks like an investment opportunity."

Scott Theil, BlackRock

"The FCA has been utterly useless about engaging with the EU. It has been good at making sure non-British companies continue to be welcome in the UK, but it has been much less successful in helping British firms to access the EU."

Anthony Hilton, London Evening Standard

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Python eats traders

Balancing man and machine will be the critical success factor for buy-side trading desks, delegates were told in Thursday's head trader keynote panel, with coding languages such as 'Python' becoming a key skills.

The growing electronification of fixed income markets is increasing the role of data analytics in the trading process, requiring asset managers and owners to invest in new skills and technologies, both on the trading desk and across the investment process. Buy-side firms should make every effort to retain traditional relationship-based fixed income trading skills, senior traders said. But they should prepare for a future in which trading is both more data-driven and multi-asset in scope.

"Trading desks need to embrace change," said Jatin Vara, head of international trading and global head of emerging markets trading at BlackRock. "I strongly believe that multi-asset traders deploying their skillset across a complex market can make a huge difference."

Traders must take an increasingly pro-active approach, both to supporting their portfolio managers and developing their own skillsets, panellists agreed.

"The old-style reactive desk has long since died out," said Darren Moore, head of investment grade, high yield and emerging market credit trading at Legal & General Investment Management. "Traders need to be proactive and increase their knowledge in this fragmented market. They need to be preemptive, going to the PM with a solution before the problem arises."

Oscar Kenessey

Preparations for a more data-driven trading desk is taking many forms. "Python is the new Excel," said Oscar Kenessey, head of fixed income, derivatives and currency trading at NN Investment Partners. "A 57-year trader on our desk who has never programmed in his life declared recently: 'I'm going to learn Python: who's going to join me?'."

Voice-broking skills will still be needed in the less-liquid markets in the medium term, Kenessey said. "But, in ten years' time, my way of working is going to be obsolete. I need to help my traders to ensure their skillsets are still relevant in ten years' time."

Panellists said the acquisition and analysis of data is now taking up an increasing amount of their budgets. Kenessey asserted that buy-side firms need to develop their own proprietary platforms for capturing and integrating for third-party providers, in order to leverage data effectively and contribute to the investment process. "You will fall behind if you wait for someone to put it on a silver plate for you," he said. "There is no way round doing this yourself."

Fabien Oreve, global head of trading at Candriam Investors Group, said that trading desks required a blend of experience and skills to optimise new data resources, but also emphasised the growing need for flexibility across asset classes, as demanded by an increase in global investment strategies.

Oreve said that all fixed-income traders were "gradually becoming multi-asset traders" due to the FX and derivatives exposures inherent in global strategies, which required investment in both skills and technology.

"Trading desks need an order management system that can access key platforms in a full straight-through-processing environment to keep manual intervention to a minimum," he said. "I believe in sharing knowledge and experience across different generations and asset classes to create a strong unified efficient desk to tackle all the diverse investment strategies that we have to serve." ■

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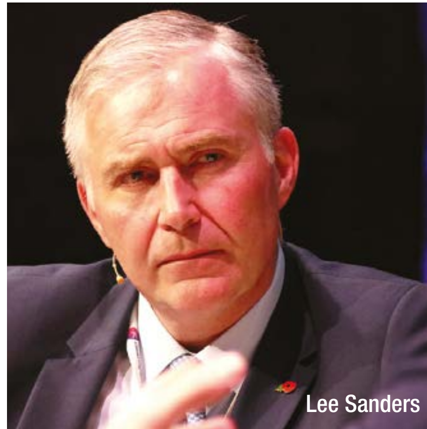
Buy side 'owes' it to the market to make progress with tech

Using innovative systems and technology to improve fixed income trading is part of the duty of care that buy-side traders owe to their clients, management and the broader market, according to Lee Sanders, head of fixed income trading in the UK and Asia at AXA Investment Managers.

Speaking in conversation with former AXA colleague Christophe Roupie, now head of Europe and Asia at MarketAxess on the second day of FILS Amsterdam 2018, Sanders issued a rallying call to buy side firms to avoid complacency and continue innovating in pursuit of the best outcome for investors.

"We owe our clients the privilege that we will go the extra mile for them. I don't think we do anything for the sake of it, we're simply doing it to get the best outcome – if we put in a new system or we go to the market, we always have that in the back of our mind," said Sanders.

A sign of recent progress in electronic trading lies in the fact that when a risk event strikes, there is often now greater use of electronic platforms whereas previously market stress would often drive a reversion to voice trading. But buy-side firms could still do more to enhance liquidity, Sanders added, applauding all-to-all liquidity pools such as MarketAxess OpenTrading


Lee Sanders

"We have been slow to use our inventory to create liquidity, but I think it's probably easier for third parties to facilitate that. We have talked a lot about revolution in the past and the move to central limit order books, but we never go there immediately, as an industry we are very slow at embracing that. It's not that we don't want to, but the buy side needs to warm up to looking at alternatives in the way they trade," said Sanders.

Despite having crossed from the buy side to a technology provider, Roupie expressed similar priorities at MarketAxess, where there is an equal need to deliver the best value for users and develop a fair and effective marketplace. For investment firms an equal challenge is to make sense of the large number of fintechs operating in the sector, filtering through the noise to identify those firms that could offer practical value to their businesses.

Mark Whitcroft, founding partner at Illuminate Financial Management, offered a roadmap to help firms navigate the fintech world, with a range of options including buying, partnering, or investing in relevant firms, building internally or ignoring the space altogether. But ignoring should be done from an informed perspective he said.

"You have busy days, you have long to-do lists from your bosses, and innovation is probably right at the bottom because there are key targets that need to be met this week, this month, this quarter," said Whitcroft. "But not all fintech start-ups are the same, so it's really about being able to filter through which are the ones that are enterprise ready, and it's really important to link whatever you choose to do in this space with your strategy." ■

Christophe Roupie

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No respite for Italian volatility

Political uncertainties will continue to guarantee challenging conditions for investors in Italian government bonds well into 2019, according to speakers on Thursday's CIO keynote panel at the Fixed Income Leaders' Summit in Amsterdam.

"The Buoni del Tesoro Poliennali (BTP) market is the fourth biggest government bond market in the world," noted Bill Street, head of investment, EMEA, State Street Global Advisors, "but it's not a mature bond market. Investors will always go to the Bund market as a source of diversification and protection against that."

The yield on Italy's 10-year government bond (BTPs) rose six basis points to 3.40% on Thursday morning, according to Reuters, increasing its spread over German bunds to 295 bps. This followed news that the European Commission had reduced Italian growth estimates, pushing the country's projected 2019 budget deficit close to the 3% ceiling permitted. As well as rising tensions between Rome and Brussels, there have been frequent reports of infighting and disagreement within the ruling coalition.

"The fiscal policy doesn't appear to have matured since the European debt crisis," added Street. "On top of that, we have a relatively immature political framework governing fiscal policy in Italy. People that haven't started exploring proxies for Italy are trading far too tightly, considering that BTPs are now trading closer to Greece than Portugal. That is going to be a problem next year."

A major sell-off in Italian bonds was accompanied by a collapse in bid-to-cover ratios, with many banks not holding sufficient inventory to respond to buy-side demand, partly due to the capital costs of holding risky assets.

"Italian credit default swaps (CDSs) are trading wider than South Africa," observed Scott Theil, deputy CIO of fundamental fixed income and head of global bonds at BlackRock. "You can't ignore the fact that every other government bond market in Europe has an extremely low rate, and Italian yields are at historically high levels for the country. That looks like an investment opportunity. The issue is that liquidity has become so unbelievably poor that you cannot really position too significantly in the country because liquidity and volatility risks are too high."

Eric Brard, global head of fixed income, Amundi Asset Management, warned of further volatility in BTPs in the run up to elections in the European Parliament. "There will be a lot of noise between now and June," he said.

Asked about to comment more broadly on geopolitical risks facing fixed-income investors, BlackRock's Thiel said the number one risk identified by clients was the deterioration of US-China trade relations, due in part to the sheer range of assets potentially impacted. ■

Bill Street

Scott Theil

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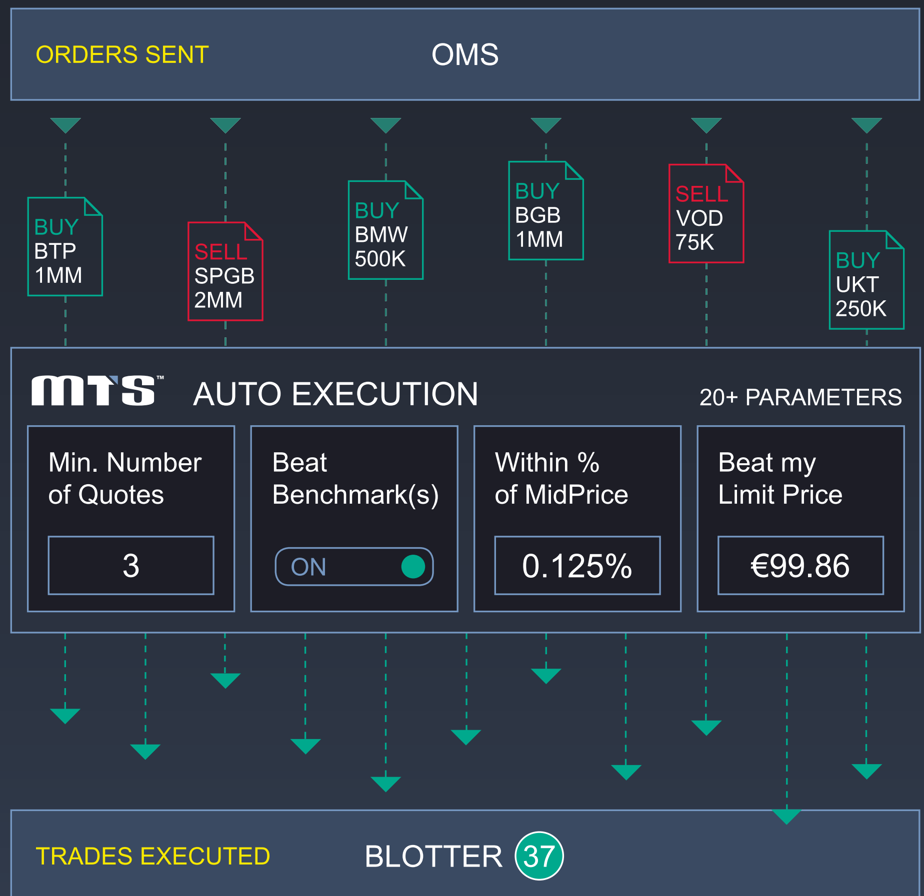

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FCA "utterly useless" engaging with EU over Brexit

Veteran city commentator Anthony Hilton delivered a harsh verdict on the UK financial regulators' efforts to support Britain's finance industry ahead of the country's departure from the European Union, speaking on the final day of the FILS event. "The FCA is not getting anywhere," said the financial editor of the *London Evening Standard*. "It hopes things will be alright on the night, but who knows?"

Anthony Hilton

Hilton suggested there was still considerable uncertainty over the nature of the future economic relationship between the EU and UK contained in any deal struck by the European Commission and the UK government.

"But it will all be couched in warm words and platitudes to make it palatable to Theresa May, so she can sell it to her MPs. It'll be like a Twix bar: the solid commitment will be the biscuit base, the economic partnership will be the fudge, and it'll be covered in chocolate. That's what I think will happen. Whether the House of Commons endorse it is another matter."

Hilton painted a stark picture of a 'no deal' scenario in which no agreement is UK-EU confirmed by March 2019.

"If there is no deal, everything stops – including MiFID II. The outline of article 50 will fall away, as will the transition agreement. The EU will regard the UK as a third country," he said. "UK financial firms will have to register subsidiaries, if they haven't done so already, but that will not be enough for firms that want to do wholesale business in the EU. They will also have to apply for equivalence. The EU will then have to decide if the application is to be accepted. Even if it is accepted it could be revoked in theory with three months' notice."

Hilton also raised the prospect of the UK government "playing hardball" with European firms if UK companies fail to obtain access to EU markets, predicting "chaos".

"The FCA has been utterly useless about engaging with the EU. It has been good at making sure non-British companies continue to be welcome in the UK, but it has been much less successful in helping British firms to access the EU. There is no agreement on any form of access to the EU other than to say that British firms will have to be compliant with EU rules," he added.

"In the longer term, there is the issue of mutual recognition of regulatory standards, not passporting. This would be the equivalent of a trade deal, so rather difficult to pull off." ■

The FILS Exhibition in full swing

Emerging market 'tourists' challenge liquidity

Chris Perryman

Emerging markets have had a volatile year, intensifying the pressure on asset managers gain better access to liquidity and pricing. Pinebridge Investments' Chris Perryman, senior trader for emerging markets fixed income, gave a masterclass on how to manage the process, through relationships and technology, at the Fixed Income Leaders' Summit on Thursday 8 November.

Emerging market suffer from 'tourist' liquidity providers, banks who will engage occasionally but then not make markets for weeks at a time. That has led to bid-less markets in some cases, during recent volatility, and required buy-side firms to manage their broker engagement more closely.

"We have used heatmaps to assess how brokers are engaging, and where they are committing capital," Perryman said. "We have increased our broker lists, mostly with local brokers."

Local brokers can be engaged with more electronically – Perryman says about 95% of local business is conducted this way – due to the depth of local market liquidity, while global brokers typically need to trade over voice, for EM bonds. However platforms are not all living up to the demands of clients.

"Platforms often have the FX component of a trade embedded, which is very useful, expect some have a delay on the FX component, which sometimes sees you going back and forth as you try to get the correct price for that trade," Perryman said. "In some cases that appears to be hardwired into the technology." ■

Take a modular approach to layering regs, industry told

Having implemented multiple regulations on a standalone basis over the past decade, market participants must now take a more flexible, modular approach that allows systems to be modified and tweaked as rulebooks evolve, experts have warned.

Speaking in the closing sessions of FILS Amsterdam 2018, officials at industry associations and technology firms suggested that with Brexit on the horizon and further changes to existing regulations likely, a fire-fighting approach to regulation is no longer appropriate.

"If you don't take the opportunity to make this kind of investment then you are short changing yourself because maintenance and operational costs will continue to be high. We talk to a number of institutions that want to invest in a much more adaptable approach, but this is not yet universal," said Brock Arnason, founder and chief delivery officer at Droit Financial Technologies.

David McClean

While industry resources may be consumed with MiFID II compliance and preparations for Brexit, standards have also been developed to address failures in conduct and market practice highlighted by the LIBOR and FX benchmark scandals.

Following the UK Fair and Effective Markets Review in 2015, there has been a steady stream of voluntary guidance and standards issued by bodies including the FICC Market Standards Board. Standards might not be binding, but there should be incentives to adopt them, said David McClean, senior technical advisor at the FMSB.

"There is a tendency when there is misconduct to default to rules, but rules don't describe conduct," said McClean. "The real advantage of standards is they make it much easier to identify what is genuinely bad behaviour." ■

Developing liquid, sustainable markets in SOFR and SONIA

In conversation with Mark Rogerson, executive director, head of interest rate products, EMEA, CME Group

Momentum is gathering in the development of alternative reference rates to replace LIBOR and the other IBORs. How is CME supporting this transition?
CME has been heavily involved in the move towards alternative reference rates and we have quickly developed innovative new products to support these rates. Most recently we launched sterling-denominated SONIA futures in October 2018 and before that we launched SOFR futures in the US in May. We have already traded more than 600,000 of those SOFR-based contracts, and we recently had a single day record of over 25,000 contracts.

How deep is liquidity in these new products?
Risk-free reference rate futures are offered as an alternative to existing benchmarks, and they are establishing themselves in their own right. Products linked to existing benchmarks such as Eurodollars remain extremely important and liquid. Eurodollar futures in 2018 trade over 3 million every day, up 20% year on year. Relative to that, SOFR and SONIA have some way to go and are moving in the right direction. More than 80 firms have now traded SOFR futures since the launch in May. Alongside futures, we also offer the ability to clear SOFR-based swaps, which creates a virtuous circle because the futures provide the price discovery for the swaps and the swaps are then hedged with the futures. The third leg is increased issuance against SOFR rates and we are beginning to see a more diverse range of issuers, which is a necessary part of the transition process. SONIA was a pre-existing benchmark so it had a head start and was already being used in the OTC market. We are supporting the market structure by giving customers a choice of where they want to trade those products.

Mark Rogerson

The Working Group on Sterling Risk-Free Rates has just completed a consultation on term SONIA reference rates. Why is this important?
The key to term SONIA reference rates is education – as market participants and infrastructure providers, we all need to better understand the need for term rates and the best way to develop them. When it comes to how the term rate will actually be calculated, there seem to be two tracks gathering momentum – one is by use of OTC OIS prices which seems to be favoured in the UK while the US track utilised data from the futures market. Both of those tracks have the potential to be successful and different outcomes may be appropriate in different markets. We will continue to work with the recommendations of the relevant working groups.

Is there a danger of market fragmentation as these new alternative rates and products are developed?
The market is already familiar with fragmentation across swaps, futures, cash bonds and bond futures, because each of those products is traded and cleared on different venues. It is inevitable that some fragmentation will remain, though we may see some consolidation at a later date. From our perspective, the most important thing is to understand what our customers need and to be as innovative as we can with the products we develop. We deliberately developed SOFR futures to be similar to existing products, which was a choice driven by more than 300 customer conversations during which we were asked to make the products look and feel familiar so that they could be adopted more quickly. Innovation will drive opportunity for customers, and by developing a varied range of products we are expanding the choices available. ■

Smart deployment of tech is key to boost FI desk effectiveness

Mehmet Mazi, Managing Director and Head of Credit Trading at HSBC, gives his expert insight into optimising the trading desk.

Mehmet Mazi

Where are the greatest risks for trading desks today?

I think price discovery in OTC / RFQ format is still a challenge for the buy side and the sell side. The market does not trade like equities, not everything is visible, and the buy side sees more price information than the sell side. Consequently the reliability of the pricing coming from the sell side can be questioned by the buy side.

Is regulation helping?

One of the better things about MiFID II, and also the TRACE implementation in the US, has been more transparency and price discovery. As MiFID II implementation progresses, we will see ticker tape being used more, bringing more efficiency in price discovery. When price discovery is more reliable, liquidity provision increases. Large tickets that the buy side would like to execute on the high-touch channel become easier to execute.

How are you responding to that?

We are supporting transparency. We look at incoming RFQs, where they have traded and also where they have missed and by how far, and also the composite observations in the street as well as ETF price observations and indices. We put this together to create our own fair price / composite with different mathematical techniques to make price discovery both faster and more accurate.

Our recent pricing algorithm has improved speed of response from 24 seconds to 14 seconds, and by bringing machines and traders together we are seeing very good results in terms of quality and speed.

Can you overcome balance sheet constraints on taking risk?

Balance sheet is not the biggest issue for the largest banks. For day-to-day market making we deploy it adequately. I think the lack of efficiency in the interbank market is the real issue. If a sell-side firm takes on a large position, they are not concerned about the balance sheet, but because they do not have 100% visibility on the fair price. That is why we need better price discovery in the market.

The rise of interbank venues, plus dealer-to-client and all-to-all venues will help. We do not know which will be most efficient, but ease of use, cost and speed will clearly determine the winners. We will differentiate the pricing we stream into venues which are mostly costly and slow.

Do you see technology as being the key to solving these issues?

It depends on the smart deployment of specific technology. In credit you do not have an homogenous instrument; you have 500,000 public instruments where in FX you have 170 pairs. So we have to make our traders, algos and machines aware of that differentiation for each type of instrument and establish connectivity to where they trade the most.

If you look at distressed and EM markets, where we have one of the most successful businesses, price making is not algorithmic, but we use technology in different ways. We use it in research, in deep-dive fundamental and technical analytics. We are looking at solutions to scout the public statements of every issuer to get the data in order to automate that process which can then contribute to price making. So you can use technology up and down the trade lifecycle, not just in automating execution and flow pricing where we deploy our algos today. ■

The reward of risk

By Larry E. Fondren, Founder & CEO, DelphX Capital Markets Inc.

Larry Fondren

Traditional risk/reward comparisons treat the effective cost of an investment's risk as a decrement to its potential return – overlooking the additional potential return available on certain investments in which risk may provide an additional source of alpha. While cost-effectively reducing an investment's risk, and/or its relative capital cost, can promote a higher return, investors that seek to harvest latent alpha potentially embedded in the risk itself may be well rewarded for their effort.

History has proven that risks are most efficiently managed in groups comprised of diverse exposures to which actuarial science and the 'Law of Large Numbers' can be effectively applied to produce consistently predictable results. Those risk-management processes have been employed by insurance and reinsurance companies to produce profitable results for centuries.

Ancient tool – modern solution

The risk-pooling processes employed by reinsurers, to globally distribute and diffuse insured risks, were originally used thousands of years ago by ancient ship owners who pooled their risks of potential ruin due to losses of their ships and cargo at sea. Where an individual owner would have been devastated by the loss of a ship, pooling the risk enabled owners to distribute each exposure among their numbers, so that each paid a relatively small amount in the event of such a loss.

The primary pooling functions historically used by reinsurers are now also available to credit investors seeking to reduce their default risks. Through a transparent distributed ledger accessible within a regulated global facility, investors can anonymously:

- Transfer the full default risk of a referenced underlying security to a secured protection-account, and, in return for their payment of a negotiated series of fixed premiums;
- Purchase a collateralised credit security in which the default risk of a referenced underlying security is embedded; and either:
- Retain the embedded default risk, or fully transfer it to a dynamic risk-pool, receiving in return a small pro-rata share of all risks transferred to that pool.

Unlike pools employed in structured securities, no assets or cash flows of an underlying security or referenced entity are included in a risk-pool. Only the default risk of the underlying securities embedded in the pooled-risk securities are included in a risk-pool.

Releasing embedded alpha

Operation of the Law of Large Numbers within a risk-pool produces an increasingly predictable default experience as the size of the pool increases. The pool's collective result also naturally regresses toward the mean of the total experiences of its constituent exposures. That increased predictability and regression proportionately reduce the capital requirement of each individual risk in the pool. In turn, that lower capital requirement:

- Reduces the required face amount of each pooled-risk security, without commensurately reducing the security's independent flow of coupon payments; and thus:
- Increases the holder's yield through its ongoing receipt of the latent alpha released from the security's diminished risk. ■

To learn more about the reward of risk, contact Larry Fondren at info@delphx.com.

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