



R&R Consulting  
Bringing science back to financial engineering

# What's ~~Good~~ *Great* about the ETP Model? (ETP="Exchange Traded Product")

PRMIA DC EVENT:

Regulation of Credit Default Swaps & Collateralized  
Debt Obligations

June 10, 2009

# A balanced, well-functioning system.

**PRICE DISCOVERY:** One market for bids & offers. **PRICE TRANSPARENCY:** Tick data with a time stamp, publicly available. **RISK DISCIPLINE:** Framework for continuous measurement of credit risk. [Rating agency ratings obviously don't "cut it" for structured products.] **STANDARDIZATION/SEPARATION OF DUTIES/SKIN IN THE GAME:** Exchange assumes oversight responsibility for the operational risks of the platform and contract market design. Clearinghouse assumes responsibility for liquidity and credit. If a problem arises in the after-market, Exchange and Clearinghouse together are responsible for the cleanup. **INTEGRITY:** Information-based framework for managing volatile credit risk on a near-continuous basis. Between our mark-to-market rhetoric and the reality of our market practices, **CONSISTENCY.**



What's ~~Great~~ *Missing* in the ETP Model?

# the spot Market

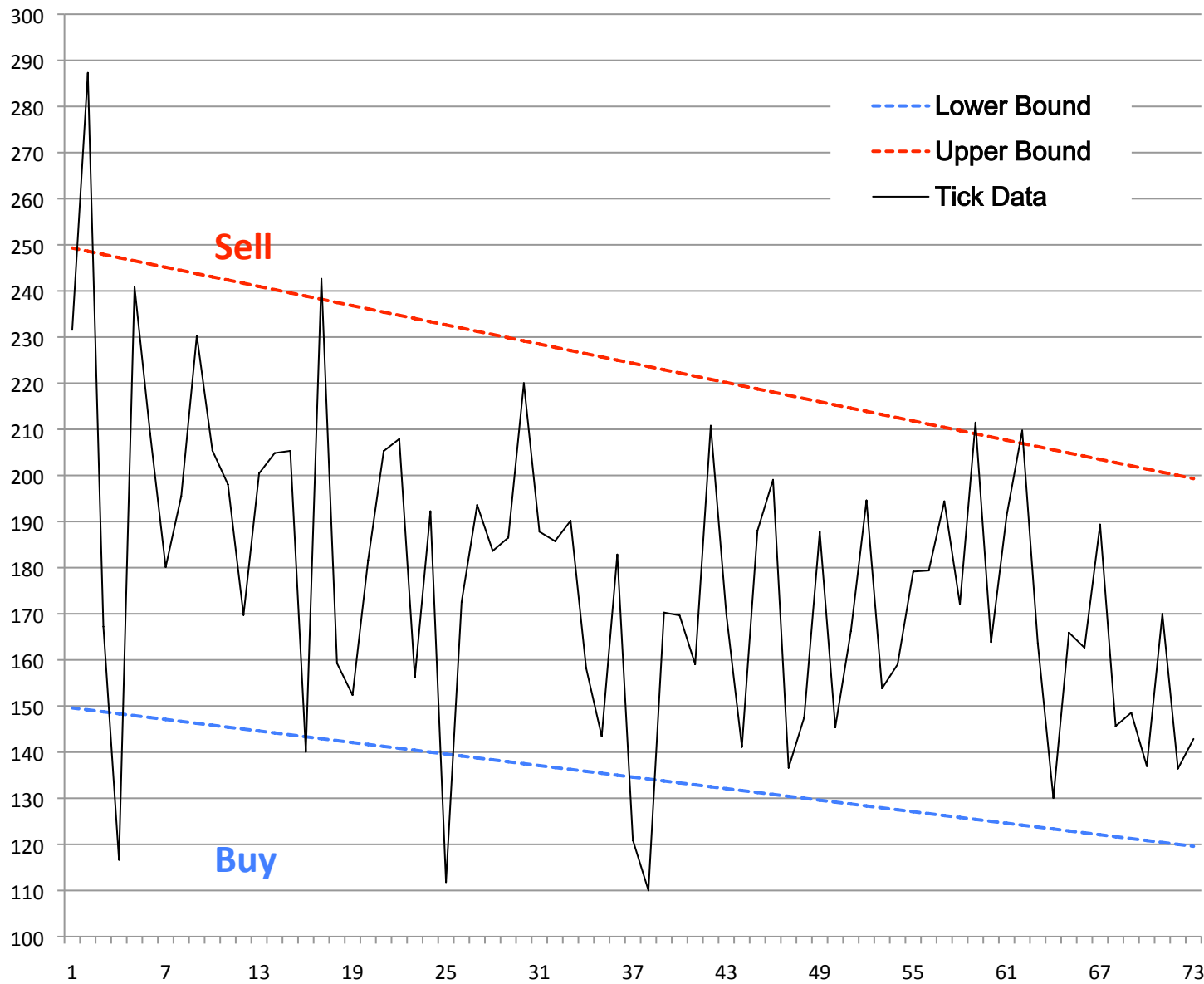


# Cash Price – Futures Price × Conversion Factor = the **BASIS**

*What makes the **bond and note basis relationships** interesting is the **combined complexity of the cash markets** and the **structure of the futures contracts**. The bond market, for example, is made up of bonds bearing a wide range of coupons and maturities and different call provisions. Thus, even though Treasury bonds all share the same creditworthiness, the bonds themselves are different enough to make the cash market interesting. Also, the futures contract is designed so that the trader who is short the futures contract has several strategic delivery options that affect both what bond is delivered and when.*

**–Galen Burghardt et. al., *The Treasury Bond Basis, 2<sup>nd</sup> Edition, xxi.***

# Trading the Basis\*

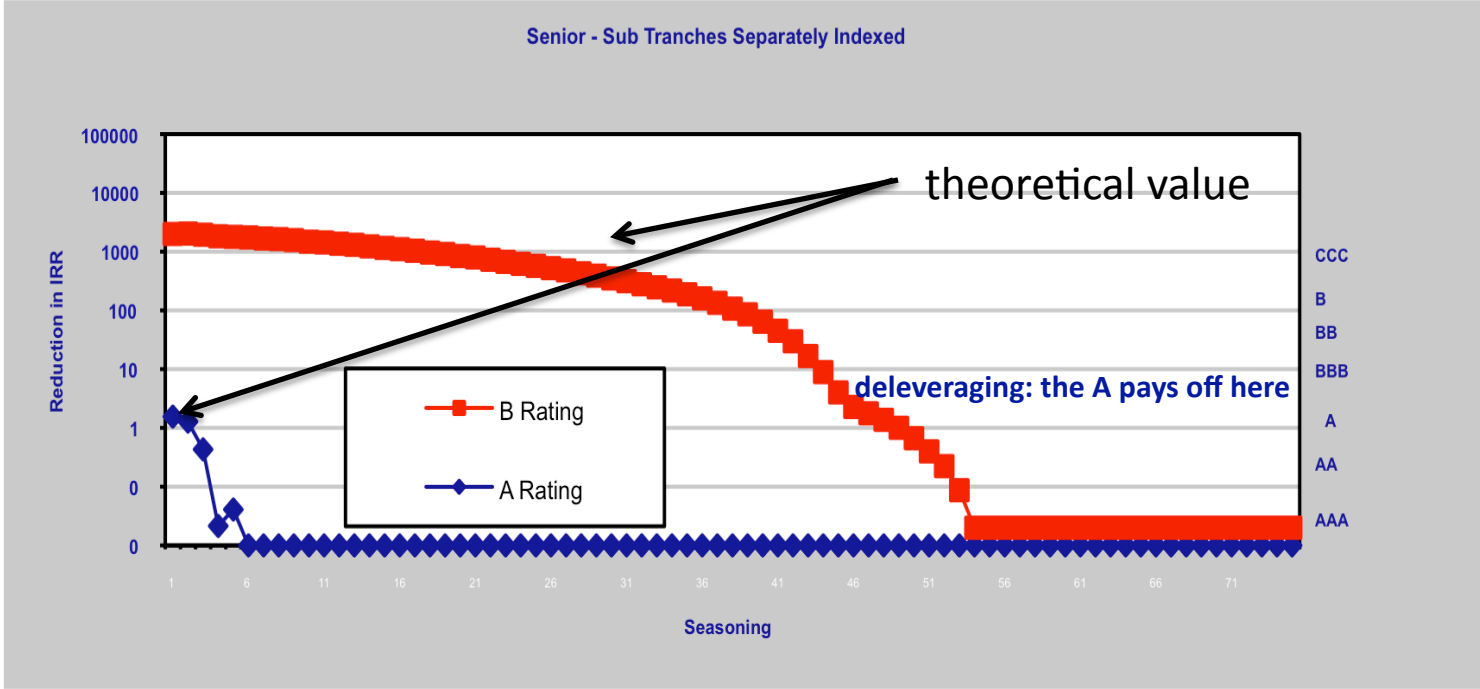


\*My freehand interpretation Exhibit 1.6, of *The Treasury Bond Basis Book*, Chicago: Probus Publishing, 1994, pp. 22-23.

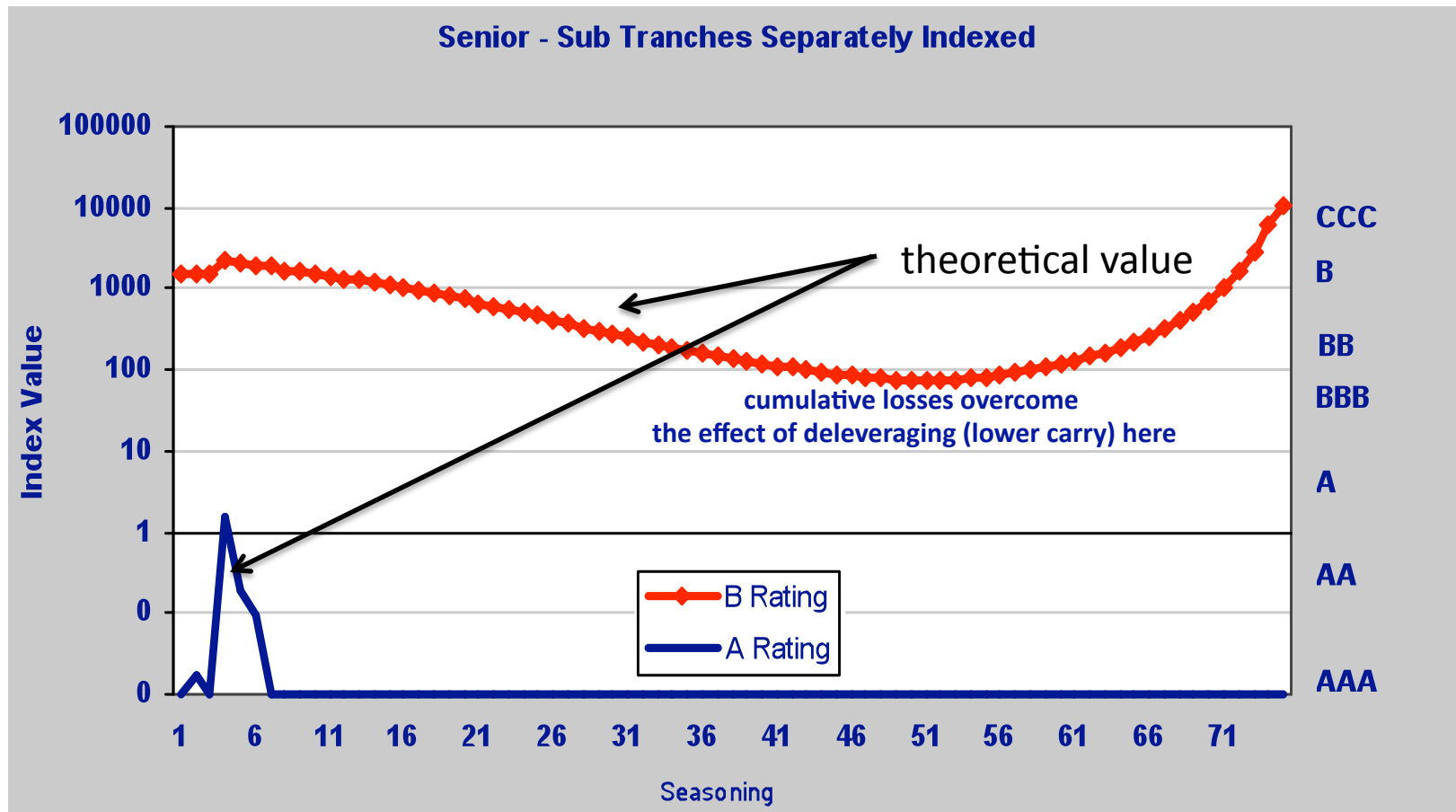


**Trading the ABS CDS without a reference spot market  
is nonsense.**

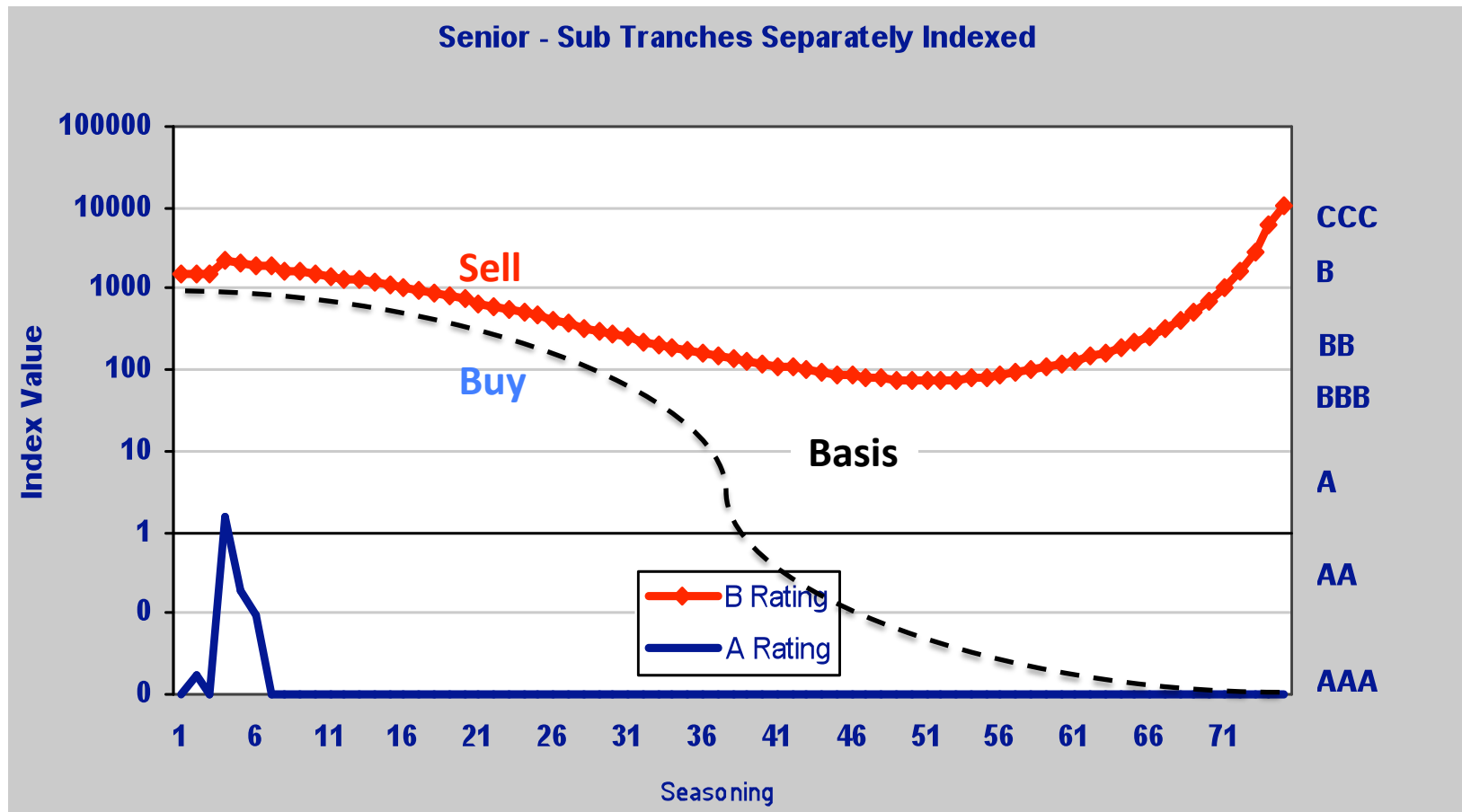
# Benchmarking Performing A- and B-Tranches



# Benchmarking a Defaulting B-Tranche



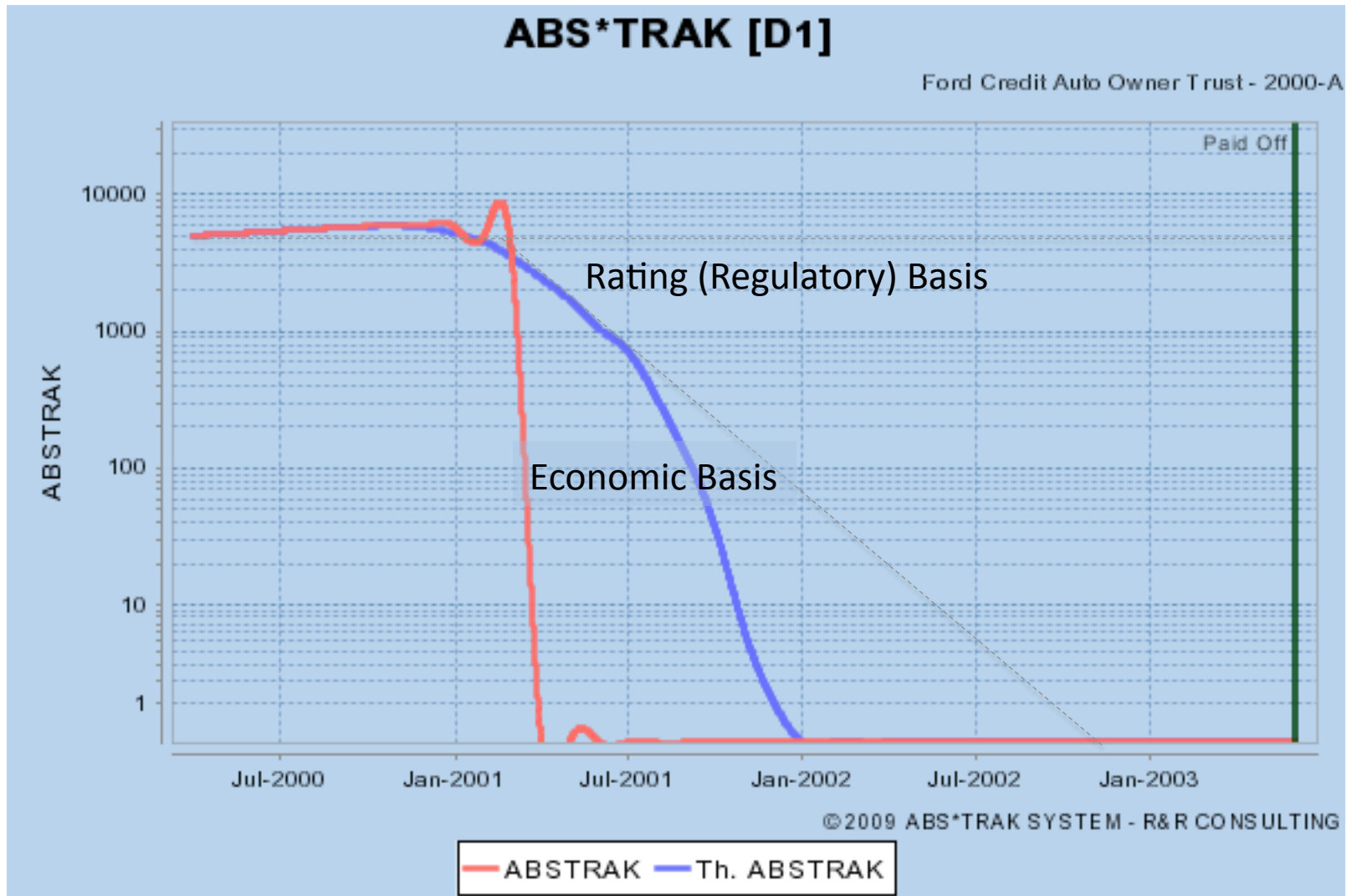
# Trading the B-Tranche Basis



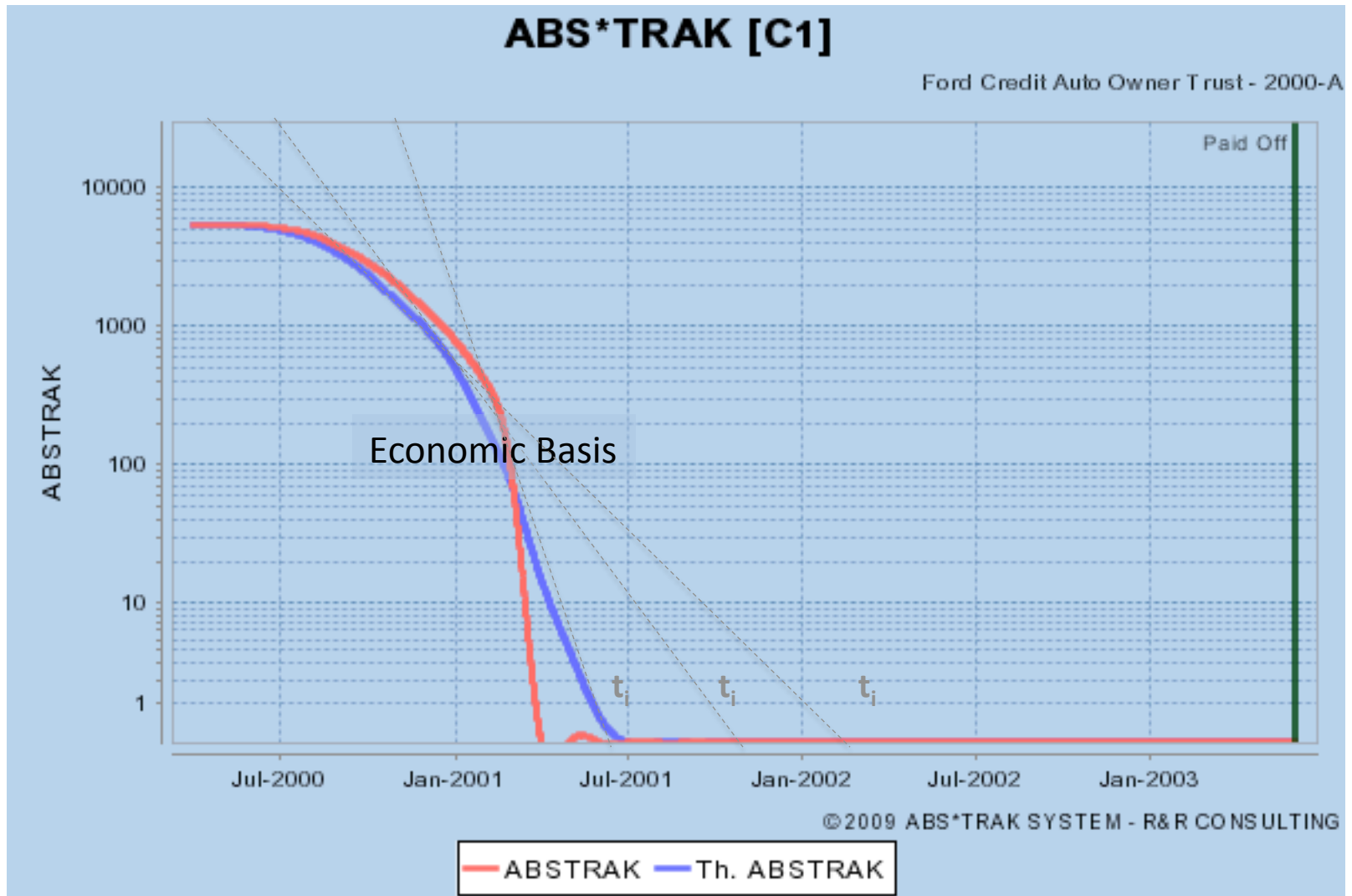


To base CDS pricing on the cash, reference the blue line.

# Ford 2000-A, Class D

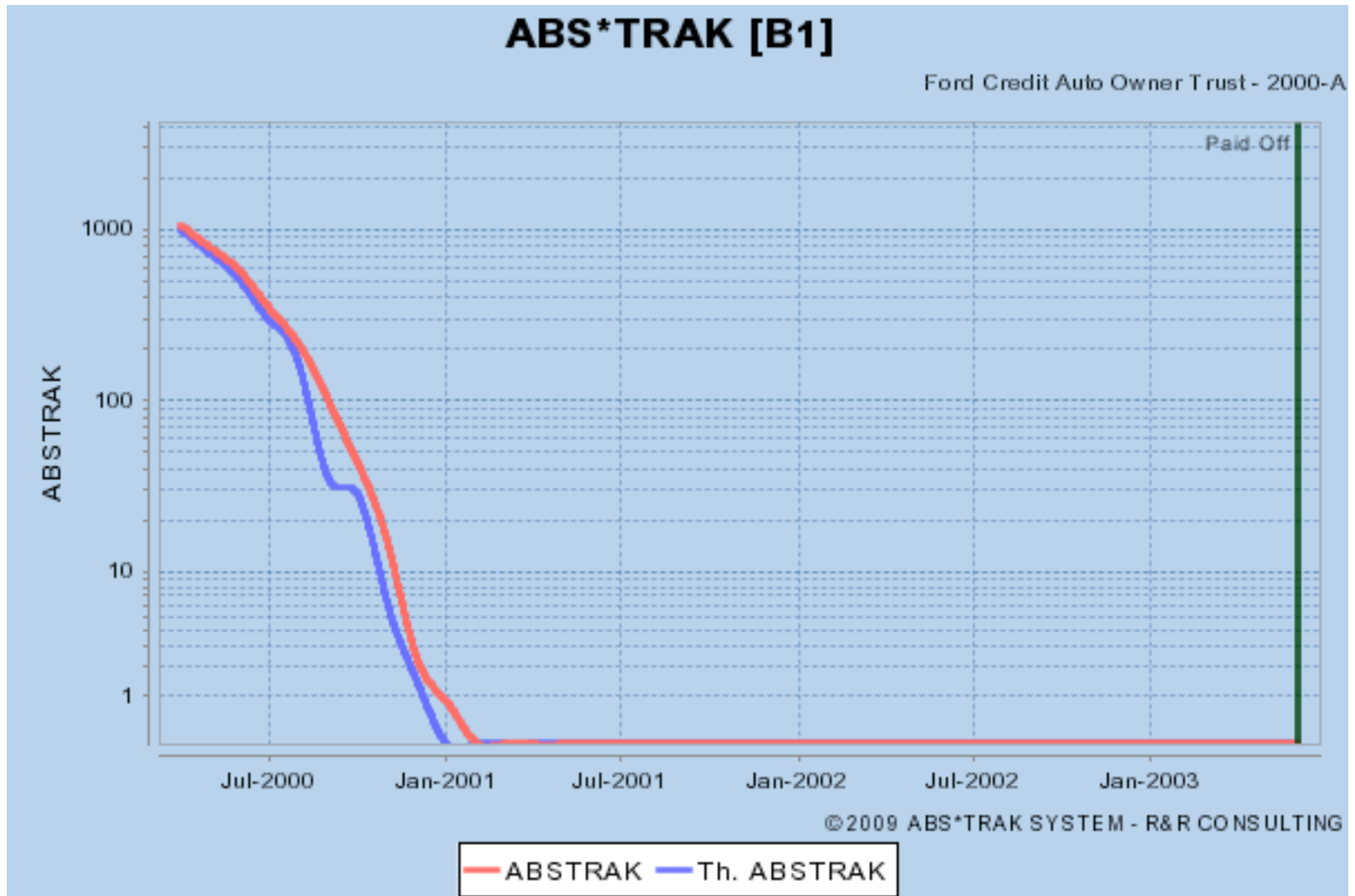


# Ford 2000-A, Class C

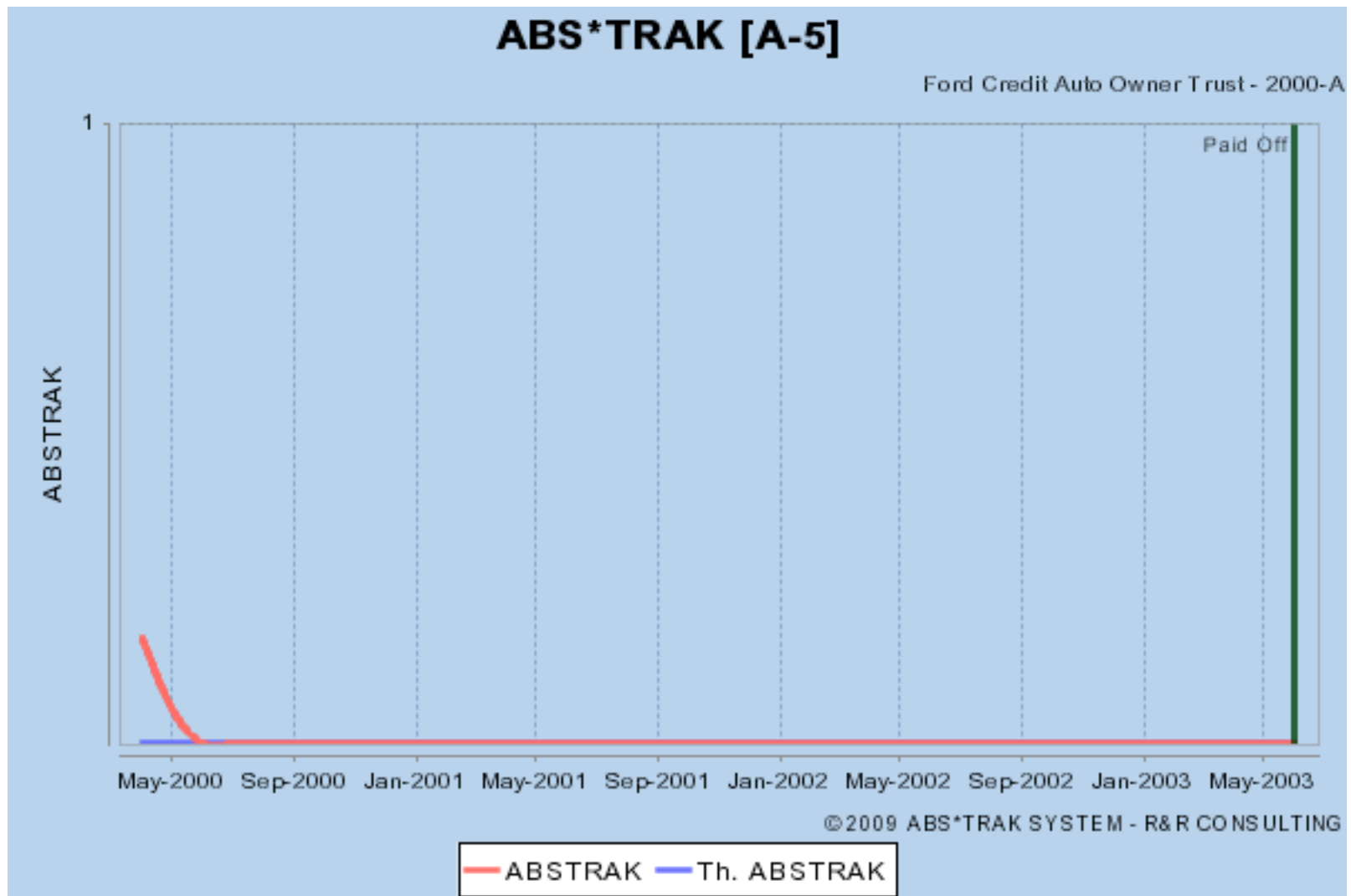


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# Ford 2000-A, Class B



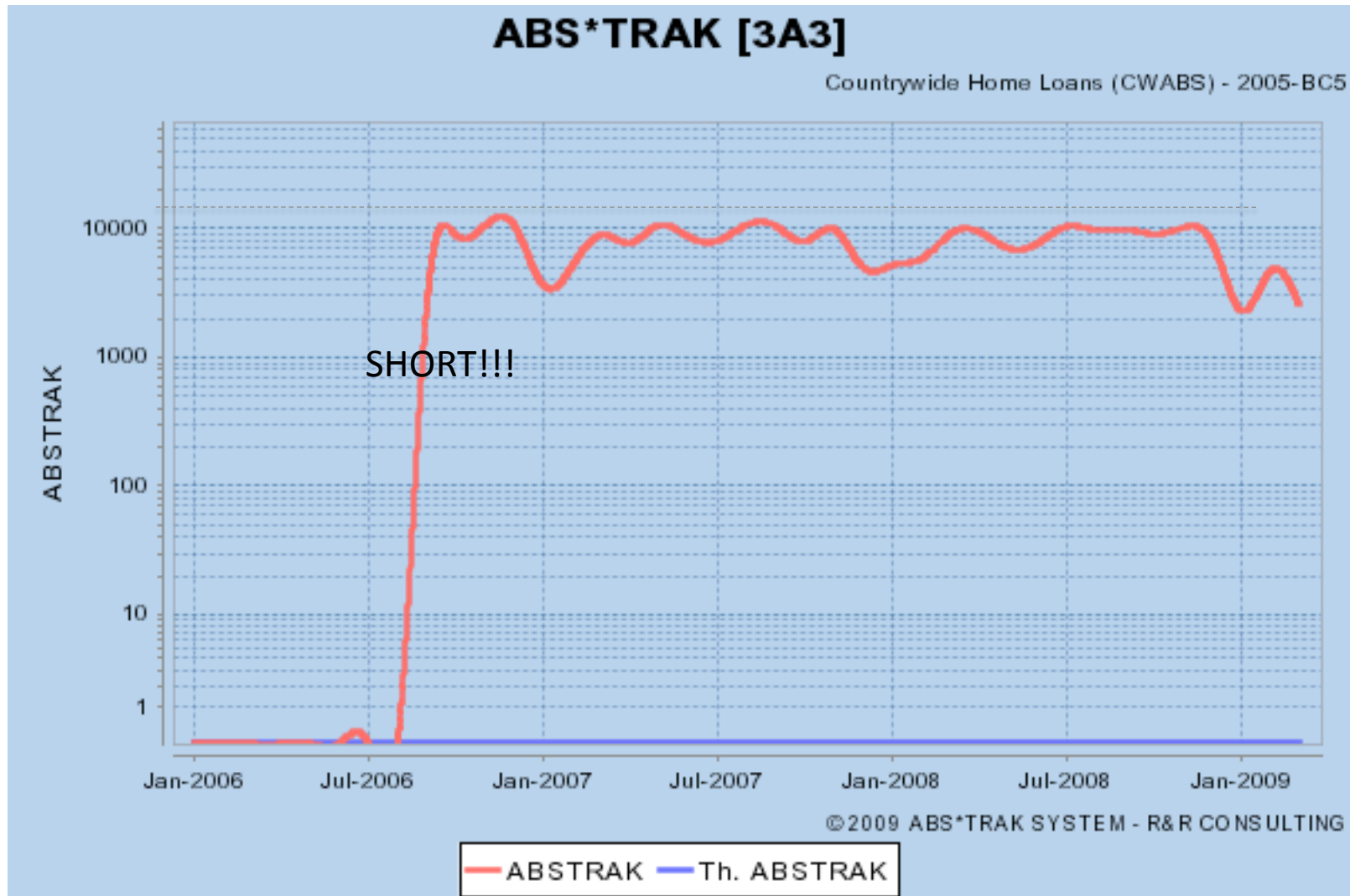
# Ford 2000-A, Class A-5



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# CWABS I Trust 2005-BC5

## 126670ND6 (ABX-HE.06-1 AAA)





**OTC structured markets today facilitate a transfer of wealth from the productive sector to the parasitic spectrum of the financial sector.  
The ETP model can't fix that over night.**

**But, without an advocate for price transparency who is both committed in a regulatory sense and commercially invested in market order,  
there is no fix.**

**THANK YOU**