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SuperDerivatives Answers Call for Credit Derivatives Transparency

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SuperDerivatives seven years ago introduced currency options pricing; it has since expanded to handle an array of product classes. Last month, the London- and New York-based provider of derivatives management tools rolled out a major upgrade to SD-CD, its online credit derivatives platform.

The enhanced SD-CD, which the company says has substantially increased functionality and price transparency, features a dynamic pricing model for bespoke synthetic tranches, which facilitates efficient hedging and risk management of collateralized debt obligations (CDOs). It arrives as investors and regulators alike are calling for better control over credit derivatives.

"In recent months we've seen the failure of at least three areas of risk"--market, operational and model risk--says CEO David Gershon, who in 2000 left Barclays Capital, where he was global head of foreign exchange exotic option trading, to found SuperDerivatives. "A major example was BNP Paribas and insurer AXA, which had to temporarily suspend redemptions on some of their funds because they claimed they were unable to value them accurately."

"In general, management didn't have the proper tools to adequately monitor or interpret these risks," asserts Gershon. Banks typically arrive at their own valuations for their positions, "often cross-checking them against prices given by rivals and third-party providers," he says. Results "vary widely since their policies generally give them flexibility to override prices they consider inaccurate. Some firms don't even look at market prices--instead they mark illiquid securities to models, based on factors such as the underlying cash flows on the pools of mortgages or loans."

The trading desks may have had homegrown systems for valuing these products, he says, but they were usually spreadsheet-based, and thus inaccessible to management. "So they recoiled from structured credit. That was the wrong move."

Gershon says SD-CD allows investors to develop strategies that take into account multiple factors, including corporate debt ratings, stock, energy and commodity prices, across asset classes while linking the correlated risk factors.

While Gershon acknowledges that there are other platforms that revalue derivatives, he claims that many don't provide a "correlated view of multi-asset and cross-asset derivatives, including hard-to-value exotic structures and emerging market currencies."

SuperDerivatives thus far has licensed its tools--which include an independent, automated portfolio revaluation service, a derivatives data archive, and trading and risk management systems--to clients in 60 countries. It has established offices in Hong Kong, Sydney, Bangkok, Seoul and, most recently, Mumbai. Its staff has grown to 400, of which approximately 300 are employed in research and development; the rest are devoted to sales and administration. About 40 are available to do on-site training of new subscribers, which comes with the subscription.

Gershon, 42, started out as an FX options trader for Deutsche Bank. He also traded for the former BZW New York, covering emerging markets. *Securities Industry News* contributor Maureen Nevin Duffy interviewed Gershon via phone from London.

The major participants in the credit derivative markets have been taken to task by the authorities for having poor pricing and risk measurement. Is it hubris to claim to have a solution in SD-CD? Not intentional hubris. We are just coming out now with an extension of our platform that directly addresses the transparency and valuation issues, such as the ones that have surfaced in the subprime crisis. We are definitely bringing something new and better to the market--real-time valuation and analysis of credit derivatives. The demand for this solution is evident from the fact that the existing products and models proved inadequate when it came to providing values and strategies for hard-to-value securities like CDOs.

Our confidence stems from our ongoing success over the past seven years, where thousands of practitioners have counted on us for their hedging, investment, trading and risk management decisions. We are gratified to have won numerous client-voted as well as panel-judged awards over the years, confirming our success in serving the derivatives market in those exact areas of pricing, analytics and risk management.

SuperDerivatives says that other platforms do not provide a correlated view of multi-asset and cross-asset derivatives, which is what firms should demand. How are you able to provide that? Our Web-based platform is unique in that it enables the user to access multiple assets--credit, IR, FX, equities and commodities--from the same user interface. For cases when two asset derivatives classes are used in the same trade, i.e., credit and interest rates, our system facilitates these types of trades by correlating the multi-asset interdependency. Additionally, our close relationships with brokers, exchanges and market makers all over the world provides us with access to highly accurate market data and indicative pricing information, which we continuously use for calibration of our calculated prices.

The SuperDerivatives benchmark pricing model has a very powerful analytic engine that allows us to accurately price the most exotic structures across all asset classes. It has been developed based on direct empirical research of actual trading in the interbank brokered market.

How does the platform work from a customer's perspective? The three primary applications for SD-CD are to obtain realistic, market-accurate quotes, versus outdated consensus prices, to evaluate, actually mark-to-market, the users' positions, which could include non-traded securities, and to create multi-leg structures and strategies. We expect our tools to be very popular among asset managers looking to accurately value the structured products offered to them. The large investment houses have access to extensive databases and sophisticated modeling tools that the buy-side firms may not. We stand as the equalizer providing more sources of data than some of the investment banks have.

A typical scenario might be an asset manager for a small to midsized firm who is offered a complex structured credit derivative deal and wants to value it before buying. Say it's a time-structured product; the manager gets the terms sheet from the dealer, which will show how the instrument is built. With that information they can independently build the product themselves using a series of menus to select the different elements of the product. It could be a credit derivative with an equity. They can easily build the instrument themselves using point-and-click methods without resorting to a spreadsheet. They can even do model-based valuations that include securities that aren't traded.

How does that sit with the sell-side client? It doesn't work against the sell side because it actually makes clients more confident to do business with them.

Who else uses SD-CD? The system is used by trading, structuring and sales desks. Beyond SD-CD, the pricing engine and data are used with the SuperDerivatives automated portfolio revaluation service, addressing the need for risk managers, controllers and auditors.

What's your view on the subprime crisis and the turmoil of the past few months? In the recent credit crunch we saw the failure of market risk, including liquidity; operational risk (spreadsheets); and model risk (out-of-model conditions). Contrary to some observers' knee-jerk reactions, one shouldn't be afraid of structured credit. A good risk manager could mitigate the market and liquidity risk by understanding how the risk is distributed across the capital structure of a portfolio. Unfortunately, market risk was often either not managed or managed from the spreadsheets by the trading desks without this information being communicated to management. This was not a problem that occurred overnight. The debt losses had been accumulating and were simply not being detected. The only way to judge the exposure to liquidity risk is to run a scenario analysis and to take appropriate reserves. Therefore, risk managers have to have access to scenarios run by the trading desks, and be able to run them independently themselves.

Lack of transparency in many structured products can be mitigated by model redundancy, i.e., having access to third-party valuations for second opinions. This should be done by the middle-office risk control team and demanded by the executive management levels on both the buy side and sell side. The market shakeout has yet again confirmed that independent and frequent revaluation--and also deeper risk-sensitivity analysis--of the entire portfolio held by financial institutions, both as assets and collateral, are not a luxury but rather an essential necessity. Such valuations should be based on three principles: a proven, market-realistic, accurate analytic pricing model; multisourced, relevant, recent and accurate market-data inputs; and constant calibration of prices with actual performed trades.

How could your benchmark have helped with the credit crisis? Some problems stemmed from the difficulty in finding sufficient sources for evaluation of assets. People could use us to do, for example, revaluation. They need to review what went wrong. Our system allows you to do retroactive analysis--to, in effect, back-check your scenarios to see what failed. Hedge funds can use our system to back-check values to, say, Sept. 30, and review their valuations week after week. Nobody else enables users to go backwards. Bear Stearns, when it realized it was losing money, found it had a lot of losses in a short time. With our system they could've seen how the losses were accumulating as they were happening.

Also, people stopped calculating indexes and started using estimates, when the indexes became more liquid. Some indexes could've been calculated directly and yet users didn't do this. Our system could help them get a better estimate, because of the huge databases we can access. People are more likely to calculate this way because it's easier to do with our system.

Is there too much of a cookie cutter-mentality in the markets? Definitely. This is why we have developed customized platforms that directly address the specific needs of each market and each application. These include SD-Funds for hedge funds and asset managers, SD-Banks for banks' front offices, and SD-Corp for corporate treasuries.

One can trace a herd mentality in the way trading and investment decisions are made. Part of the reason is the lack of easy-to-use, readily available tools for pricing, structuring and risk management. The advent of Web-based, highly accessible tools like the SuperDerivatives real-time pricing and analytics applications allows practitioners to make more sound and creative decisions, rather than be impacted by the de jour investment idea.

In the early 1990s banks and clients would agree to run the same models so that they could verify a price using the same criteria. How can you escape that? Don't you still have to compare apples with apples? That is exactly our goal: to bring transparency to the buy side and sell side so that when they do business they are in fact comparing apples to apples--but extremely accurate apples that are still ripe. We bring transparency to derivative pricing and risk management, making it very easy to work with derivatives so more people will be able to take better advantage of them. For sure, the big market makers and investors will always have their own proprietary modeling and structuring techniques, which constitute their competitive advantage. This, however, does not contradict the need for a universally available benchmark pricing platform.

What do firms pay for SD-CD? We license our pricing platform in annual subscriptions, starting at $15,000, which includes on-site employee training.

In addition to your new office in Mumbai, you've announced plans to expand in Hong Kong, Sydney, Bangkok and Seoul. What's your global strategy? We are in 60 countries and plan to keep expanding. Asia is a big growth area for us.

Why Asia? Because they're an economic growth area. Some Asian countries are fond of derivatives. They like working with complex structures and are growing more comfortable with them.

What's ahead for SuperDerivatives? Our goal is to bring transparency through powerful tools for all derivatives practitioners all over the world. So far we have delivered on that. In the future we will be the leading supplier of derivatives technology.

What does the future look like for credit derivatives? There will be a resurgence in the use of credit instruments and with it an even greater desire for multi-leg structures and the ability to accurately value them.