

Driving democratisation

Farooq Jaffrey, founder, chief executive and head broker of Traccr, answers SCI's questions



Q: How and when did Traccr become involved in the structured credit market?

A: We got UK FSA approval this month (June) and are now operating as the first retail CDS broker to market. Traditionally, the CDS markets have been available exclusively to volume players. However, the growing liquidity, ease of use and transparency of credit derivatives has drawn the attention of retail traders. Many people wish they'd had an opportunity to short the iTraxx, for example, a year ago, but the infrastructure wasn't there.

Q: What is your strategy?

A: Traditionally, most CDS products were pushed through dealers' private client networks and were pre-constructed as opposed to being customised for retail investors, so often re-distributors did not know what they were selling and accounts didn't really know what they were buying, besides the headline marketing information. But through our dealing relationships, we can create customised products with the appropriate education and disclosure.

There is demand for credit derivatives for risk management purposes too. Retail investors typically have a 25% allocation to corporate bonds and so have a need to hedge their positions with CDS. They couldn't do this before Traccr launched.

Private banks in particular have suffered recently because their portfolios were mostly long-only. We're working with clients to mitigate that risk; for example, by providing an index hedge using CDS indices or buying protection on certain names if there is a large concentration.

The Traccr service is also perfect for managed account platforms because it enables fund managers to do one trade but divide it into lots of US\$10,000-sized buckets via a CLN, so that each investor on the platform has an allocation. Historically, it was impossible to break a CDS trade into retail sizes, but this way it's easier for the fund manager to allocate gains and losses on the position for each managed account.

Q: Which market constituent is your main client base?

A: Our clients are professional traders within the FSA definition of professional client; in other words, someone who understands CDS and has a minimum net-worth. This encompasses high net-worth individuals up to institutions, such as private banks and stock brokers. The idea is to enable them to trade on their own account.

Private banks have historically been significant issuers of CLNs, although they aren't typically specialists in credit derivatives. They are relationship managers that assist in finding the appropriate trading strategies for their clients, and thereafter source execution either in-house or through the market. They often do not have accessibility to CDS, however.

We're working with private bank clients in particular to explain how the product works. Given all the changes happening in credit derivatives at the moment, such as the move to trading upfront plus coupons and the big/small bang protocols, there is still a lot for people to understand about the market. Education is an important aspect of the business and so we provide trading simulations and will supplement the infrastructure with more tools over time as the market develops.

This also serves to supplement the efforts of dealers, who obviously want to maintain these client channels but are also aware of the compliance issues and so want to be sure that the counterparty understands what they're getting into (in light of the minibond scandal and so on). The retail channel is very important for banks: it's a mass market where they can do interesting and different trades around the world. Although these trades are usually in the form of CLNs, they can take customised forms and have different underlyings.

Q: How do you differentiate yourself from your competitors?

A: We have first-mover advantage. As central clearing of CDS picks up, it will naturally make the product more transparent and then real money should enter the market. Consequently, we expect some competition in the future, but we'll differentiate ourselves by our knowledge of CDS and broking.

I was previously head of structured credit trading at CreditTrade and my partners are an ex-CDS trader and CDS compliance professional. We believe that ultimately the quality of service we provide is the most important differentiator. Given our target market, this service needs to be client-led.

Q: Which challenges/opportunities does the current financial environment bring to your business and how do you intend to manage them?

A: Our challenge is to get people familiar with the Traccr platform. We believe that once customers understand the service, they'll get the concept straight away.

At the moment participants aren't necessarily sure where the market is heading. CDS sold off last year, which created lots of volatility, which has since disappeared now that people are waiting to see what happens. Volatility is good for the credit derivatives business, but there are still opportunities for investors to put on one- to three-year mezz iTraxx index tranche trades or first-to-default baskets on reference credits they are comfortable with. Investors are happy to take on this risk because they want yield, know the reference names and are comfortable with the risk.

When volatility returns to the market, a good trade to put on would be options on CDS. There are so many different structures on offer; the key is to provide the products that clients need.

Q: What major developments do you need/expect from the market in the future?

A: As soon as CDS begin to be widely cleared with via central counterparties, we'll start seeing a democratisation of the product. Anyone can trade FX or equity options, for example, and in some ways CDS are less risky than these asset classes because you can't lose more money than the notional you bet. CDS may have got a bad name due to the fallout from the subprime debacle, but a need to transfer credit risk will remain - and the need to educate the market will continue.

The current industry initiatives that are underway - central clearing, big/small bang protocols and so on - are positive for the market. There is a general impetus from dealers to improve the

transparency of the CDS market and educate investors, as well as the public, about the usefulness of the product.

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