



Haircut Snippets

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Landscaping, Capital Charges and a Plan for the Future

Len Bole

The landscapers just left. When we built here four years ago, we decided NOT to plant a lot of grass. We opted for indigenous ground covers, perennials, shrubs and trees along with a pond and some walkways.

Over the years, we learned how to take care of things and, this year, planned to handle it ourselves. All went well till the rains of July. After that the weeds were rampant, the plants were out of control and the mosquitoes ruled.

To maintain our investment, we brought the landscapers back in and they did a great job: they cleaned things up, made them look better and upgraded the plantings. What would you expect? It's what they do for a living.

Those of you who are clients have invested in various LDB packages. The regulatory environment is dynamic and growing, just like the stuff in my yard. There are new products, interpretations, rule changes, and better ways to accomplish things. It only makes sense to keep your investment current and up to date.

Starting in 2004, LDB Consulting will be providing UNLIMITED support and ALL upgrades for an annual fee via the Customer Upgrade/Support Package (CU/SP).

No more sporadic invoices for answers to questions and solutions to haircut problems. No more unexpected rule or format changes requiring you to make room in the budget for the latest version. No more tracing payments for these non-standard invoices through AP.

With CU/SP, you know you will be able to utilize the latest features (like handling all ETF baskets and MBA relief described below) and satisfy the latest requirements as clients and regulators alike share their feedback with us.

With CU/SP, you may avail yourself of our RBH analysis service and have us review the many switch and parameter settings that may affect your calculations.

With CU/SP, you can call with questions and problems and not wonder if you're on the clock or not. (Of course, in the past you normally WERE on the clock...)

You will get all this for a single annual fee. LDB will be contacting you in the next few weeks to introduce the CU/SP particulars to you and explain the advantages of the program. It's our version of KISS: Keep It Simple and Surpriseless.

Allow ALL ETF Baskets

RBH has always used the P records in the OCC PL file to recognize legitimate baskets and to compute RBH basket relief for those hedged baskets that reach the required capitalization.

With the increasing popularity of Exchange Traded Funds (ETFs) and the constant addition of new ETF products, there are now ETFs that are NOT currently recognized as RBH baskets by the OCC.

As of August 29, there were more than 45 ETFs reported in the Wall Street Journal, but not included as legitimate baskets in the PL file. If your firm trades any of these products (contact us for a list of these ETFs) and hedges them with baskets of underlying securities, you are currently receiving NO HAIRCUT RELIEF for the strategy.

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Relief is allowed per SEA Rule 15c3-1 (c)(2)(vi)(J)/014. ETFs hedged by qualified baskets should be haircut at either 5% or 7.5% of the basket value.

The next version of RBH (6.0) will offer this relief for clients. Users will be able to define those ETFs they wish to handle, indicate whether they require 5 or 7.5 percent charges, indicate whether they are narrow based, high cap broad based or non high cap broad based and provide a basket composition file.

RBH will then examine the baskets, make certain they are both properly hedged and capitalized, generate a basket composition report and charge for the strategy, reporting the charges in the NON RB portion of the system.

Mortgage Backed Agencies

LDB is currently working on the next version of Fixed Income haircuts, version 5.0. Among other features, it will allow users to obtain relief for mortgage backed agency securities (MBAs) as defined in the December 30, 1996 no action letter.

In brief, the letter recognizes the probability of prepayment on these securities and uses price as a surrogate for duration. Eligible securities may be moved into nearer term maturity bands, thus qualifying for lower haircut charges. Additional charges apply if Treasuries or other MBAs hedge these securities.

The user will be able to toggle this functionality off and on and to apply the relief to ALL MBA securities or to a subset of the MBA securities in the position file.

This relief and other improved functionality should be available in the first quarter of 2004.

RBH Analysis Summary

Last March, we offered our RBH users the opportunity to have us evaluate their RBH settings. We first ran the data using their environment to establish a baseline. Then we experimented with switches and INI settings, as well as the Weaver and Wrapper, in an attempt to reduce the haircut charges.

- 9 firms sent data and we found savings for 7
- Total reductions of **\$243.9 million**
- Average reduction of **7.59%**
- Largest reduction was **\$191,000,000 or 25%**

If you are interested in having us evaluate your settings, please send a CD with your RBH environment, positions, P/L file and basket composition files.

Wrapper™

Many of you are familiar with the Basket Weaver™. It has been used for years to lower haircuts on security baskets. Positions are netted and the remaining stocks are placed into baskets in a manner that seeks to minimize charges by making as many baskets as possible.

Netting securities is a good thing. You save the minimum charges on the long and short side of stocks held in different baskets. However, with the increase in sector baskets (see the ETF article above), this approach does not always provide the best results. Netting large broad based positions with smaller sector positions can remove stocks needed to create these less populous baskets.

Enter the Wrapper™. The Wrapper™ recognizes that what's good for the goose (broad basket baskets) may not be good for the gander (sector baskets). It divides positions into potential narrow and broad based sections and examines each separately, applying various

treatments (No Weaver™, Traditional Weaver™, Weaver™ Target2) to both universes.

Then each of these individual scenarios is recombined as the system looks for the best combination of settings for the entire position.

Finally, the system examines the baskets that have been created in the separate runs and looks to insert naked stock from one run into baskets from the other run, using as much stock within baskets as possible.

Depending on your positions and whether or not you are able to identify baskets in your inventory, the Weaver™ has saved 4-12% on haircut charges.

The Wrapper™ may save an additional 5-15% ABOVE the Weaver™ savings.

If you would like to see the results of a Wrapper™ run on your data, please contact us.

OTC Option Haircuts

RBH now offers an add-on module that will compute charges for OTC options. OTC options will be hedged with long listed options and common stocks where allowed and the proper charges will be computed. Unused stock and listed options will be fed back through RBH and appear in the detail and naked stocks reports as before.

Electronic Newsletter

If you can receive this letter via email, please provide me with your email address. If there are others in your organization that ought to receive this missive, please provide their email address to me as well. You can email me at: LDB-LENBOLE@att.net

No Mas...

If you do NOT want to receive future issues of this newsletter, please email, write or phone me and I will gladly remove you from my mailing list.

