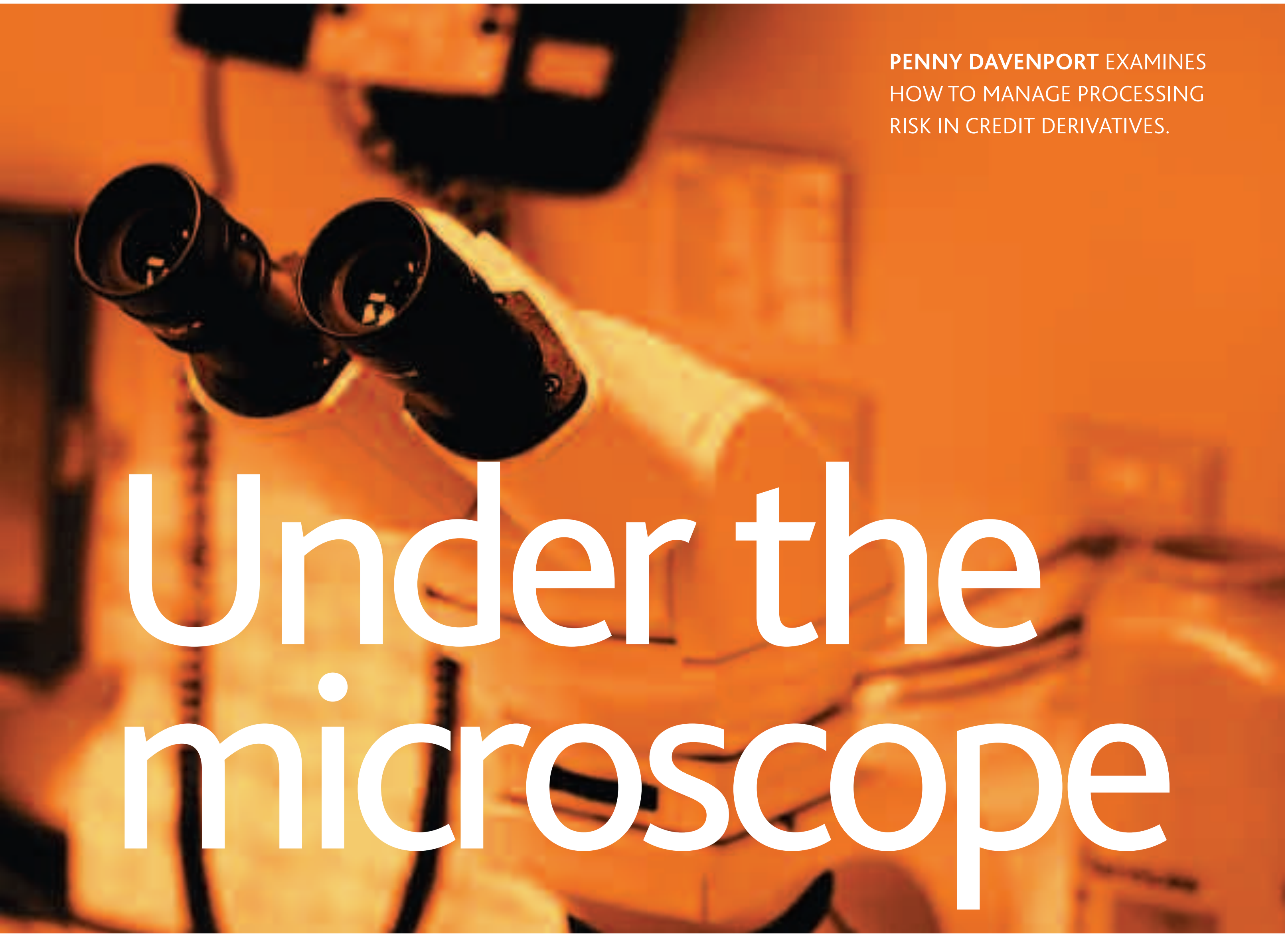

Under the microscope

PENNY DAVENPORT EXAMINES HOW TO MANAGE PROCESSING RISK IN CREDIT DERIVATIVES.

The credit derivative market has come under the regulatory microscope in 2005. Concerns over the levels of operational risk in the large investment banks have been heightened by a recent International Swaps and Derivatives Association (ISDA) survey that showed 128% growth in the credit derivative market year on year to $12.4 trillion.

An open letter from the Financial Services Authority to all chief executive in February this year first raised public awareness of the issues in processing credit derivative transactions. In July, the Counterparty Risk Management Policy Group, a committee of Wall Street dealers, reported that backlogs in the confirmation of credit trades needed to be addressed "as a matter of urgency" and advocated electronic trade processing to speed up settlements.

In September, the Federal Reserve nailed its colours to the mast with an invitation to 14 investment banks and their regulators to a meeting to discuss the thorny issues of unsigned trade confirmations and novations (also known as assignments, and referring to an investor stepping out of a deal and reassigning it to a third party). Novations are a major contributor to the delays in trade confirmation because of heightened documentation issues and a lack of standardisation when communicating the novations.

Executive summary

- Regulatory concerns exist over processing credit derivative deals.
- Dealers pledged to cut backlogs in trade confirmations.
- Markit RED is the standard identification methodology for reference entities and reference obligation pairs in credit markets.
- Automation keeps costs under control, and error level acceptable.

In early October, the dealers who attended the Federal Reserve meeting pledged:

- to cut backlogs in trade confirmations over 30 days old by 30% and set further targets in December;
- submit processing statistics to regulators 10 business days after month-end;

- adopt the ISDA novation protocol (which facilitates the transfer of an existing trade to a third party) from 24 October;
- reject assignments from hedge funds that do not adopt the protocol unless they receive written consent from the other party; and
- ensure active clients use the Depository Trust & Clearing Corporation (DTCC) by January 2006.

ISDA's 2005 Operations Benchmarking Survey highlights several areas in which credit derivatives processing has improved.

Markit's RED is the standard identification methodology for reference entities and reference obligation pairs in credit markets. A legal reference entity name is established through due diligence procedures, and confirmation obtained that the reference entity in question has issued or guaranteed the relevant reference obligation. Each entity is identified by a unique six-character code, and the reference entity/reference obligation pair is identified by a unique nine-character code. This information is maintained in the face of corporate events such as name changes and mergers.

Today, RED has almost 100 subscribing firms, in addition to all the major service providers in the credit arena both for single-name and index trading. RED has very quickly become a key part of the infrastructural developments in the industry which have enabled processing risks to be managed and costs reduced considerably.

OUTSTANDINGS The first area the ISDA survey highlights as having improved in credit derivatives is in the number of "outstandings", or unconfirmed trades. Outstandings have fallen from 21.1% to 11.6% between 2004 and 2005.

Outstandings are those trades for which a confirmation has been issued or received but not matched and represent potential future headaches. The level of outstanding credit trades has been difficult to manage because of the terms that need to be agreed, not least the reference entity and the reference obligation.

The reference entity in a credit derivatives confirmation needs to match exactly – right down to punctuation. Different entities in the capital structure of a company will have different levels of credit risk and firms need to be clear which they are trading. For example, the two "Boots" entities are completely different. RED, through its establishment of the correct legal name and the use of a unique identifier, shows the difference.

The other key field that causes mismatches is the reference obligation. Typically, many bonds can be referenced in a confirmation for the same tier of debt, but sometimes firms have a view on the most desirable bond. If this view diverges, different reference obligations may appear in confirmations and so fail to match.

RED has drawn up a list of more than 800 reference obligations which the market has agreed as "preferred". The dealers use these as the default reference obligation in confirmations unless otherwise agreed. The preferred flags are set by reference to the obligations in the Dow Jones CDX and iTraxx indices as well as those most widely traded by the dealers.

The steering committee of DTCC Deriv/SERV made the use of RED codes mandatory for all dealers on the platform from 30 June 2005 to capitalise on the matching benefits that these codes bring.

RED also plays a consultancy or arbitration role in many cases surrounding outstandings. From time to time, RED provides advice as to potential differences between two reference entities that two dealers may be trying to confirm.

AUTOMATION The survey also announced the automated generation of confirmations in credit derivatives as having increased over the previous year from 24% to 40%. Automation keeps costs under control, and error rates to an acceptable level. Firms have made great strides with in-house technology and processes but a number of industry platforms have facilitated the automated generation of confirmations.

Online trading of both single-name CDS and index trades has taken off following the launch of platforms by Creditex, ICAP, Bloomberg, TradeWeb and MarketAxess, among others. It is essential to have an upfront agreement on reference entities and reference obligations for these platforms to work.

As a result, once the trade is done, it is not only easy to generate the confirmation automatically, as say Bloomberg's Auto-Ex does, but given that the reference entity/reference obligation pairs are established as a standard in advance, that confirmation will match and can be agreed promptly between the two parties.

The MarketAxess platform goes one step further in that CDS index trades transacted between dealers and buy-side firms, using the standard RED information, feed directly into DTCC'S Deriv/SERV trade affirmation and matching engine, which provides an online, legal trade confirmation.

BACKLOGS The final area highlighted by the ISDA survey is backlogs. The backlog of credit derivative confirmations, or number not yet processed, fell from an average of 17.8 business days in the 2004 survey to 11.6 in the 2005 survey.

Backlogs can occur for any number of reasons but many of these are lessened in situations where the affirmation model used as trade information is agreed at source, at the time of execution in the front office, rather than downstream in the middle or back-office. SwapsWire and the recently launched T-Zero are examples of the affirmation model which is popular as it is a straightforward way of reducing backlogs. ICAP similarly capture information directly from their BrokerTec platform and feed that information on behalf of both parties into DTCC. SwapsWire, ICAP and T-Zero make use of RED, again to provide the standardisation necessary for full efficiency.

LOOKING AHEAD 2005 has seen regulators and industry bodies voice concerns over pressures on the middle and back offices caused by the continuing growth of the credit markets. The industry now needs to follow through with its pledges to solve these well-publicised issues, and ease operational difficulties by streamlining settlement processes. As these issues start to be addressed, the debate has turned to the market's ability to cope with bankruptcies in the corporate bond markets.

After the bankruptcy of former General Motors subsidiary Delphi, Markit and Creditex conducted their largest ever Credit Event Fixing on 4 November to help the industry cash-settle the billions of dollars' worth of credit derivative index trades that referenced the name. 575 parties participated in the auction, which successfully generated a cash settlement price for Delphi, thus averting undue strain on the credit derivative market.

Credit Event Fixings will also help the market transition from physical to cash settlement in line with the intention of leading dealers to make cash settlement the standard for CDS index contracts before the next index roll in March 2006.

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