Reducing the backlog

Executive summary

- Credit markets have come under intense scrutiny from regulators.
- Credit derivative trading volumes have increased exponentially year-on-year since the market's inception.
- The industry united to solve processing backlogs.
- Technology investment in operations rose by 32% in 2005.
- ISDA is working to unify the industry behind new mechanisms for trading and settling credit default swaps.

Derivatives operations are an unforgiving area of finance. With mistakes so costly, professionals look to make the operations process as efficient and accurate as possible. This is where straight-through processing (STP) comes in, because it limits human intervention, which is the cause of most errors. JPMorgan is a pioneer in implementing a STP infrastructure, particularly for interest rate derivatives. Progress in other financial instruments, however, has been relatively ponderous.

MORE DEBIT THAN CREDIT According to the International Swaps and Derivatives Association (ISDA), total outstandings of credit default swaps (CDS) grew by 52% in the first six months of this year to $26 trillion from $17.1 trillion. The 2005 Markit Scorecard shows that the average number of CDS trades executed monthly increased by 89% over the previous year. There was also a marked increase in the volume of credit index transactions, with one index trade executed for every three single-name trades compared with a ratio of one in every eight in 2004.

CDS trades are notoriously difficult to confirm, owing to the specificity of trade parameters such as the entity and obligation to which the trade refers. The combination of the vertiginous growth of the CDS market and the complexities surrounding trade settlement left the processing infrastructure creaking at the seams. The Financial Services Authority (FSA) and the US Federal Reserve Board (Fed) led the charge in 2005, insisting that trading firms clean up their backlogs in a systematic manner, and that failure to do so would lead to their CDS businesses being shut down.

CREDIT WHERE CREDIT IS DUE The industry united in an almost unprecedented manner to solve the issues that centre on processing backlogs. A series of "lock-ins" took place which saw operations staff sitting with their opposite number from other firms, often late into the night or over weekends, in order to resolve the outstanding confirmations between them.

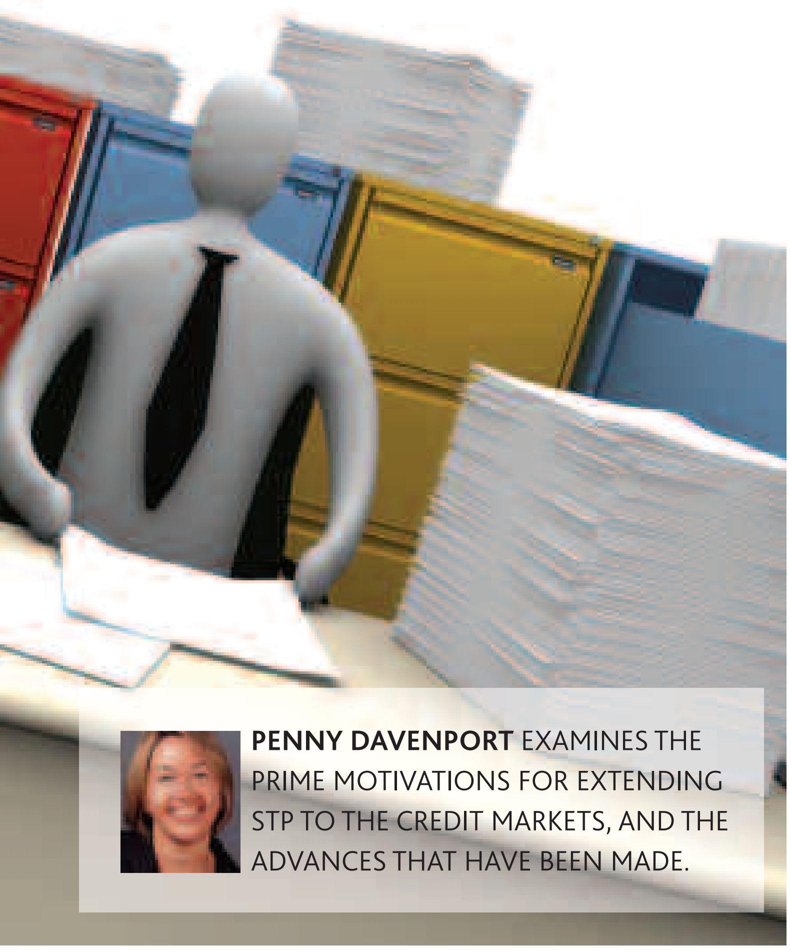
Major dealers adopted the Markit Reference Entity Database (RED) to define market-standard reference obligations, which had historically been a major cause of confirmation breaks. The most common changes to confirmable amendments were the reference obligation, counterparty name, first payment date and the reference entity. The key errors arising from auto-matched trades were the reference obligation and the reference entity.

The industry moved fast to adopt DerivServ from Depository Trust & Clearing Corporation (DTCC) as a matching platform for CDS with the smaller players also brought on board.

A meeting called by the Fed in September 2005 for 14 of the largest dealers in the CDS market and their regulators led to the establishment of a series of targets for reducing outstanding CDS trade confirmations. These targets are measured via extensive monthly reporting conducted by Markit and the Derivatives Consulting Group. The dealers' efforts paid off. The dealer group, which is now 16-strong, has exceeded all targets to date, achieving a 30% reduction in outstanding trades by 31 January 2006, 50% by 31 March 2006, and 70% by 30 June, 2006.

On 27 September 2006, the Fed announced that the number of confirmations outstanding had seen a reduction of 70%, with outstanding trades of more than 30 days down by 85%. In addition, the share of trades confirmed on an electronic platform had doubled to 80% of total trade volume.

REDUCING ERRORS AT POINT OF TRADE As well as reducing the backlogs in outstanding confirmations, the industry has also devoted its efforts to minimising the factors that cause backlogs in the first place by reviewing the entire trade lifecycle. Error rates and delays in trade capture increase considerably the further away from the point of trade that these occur. Therefore, capturing trade details immediately on trade execution – and preferably by the trader or trader's assistant – is much more likely to reduce errors and minimise backlogs. The 2005 Markit Scorecard showed that the cost of



PENNY DAVENPORT EXAMINES THE PRIME MOTIVATIONS FOR EXTENDING STP TO THE CREDIT MARKETS, AND THE ADVANCES THAT HAVE BEEN MADE.

amending an error increased significantly the further away from the point of trade that error was picked up. In addition, errors took longer to amend and reconfirm if they were not picked up until further downstream.

SOLUTIONS, SOLUTIONS For every problem, there is always a solution and for every well-publicised industry problem, there will always be a multitude of possible solutions. The credit derivatives business is no exception with its numerous tools, systems and platforms springing up to meet requirements at every stage of the trade lifecycle, in line with the industry's move to a true straight-through processing model.

With respect to trade capture, much of the effort and investment in the credit derivatives market has focused on internal systems and staffing. Technology investment in operations rose by 32% in 2005 and there was significant investment in skilled resources, with the average headcount in credit operations at the major dealers increasing by almost 25% year-on-year.

Post-trade capture has seen a focus on trade affirmation and confirmation software and systems.

SwapsWire has a well-established platform that affirms in real-time and is widely used for interest rate swaps although it has its supporters in the CDS market. T-Zero offers an affirmation platform specifically for the CDS market and has recently linked to Bloomberg's trade execution platform to provide STP at that end of the trade lifecycle. DerivServ remains the confirmation and matching engine of choice for the CDS markets. This summer, DTCC announced the launch of AffirmXpress, in partnership with GFI Group, ICAP and Tullett Prebon. The platform allows dealers to affirm credit derivative trades from inter-dealer brokers.

The Markit trade processing platform covers over-the-counter (OTC) derivative products across the entire trade lifecycle, including affirmation and confirmation, the latter through electronic links to DTCC and SwapsWire. By automating both STP and non-STP trades, the service focuses on "exception processing" – in other words, anything that does not need human intervention goes straight through the processing infrastructure, leaving staff to handle the anomalies. Downstream, the service provides portfolio reconciliation, which is key to achieving true STP.

An array of solutions to choose from will always be welcomed in any market and investment banks, inter-dealer brokers and buy-side firms alike are notoriously vocal about any monopolistic behaviour from suppliers. However, a fragmentation of solutions is equally damaging to industry efforts to solve problems such as confirmation backlogs. Too much choice makes selection harder for users, and split decisions over solutions mean the banks have to interface with a larger number of platforms so they can process trades with their clients. The host of solutions available today may individually achieve milestones on the route to full STP but the very existence of such a range makes it increasingly less likely that it can be achieved. Tie-ups or alliances between providers of difference services at the various stages of the trade lifecycle can only be helpful.

LIFE OUTSIDE OF TECHNOLOGY Another initiative in play outside the technology arena is being led by ISDA, which has spent time this year working to unify the industry behind new mechanisms for trading and settling CDS. The driver for this initiative was a series of credit events in North America last year, when a number of companies defaulted on their debt obligations and the settlement of trades stretched operations staff to their limits.

ISDA's auction settlement mechanism now encompasses all credit derivative instruments, having previously applied only to CDS index trades. A number of other issues have been highlighted and tackled – for example, the ongoing difficulties in the selection and matching of the reference obligation in CDS transactions. One proposal on the table is that the market directs all trades to the Markit RED preferred reference obligation, something which would be a major contributor to achieving STP.

LOOKING AHEAD The progress made in credit derivatives processing cannot be underestimated. Market participants have addressed the crucial issues head-on and made the settlement process less cumbersome, thereby reducing operational risk.

The industry plans to extend the range of trades eligible for STP. Innovation in finance can make it difficult for operations departments to keep up, and not all asset classes are at the same level of maturity as interest rates, where STP has been adopted wholeheartedly. Having commended the progress made in credit derivative trade processing, regulators are now calling on market participants to streamline these procedures for equity derivatives, and it is clear that more challenges await the broad OTC derivative marketplace.

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