SMART SOLUTIONS FOR OTC DERIVATIVES

For hedge funds, asset managers and other buy-side institutions, over-the-counter (OTC) derivatives are an increasingly important element of their investment and trading strategies. Yet, for various reasons, buy-side firms are not always first in line to use the best post-trade processing solutions being developed in the market.

With recent events focusing more attention than ever on risk management, now is a good time for the industry to leverage the growing array of technology tools and market forums to deepen engagement with the buy-side.

OTC derivatives have proved to be a critical instrument for hedging risks. Their non-standard characteristics make them uniquely adaptable to trading parties' market views. The triple-digit increases, year after year, in OTC derivatives trading volumes as well as notional contract values outstanding prove that these instruments are fulfilling an important need for market participants.

CONTRACT VARIATIONS

This growth encompasses not merely increases within product categories – credit default swaps (CDS), for example – but also an explosion in the breadth of contract variations as the industry continues to devise new derivatives.

Historically, the downside of the OTC derivatives market's ingenuity has been that much of the documentation and payment management that ensue from trades made in front offices has been handled in a manual or quasi-manual fashion via phone calls, faxes and emailed spreadsheets. Keeping up with the growth in volumes and new products requires that all market participants work smarter, otherwise exposure to operational risk becomes problematic.

The dangers to the world financial system, not to mention to individual firms, of such a fast-evolving post-trade ecosystem have not gone unnoticed. We have experienced major advances in the post-trade landscape in recent years –

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driven partly by UK and US regulators – but also through significant cooperation among large financial institutions on both the sell-side and buy-side. Business practices across the industry have been standardised and new technology solutions developed by service providers. Besides private offerings, utilities such as Deriv/SERV and SwapsWire have also made important contributions to the industry's automation and standardisation efforts.

Another important advance is the creation and widespread adoption of FpML™ (Financial Products Markup Language). The FpML protocol, developed through an open-source effort with the guidance of the International Swaps and Derivatives Association (ISDA®), provides a standard language for OTC derivatives contract data. And a growing array of third-party vendors continues to bring to market numerous electronic workflow and processing applications.

Buy-side uptake of automation solutions for their OTC derivatives trade processes is strong and growing. At DTCC Deriv/SERV, which has the largest community of users globally for post-trade processing of OTC derivatives, over 1,000 of our 1,100-member customer base are buy-side firms from 31 countries across the globe, with major derivatives dealers comprising the balance of our customer roster. Despite the strong buy-side uptake, automated post-trade processing has not matured to the point that solutions are meshing with the operational realities of the full range of participants in the market.

Most technology solutions in this market space are designed on a product basis and are equipped to handle high volumes, so they are well suited to banks and other large institutions that organise their back-office functions by asset class. These qualities render such solutions ill matched to buy-side firms since they tend to build their operational groups and technology platforms to run across all asset classes. The buy-side environment places a premium on automation services that integrate across asset classes and offer technology in multiple-sized packages.

Custodians and fund administrators that provide services to the buy-side confront their own automation challenges. These third-party providers are themselves pressed to develop processing solutions for the fast-paced OTC derivatives market. And, it must be noted, the diversity of firms within the buy-side community has made it difficult for them to act cohesively in driving market solutions.

PROGRESS TO DATE

Just as the OTC derivatives market is growing rapidly in terms of trading volumes and product offerings, so is its post-trade processing environment evolving quickly. A look back at the industry's progress over the past four years is illustrative. The history of just one of the service providers in the post-trade market space is representative of the fast-emerging changes.

DTCC Deriv/SERV was established with broad industry support in late 2003. Its initial mandate was to drive the clean-up of unconfirmed credit derivatives trades worldwide. In the space of a few years, Deriv/SERV has become the recognised global industry standard for automated processing of OTC credit derivatives – single-name CDSs, CDS indices and CDS index tranches – over their life cycles. By the end of 2004, 15 per cent of credit derivatives were being matched and confirmed electronically; by 2007 this percentage had risen to over 85 per cent.

In 2006, DTCC introduced the Trade Information Warehouse, providing the industry's first and only central repository of "golden" trade records along with infrastructure for processing these contracts over their lifecycles, from matching and confirmation through to payment settlements. The warehouse initially supports credit contracts but is designed to be extended to equity, interest rate and other asset classes.

Deriv/SERV also provides automated matching and confirmation for OTC interest rate and equity derivatives transactions, making it the only electronic platform where market participants can match and confirm trades in the three primary asset classes with virtually all major dealers.

For all these services Deriv/SERV offers low, medium and high-technology connectivity options, allowing users that are not fully automated to gain full access to the services and their benefits. And, as users' trading volumes climb, they can progress in stages to more elaborate connectivity options with Deriv/SERV. No user's technological sophistication impacts other users of the Deriv/SERV platform.

SwapsWire has built a strong franchise processing interest rate contracts. And a number of third-party technology vendors (Thomson TradeXpress, T-Zero, Markit, Interwoven, to name a few) have stepped forward to provide specialised services to front, middle and back offices. These range from securities valuation to document management to portfolio reconciliation. In addition, since 2006 Swift has supported FpML messaging services over its network, facilitating automation between asset managers and their service providers.

As noted in *OTC Derivatives – Simplifying the Complexities*, a 2007 report by CorFS, dealers and buy-side firms experience chronic shortages of qualified back and mid-office staff in the OTC derivatives area. This finding was supported by a survey commissioned by US executive search firm Rothstein Kass, which reported in December 2007 that all firms trading in OTC derivatives find it difficult to retain back and middle-office personnel.

While hedge funds can boast a strong record over the past few years in attracting the best young talent, they share with large banks the same problem of retaining good people, and hence developing processing expertise in complex trading instruments. Buy-side spending on back-office technology and personnel may creep up over time, but it is realistic to assume that buy-side decision makers will prefer to direct limited internal resources to their front-end trading and deal-making functions.

Yet compared with large banking institutions, the majority of buy-side firms do more with fewer resources, both technological and human. As a result, they tend to hold back in signing up to new automation solutions, waiting to see where the uptake is by their counterparties and, as confirmed by a 2007 Celent Group study, to look for platforms that accommodate multiple asset classes and product types.

COLLABORATION

As the OTC derivatives industry has shown, the best enhancements to post-trade processes emerge from collaborative efforts among market participants. The buy-side has the ability to help drive change, and infrastructure platforms and software developers are well positioned to produce and provide the new features that will serve the needs of all market participants.

On the basis of cost savings and transparency, the solutions that win favour should be those that support multiple products and manage contracts through the full range of post-trade events over their multi-year life spans. For buy-side institutions, multi-product platforms (especially those with graduated levels of automation) are the best value operationally.

Some of the gaps and shortcomings of existing post-trade processing solutions are already being remedied by the introduction of new services, proof that service providers are responsive to users' needs.

New product activity at Deriv/SERV alone demonstrates this point. In 2008 Deriv/SERV is streamlining its data fields to speed and tighten the matching and confirmation process; introducing a service to automate the negotiation and execution of master confirmation agreements (MCAs) for OTC equity derivatives, which will enable trading parties to move their equity transactions to an electronic matching platform for post-trade processing; and launching an open-industry novation consent service, which transforms a cumbersome three-way assignment process into a seamless electronic operation by leveraging data in the Trade Information Warehouse.

Automated credit event processing may best exemplify what can be accomplished when market participants cooperate to apply an industry solution to post-trade contract management. Until recently, the processing of net cash payments and other payment adjustments that ensue from a bankruptcy or other major credit event was handled manually.

Deriv/SERV launched credit event processing capabilities in 2007. These functions, easily accessible to buy-side and sell-side users of the warehouse, are being deployed in a recent credit event to automate preparation of the industry's portfolios for adherence to the ISDA protocols. The result for the industry is a conservation of resources and reduction of operational risk.

DTCC

DTCC, through its subsidiaries, provides clearance, settlement and information services for equities, corporate and municipal bonds, government and mortgage-backed securities, money market instruments and over-the-counter derivatives. In addition, DTCC is a leading processor of mutual funds and insurance transactions, linking funds and carriers with their distribution networks. DTCC's depository provides custody and asset servicing for more than 2.5m securities issues from the US and 100 other countries and territories, valued at \$31,200bn. In 2007, DTCC settled more than \$1.8 quadrillion in securities transactions. DTCC provides automated matching and confirmation for OTC derivatives contracts through its DTCC Deriv/SERV LLC subsidiary. In 2007, Deriv/SERV processed more than 5.8m OTC derivatives transactions. DTCC has operating facilities in multiple locations in the US and overseas, including London and Shanghai.

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