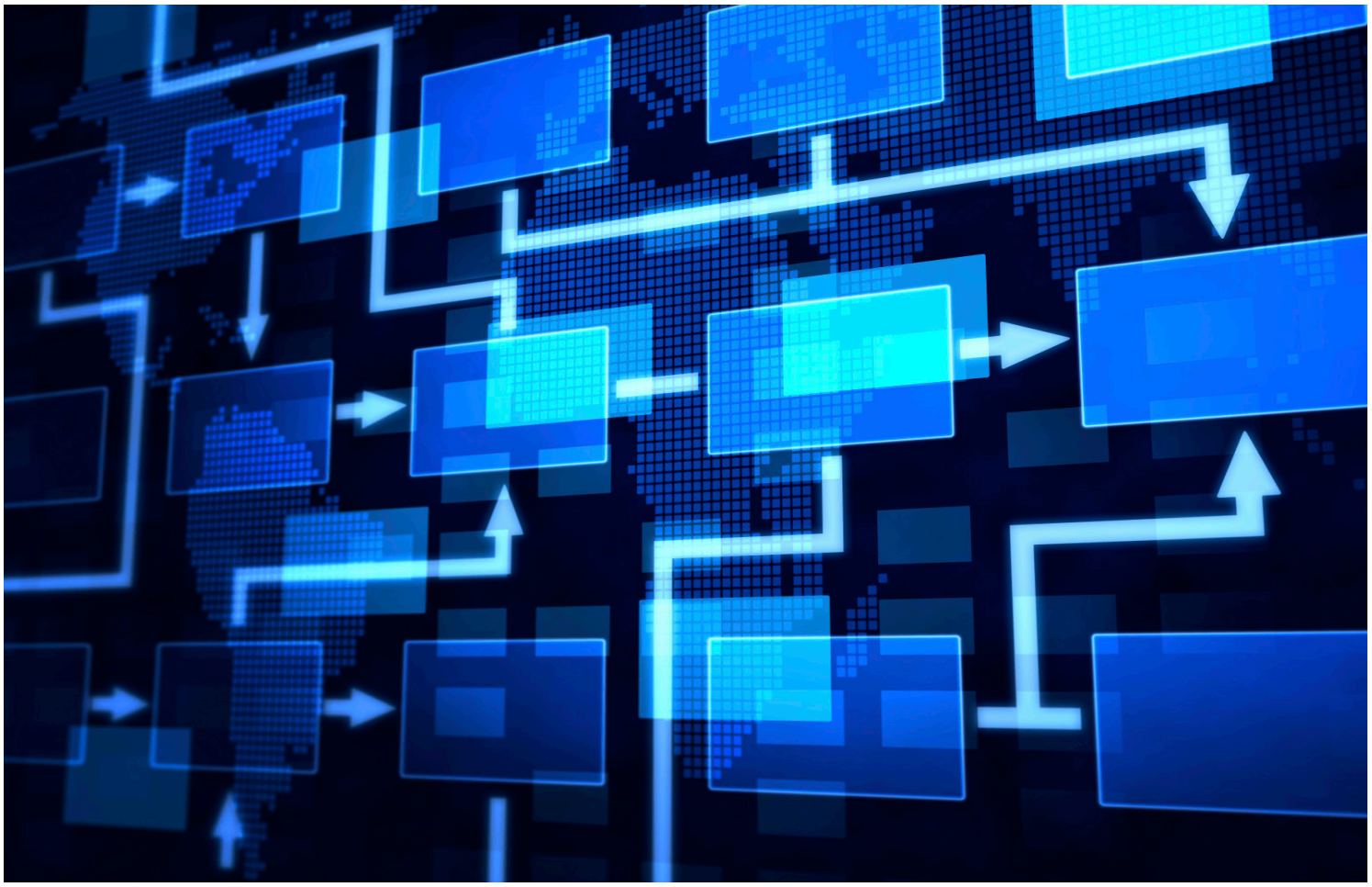
Cleared Derivatives Processing

A Strategic Approach



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During the month of January 2014, Greenwich Associates conducted telephone interviews with 51 operations professionals at both buy-side and sell-side firms to understand the current state of the Exchange-Traded Derivatives (ETD) market. Respondents were asked how regulatory changes across the globe impact risk management, trade support, work-flow processes, trade reporting, and client service for ETDs. Study participants included 19 respondents from North America, 27 from Europe and 5 from Asia.

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Executive Summary

Central clearing and trade reporting are at the center of global financial reform. This focus has created a huge burden on COOs around the world as they are forced to spend shrinking budgets on ensuring compliance with new rules and processing higher trade volumes. While the implementation of new derivatives rules is far from over, a huge milestone has been hit in the U.S. with the implementation of swaps central clearing requirements in 2013 and swap trading requirements in 2014.

With these first key deadlines behind us, cleared derivatives operations teams at investors and dealers alike must now shift their trade processing approach from a best efforts basis to ensure compliance to developing best practices that will endure over time.

For many this will be akin to changing the tires on a car while it is still moving. Macro economic forces including a back-up in rates and unrest in emerging market countries are causing periodic volatility and spikes in volume. Furthermore, the increasing cost of capital due in large part to Basel III is forcing dealers and investors to rethink product selection and trading strategies. These and other similar factors are driving a steady increase in cleared derivatives volumes, which has put further pressure on already overburdened back-office teams.

Clearly the old way of doing things won't work. Manual processes such as confirming trades via voice and fax are still common. A limited few match trades on a real-time basis, with the rest ensuring trades are final hours after the original execution took place. This creates unnecessary risk for trading desks during a time when a speech from a policy maker could create unexpected market movements in seconds.

Industry collaboration is crucial. Trade processing is a challenge for every organization in these markets, and so working together can only help ease the burden for all.

While the shift to central clearing has created short-term complexity in the swaps market, the long-term effects should be positive. The resulting workflow is one that is more automated than was ever the case in the bilateral market. And although the cleared swaps market is not a carbon copy of the futures market, operational synergies should allow COOs to find cost savings by employing similar technology and best practices for both product sets.

Regulatory reform drove financial institutions to reassess their post-trade processes for cleared derivatives. While both investors and banks did a tremendous amount of work to prepare for swap futures and make the launch of swaps clearing in 2013 a success, there's much more to be done. A race to meet deadlines focused all market participants squarely on compliance and not necessarily on the ideal end-state. With swap execution facility (SEF) trading now live, swaps clearing approaching business as usual status, futures volumes increasing, and macro-economic factors driving markets more than regulators, it's time for the market to think strategically.

The path to that strategic end-state, however, will prove much more winding and complex. On the surface there exists a need for new connectivity, the ability to handle a higher number of trade tickets and the establishment of new futures commission merchants (FCM) relationships. But, with buy-side firms using an average of 12 executing brokers and four clearing brokers for swaps trades, the accurate movement of data from front to back requires dozens of connections and legal documents that extend to SEFs, futures exchanges, clearinghouses, affirmation platforms, credit hubs, and swap data repositories—and that's only for the United States. Integration of the futures workflow with the new cleared swaps workflow and the creation of processes and technology to handle cross-margining only add to the challenges faced by COOs on both sides of the street.

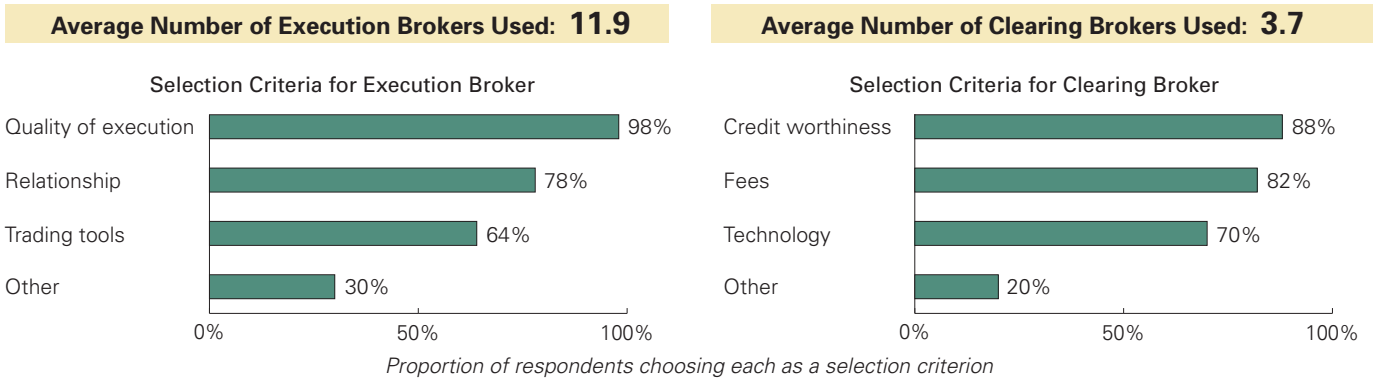
Manual Risk Management Still the Norm

The buy side views risk management as one of the most important functions provided by their operations teams. A big part of this risk management is ensuring that trades completed by the trading desk are reconciled, confirmed and made official. In doing this, the operations team also ensures that the data fed into front office risk, portfolio management and order management systems are accurate and up to date. The old cliché, "garbage in, garbage out," applies well here.

Despite the focus on risk, buy-side firms still average over 100 trade breaks per month. While in most cases this amounts to less than 1% of total trade tickets, it only takes one major break to create one major loss. A lack of timely resolution only exacerbates the problem. Less than half of buy -side firms confirm and reconcile their trades in real time. Even those performing these tasks by end of day (66%) leave hours open where the data used by the portfolio manager to make the next investment decision could be inaccurate or incomplete.

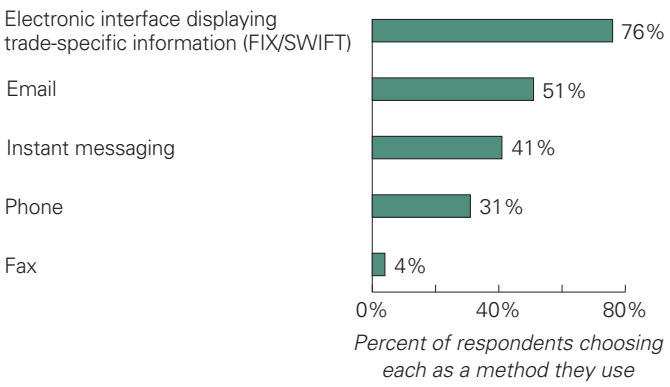
Furthermore, despite the growing use of electronic messaging to confirm trades, nearly two-thirds of investors use more manual methods including phone, email, instant messaging, and fax, slowing the process and increasing the risk further. This is particularly concerning given the speed of today's markets and the recurring bouts of sudden volatility that have become the norm since 2008.

Execution and Clearing Broker Selection for Swaps Trades



Note: Based on responses from 50 trading operations professionals globally in 2014.
Source: Greenwich Associates 2014 Cleared Derivatives Processing Study

Method of Communicating Post-Trade Allocations to Clients

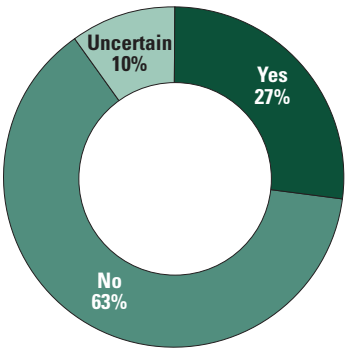


Note: Based on responses from 51 trading operations professionals globally in 2014.
Source: Greenwich Associates 2014 Cleared Derivatives Processing Study

Why Old Ways Won't Work

That said, one could argue that given the maturity of the futures market and its fortitude throughout the financial crisis, current practices work just fine. That might very well be true if the future of cleared derivatives looked the same as its past, but that's not what market participants expect. Nearly one-third of buy-side study participants say they're already seeing a shift from over-the-counter (OTC) products to futures, and market data tells us that number is likely to grow. A potential leading indicator, CME saw an increase in volume of 11% in Q4 2013, with rate products seeing a 29% jump.

Shift in Mix of OTC vs. Listed Derivatives Usage in Past 12–18 Months



Note: Based on responses from 50 trading operations professionals globally in 2014.
Source: Greenwich Associates 2014 Cleared Derivatives Processing Study

The sell side is also experiencing volume increases in cleared derivative products, driven both by the onboarding of new customers and the added volumes created by existing futures customers starting to clear swaps. This has created a noticeable capacity problem at major FCMs, a less-than-ideal scenario for a business whose success is critical to the franchise. Those who handle this transition successfully will be the big winners, with success measured as the ability to onboard new customers while continuing to provide a high level of service to existing clients.

Regulations will continue to be a driver of change. Basel III will have a major impact on sell-side and buy-side trading habits. U.S. clearing mandates have driven some volume to futures, but the impact of new clearing fees and margin costs have not yet been great enough to inspire a wholesale move. U.S. swap trading requirements are expected to shrink trade sizes and increase ticket counts as SEF trading picks up steam. And looking across the Atlantic, implementation of EMiR and MiFID II in Europe still has barely begun, with only reporting requirements now in place.

Despite its importance, COOs looking only at regulatory reform when setting priorities will likely find themselves unprepared and their infrastructure unable to keep up. Although regulations will continue to impact trading behavior in the next few years, traditional market factors are set to have a more significant impact on cleared derivatives markets going forward. This sentiment is echoed by our study participants. Roughly 80% of institutional investors say their changes in product usage are due to shifts in asset allocations and/or fund performance.

Volatility is a major driver of trade volumes, and volatility is beginning to show itself with more frequency across the major asset classes. Emerging market woes are impacting FX volumes, the coming rise in interest rates is bringing volatility to the fixed-income market, and equities trading is finally picking up after a multi-year lull driven by an increasing unemployment rate and the not-so-great rotation.

These market moves will all have major impacts on exchange-traded derivative volumes as investors look to take directional bets on macro trends or to hedge against unexpected price swings. More volume

means more breaks, more trades to report and more operational risk. So while regulations must be adhered to, investors are getting back to doing what they do best—investing—and operations teams must be ready to support them.

Getting the House in Order

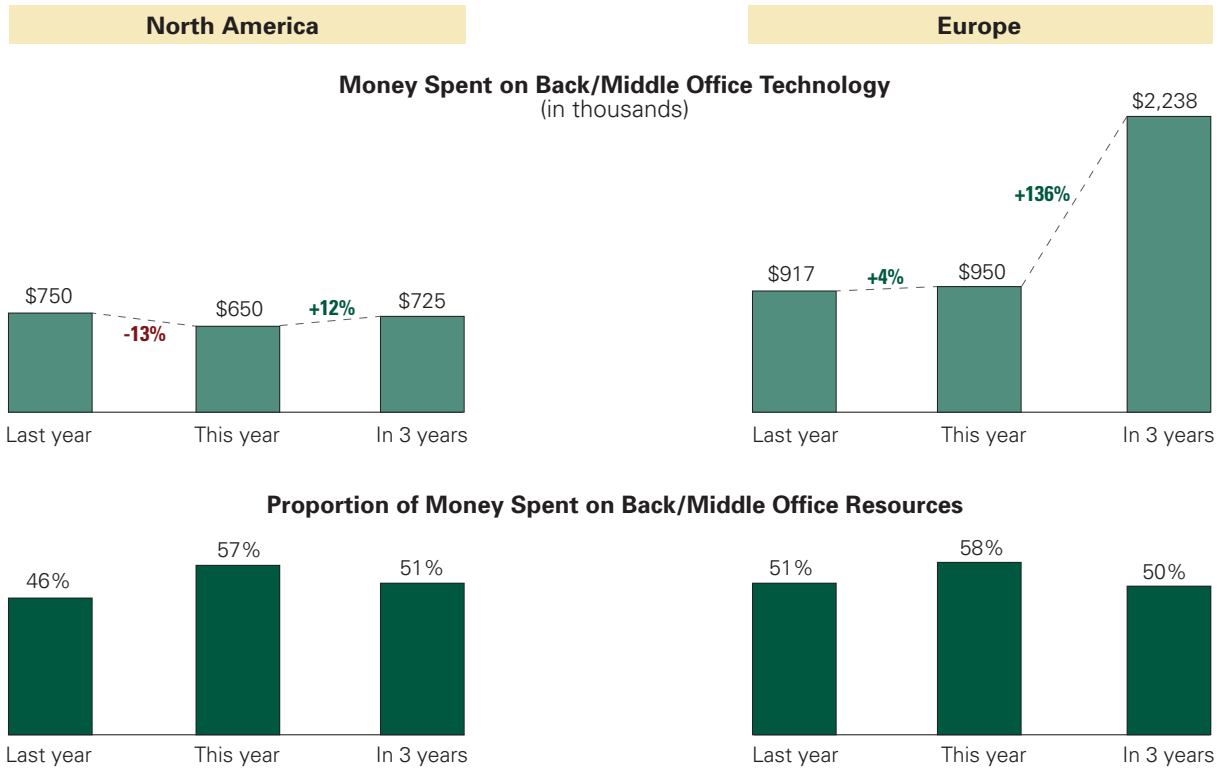
Trading and clearing cleared products is a much lower margin business for the sell side than OTC derivatives trading. Bid/ask spreads are generally smaller and processing costs are higher, leading to lower profits. And despite a clear trend towards raising client clearing fees, the cost of default fund contributions, new leverage ratio rules and clearinghouse liquidity charges will squeeze margins even tighter. Besides impacting the bottom line of bank financial statements, the reduction in profit means operations teams must put in place processes and technology that can handle higher trade volumes.

Our buy-side study participants spend an average of US$800,000 annually on cleared derivatives processing. Nearly 60% is spent on human resources, including an average of three people to handle breaks, and the rest is spent on technology. Over 80% of respondents say they have no plans to hire new resources in the next few years, but instead plan to focus their scarce budget dollars on new systems to help streamline the process.

In North America budgets are leveling out after a big push for Dodd-Frank compliance. Operations teams are focused on reducing the number of breaks and reducing the average cost per break to ensure the people, processes and platforms currently in place can handle the expected uptick in volume with no additional spend.

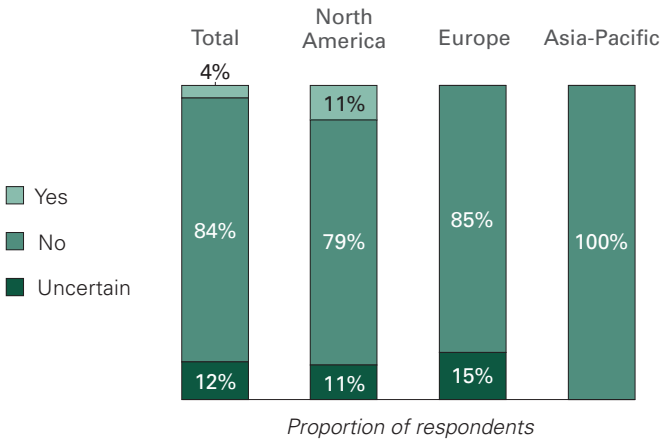
The budget story in Europe mimics that in North America but with a three-year lag. With EMiR implementation just now getting underway and MiFID II not yet finalized, money managers in Europe are planning for a dramatic

Money Spent on Back/Middle-Office Technology and Resources



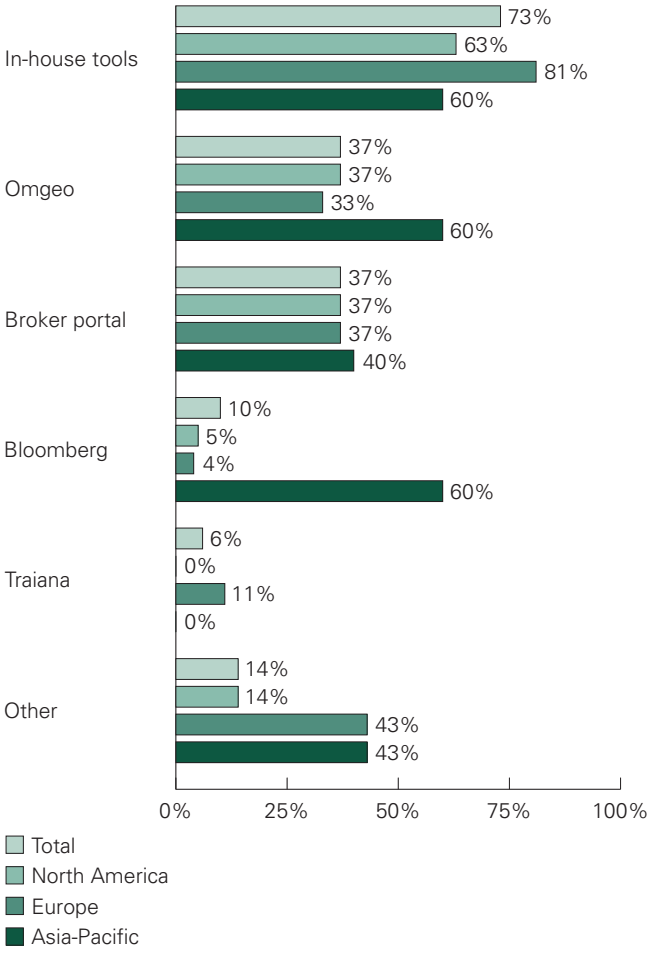
Note: Based on responses from 8 trading operations professionals globally providing spend figures in 2014. Figures exclude 0.
Source: Greenwich Associates 2014 Cleared Derivatives Processing Study

Plans to Hire Resources to Manage Trade Breaks



Note: Based on responses from 51 trading operations professionals globally in 2014 including 19 in the U.S., 27 in Europe and 5 in Asia-Pacific.
Source: Greenwich Associates 2014 Cleared Derivatives Processing Study

Products/Technology/Automation Tools Currently In Use



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increase in spending, doubling in many cases, to ensure compliance and capacity in the next few years. Reporting complexities are high on the priority list in 2014 (we will discuss this more shortly), with increased volumes expected in 2015 and beyond as clearing mandates finally settle in. Automation of the post-trade environment will be a key element of this preparation.

For those using software to help automate the reconciliation and confirmation process, the majority are working with in-house systems. As in most cases with financial technology, these systems were often put in place before off-the-shelf systems were readily available and proprietary technology was seen to provide an edge when attracting new clients. Broker portals are also a popular choice, as they come at no additional charge assuming the investor is paying commission to the broker providing the portal.

While both of these choices are not without merit, times have changed. Operational efficiency in post-trade matching comes when all market participants can communicate in the same way via a single interface. In today's connected world, the best technology is of little use if those with whom you wish to interact are not also users. Think Facebook—what fun would it be if you didn't know anyone else using it? The same holds true within a single global organization. With new derivatives regulations taking different shapes in each major region, asset managers and major dealers will need operations teams all over the world. One platform will allow them to act as one global team.

Cleared Means Cleared

Taking the one platform mantra one step further, it's also important to redefine what is meant by cleared derivatives. You may have noted that throughout this document we've used the term "cleared derivatives" rather than "exchange-traded derivatives." That was no accident. Until about 2010 there was nothing here to discuss. Exchange-traded derivatives were futures

Institutional investors should move to process both futures and cleared swaps through the same infrastructure.

and options traded on exchange. But with an ever-expanding variety of swaps now being cleared (interest rate swaps, credit default swaps, non-deliverable forwards, et al.), how to define these derivatives becomes more than an issue of semantics.

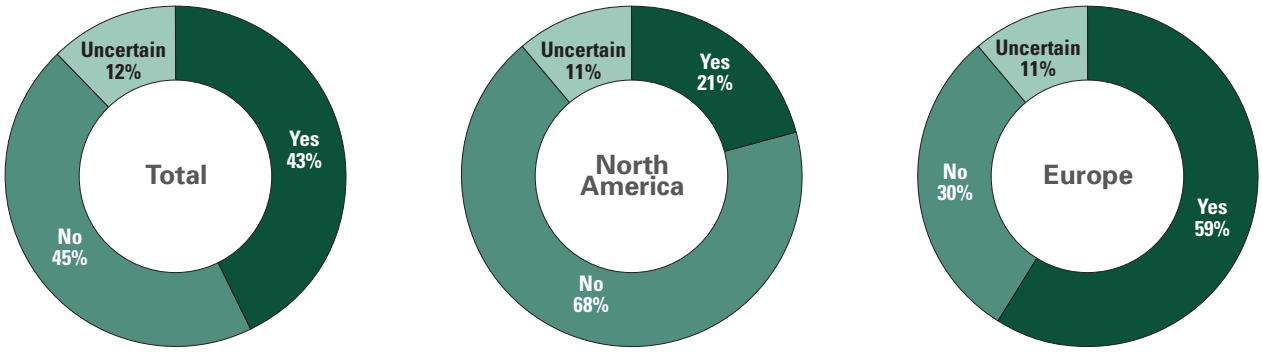
While many of these cleared products will not be technically traded on an exchange, their characteristics are similar, if not identical, to those products that are: counterparties all face a clearinghouse once trades are settled, variation and initial margin must be posted daily, and positions in one clearinghouse are not fungible with positions at another clearinghouse. And most importantly, the operational process is nearly identical. Hence the term cleared derivatives is now much more accurate.

Institutional investors should begin to think about processing both futures and cleared swaps through the same infrastructure. This will eliminate duplication of efforts and allow operations teams to take a portfolio view of derivatives exposure rather than one broken down by product legal designations. If implemented properly, this single industry standard solution should also provide the scale needed to handle expected increases in trade flows regardless of whether futures or swaps become the instrument of choice.

Emerging Trends to Watch

Handling all cleared derivatives via one operations team using one system provides additional benefits. As mentioned earlier, buy-side firms are using an average of four swaps clearing brokers in addition to at least two (a primary and a backup) for futures. While you might expect there to be substantial overlap in these two lists, many on the buy side diversify their FCM choices across swaps and futures for both counterparty risk management and based on who they view as the best in each instrument type. While a reasonable business decision, this creates additional complexity for

Plans to Implement New Processing/Technology to Manage ETD Regulations



"We are passing over all the reporting to our brokers under new regs. We can elect to do it ourself or for our brokers to do it. We have elected for our broker to do it for us."

"We are looking to engage with our brokers or a third party. We are not going to build anything ourselves."

"We have proposed to upgrade our current order management system to facilitate multiple clears, banks, and add any relevant software which would enhance that."

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operations teams that are left managing multiple fee schedules, margin rules and other legal terms.

Using different FCMs for swaps and futures makes cross-margining easier said than done. For futures and swaps positions to receive cross-margining treatment, the positions need to sit in the same swaps account at the same FCM at the same clearinghouse. It would not be prudent to leave all futures positions in the swaps account as they would be margined at the higher swaps margin rate. That means the futures positions need to be reallocated between the swaps and futures accounts daily to ensure optimal margin requirements.

If all positions are within a single clearinghouse (likely) and at a single FCM (less likely) the transfer is complex but not impossible. If the futures and swaps positions sit at different FCMs, as is common per the above, this daily transfer is nearly impossible. Inter-FCM position transfers remain a multi-day process often involving the use of faxing. This is a problem easily solved with technology, but only if the industry can agree to a standard approach.

After the markets close on trade date, but before margin payments are calculated and transmitted, a fund's positions could be rebalanced to optimize initial margin requirements, with messages sent to the relevant FCMs who can approve the transfer. A central post-trade platform facilitating such communications between operations teams on the buy side and between the FCMs would be a big step toward the final answer.

Last, but not least, there's reporting. Nearly half of our study participants say they plan to implement new technology to deal with new trade reporting requirements. Implementing these rules has proven harder than first thought, however. Put in simplest terms, in the United States the swap dealer counterparty to each trade is responsible for reporting both sides of that trade (CFTC Rule 49.11). This leaves the buy side off the hook on trade date, but they're still left having to confirm the trade details reported on their behalf are correct.

European reporting requirements have just taken effect and are even more complicated. This is why two-thirds of our European respondents are more likely to be implementing new reporting technology than U.S. investors. In addition to requiring futures trades to be reported alongside swaps, they require each party to the trade to do their own reporting. As most buy-side firms do not currently have the infrastructure in place for this type of reporting, many have outsourced this requirement to their trading counterparties. The result: The dealer will report both sides of the same trade for matching, which guarantees a match and defeats the purpose of dual reporting. For both the United States and Europe, a centralized solution for cleared derivative processing would both ease the pain on market participants and allow for the checks and balances the rules always intended. ■

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NOTES

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