



Reform agenda

G14 dealers and buy-side institutions set down their latest industry commitments designed to bring structural improvements to OTC derivative markets.

Bob Currie reports

Most of you in this room probably invest in the stock market. Imagine if the stock markets functioned the same way as the over-the-counter derivatives markets. Would you put 100 shares of a stock into your 401(k) with no knowledge of where the market prices the stocks? Similarly, we should require that standardised derivatives be traded on regulated trading venues where all market participants get to see the pricing.

Gary Gensler, Chairman, CFTC

On 14 January 2010, key OTC derivative market participants met with international financial regulators at the Federal Reserve Bank of New York to identify reforms to the financial infrastructure and market practice required to reduce risk and to improve efficiency in trading and processing OTC derivative transactions.

Building on the conclusions of this meeting, market participants submitted a letter to the New York Fed on 1 March which outlined new commitments designed to bring greater transparency and standardisation to OTC derivative markets. The focus of these commitments centred on:

- **Market Transparency.** Market participants will provide regulators with data and analysis to evaluate how greater price transparency in the OTC derivatives markets might improve financial stability.
- **Central Clearing.** Market participants will expand central clearing in both the credit and interest rate derivatives markets through extending the range of supported products and effecting broader market participation in clearing.
- **Standardisation.** Market participants will work with supervisors to evaluate levels of standardisation in credit,



Robert Pickel,
Executive Vice Chairman,
International Swaps and
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equity, and interest rate derivatives products and to prioritise areas that would benefit from greater standardisation.

- **Collateral Management.** Following the development of best practices in collateralising bilateral OTC derivative trades, market participants have committed to implementing these best practices in order to help reduce counterparty credit risk.

The 14 January meeting was the sixth to be held between market participants and global regulators since the Federal Reserve Bank of New York, working in association with other national regulators, called together 14 major dealer firms in 2005 to discuss means of reducing the escalating backlog of unconfirmed trades in the OTC credit derivatives area (for background, see FSR, April 2007, pp 24-39; FSR, Q3 2008, pp 56-75). The NY Fed reflected the sentiments of a number of regulatory authorities globally in stipulating that it would not allow firms to continue to trade in an environment where they could not be certain who their counterparties were, whether they had clear and binding contracts in place, and whether their trades would settle.

This call from national regulators raised the profile of efforts to reduce operational risk in processing OTC derivatives. However, important work was already ongoing within the industry prior to this point. In 2003, the International Swaps and Derivatives Association (ISDA) issued an Operations Strategic Plan, sponsored by banking members of the ISDA Operations Committee, which established a framework through which ISDA members could work collectively to standardise procedures through which they executed, confirmed and settled trades. In March 2004, ISDA published an Operations Implementation Plan, designed to give further operational substance to this set of industry goals. This confirmed the willingness of 21 leading derivatives firms to put aside their competitive differences and to work together to eliminate shared inefficiencies and risks in processing OTC derivatives (see further in FSR, April 2007, op. cit.).

Robert Pickel, ISDA's Executive Vice Chairman, observes that many of the

core objectives set out in the Operations Strategic Plan in 2003 have now been delivered. This initiative was important in bringing together firms that were trading OTC derivatives and encouraging them to set aside competitive differences in order to eliminate risks and inefficiencies in this sector. Subsequently, ISDA has worked closely with its members, with financial supervisors and with other industry associations to achieve operational advances in a range of areas. These include the development of standardised confirmation templates to support electronic confirmation of OTC derivatives trades. In September 2005, the industry introduced the Novation Protocol, which has promoted significant reduction in the risks associated with assignment of trades. Also, it has overseen the introduction of cash settlement procedures for credit events, initially through a series of ad hoc protocols and subsequently through procedures for auction settlement codified in 2009 through Big Bang and Small Bang protocols (see later in this article).

Though the Operations Strategic Plan, and the subsequent Operations Implementation Plan of 2004, did reflect industry best practice in framing a set of goals that it aimed to achieve, Robert Pickel explains that ISDA does not have – nor does it seek – authority to impose sanction if firms fail to meet targets in delivering those objectives. In this respect, the intervention of the New York Fed and other national regulators was important in autumn 2005 in giving additional momentum to these ambitions through calling together 14 major dealer firms to discuss means of reducing the escalating backlog of unconfirmed OTC credit derivative trades.

Responding to the Global Financial Crisis

Inevitably, the global financial crisis has also been important in focusing industry attention on the risks that they face in trading and processing derivative products. Mary Schapiro, Chairman of the Securities and Exchange Commission (SEC), indicated in a statement to the US House Committee on Agriculture in September 2009 that the financial crisis has highlighted serious weak-

nesses in US financial regulation. Prominent among these are gaps in the existing regulatory structure, failure to enforce existing regulatory standards, and delays in redesigning a regulatory framework that was developed to supervise traditionally 'siloe'd markets but which has become increasingly interconnected through globalisation, deregulation and advances in technology. A principal deficiency in the regulatory structure, she believes, was the lack of regulation around OTC derivatives, which were largely excluded from the regulatory framework in 2000 by the Commodities Futures Modernisation Act.

Gary Gensler, Chairman of the Commodity Futures Trading Commission (CFTC), imparts a similar sense of urgency in his testimony

improving investor protection and eliminating "unnecessary, unwise and destructive speculation". Congress responded by enacting the Securities Act of 1933, the Securities Exchange Act of 1934 and the Commodities Exchange Act of 1936. Gensler proposes that the same type of comprehensive regulatory reform is needed to remedy regulatory weakness in OTC derivative markets. The comprehensive regulation of this segment will, he suggests, demand two complementary regimes – one for regulation of derivatives dealers (ie "the actors") and one for regulation of derivatives markets ("the stage"). Only through this twin regulatory focus over dealers and markets can financial supervisors have full authority to lower risks, promote transparency and eliminate fraud and other market abuse.

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to the House Committee, stating that as the financial crisis gathered momentum the financial regulatory system failed the American public. "We must now do all we can to ensure that this does not happen again," he suggests. As a critical element of reform, it is key to bring comprehensive regulation to the over-the-counter derivatives markets in order to reduce risk, promote greater market integrity and improve market transparency."

The need for reform, Gensler suggests, parallels the challenges that the US faced as a nation in the 1930s. In 1934, President Roosevelt proposed to US Congress the introduction of legislation that extended regulatory control of Federal Government over the activities of exchanges dealing in securities and commodities with a view to

Faced with these priorities, the US Treasury Department, working in collaboration with the SEC and CFTC, issued a joint proposal designed to remedy this regulatory and operational deficit in OTC derivative markets. US Treasury Secretary Tim Geithner explained that although significant reforms of the OTC derivative market were proposed prior to the onset of the current crisis, regulators and market participants had moved slowly to adopt those reforms. The US Treasury Proposal attempted to build on the fundamental principle established under the Commodity Exchange Act and federal securities laws whereby, unless there is an applicable exemption, futures and other derivatives are required to be treated on a regulated derivatives exchange. However, a range of exemptions have been extended to this general principle, most notably under



Mary Schapiro,
Chairman, Securities and
Exchange Commission

the Commodity Futures Modernisation Act of 2000, whereby contracts that are “subject to individual negotiation by the counterparties”, or that are “entered into between parties that are ‘eligible contract participants’ at the time of the agreement” may be traded off-exchange in certain circumstances.

The US Treasury Proposal intends to review these exemption criteria in order to protect unsophisticated parties from engaging in inappropriate OTC derivatives transactions. More generally, it aims to create a comprehensive framework for regulating OTC derivatives which is designed to: (i) prevent activities in the OTC derivative markets presenting risk to the financial system; (ii) promote efficiency and transparency within those markets; (iii) prevent market manipulation and other market abuse; (iv) ensure that OTC derivatives are not marketed inappropriately to unsophisticated parties. The SEC’s Mary Schapiro observes that the US Treasury proposal represents an important step in bringing previously-unregulated swaps, swaps dealers and swaps markets under a comprehensive regulatory framework. It will also facilitate the standardisation and central clearing of swaps, thereby “fostering a better market and reducing counterparty risk”.

However, she believes that the proposal could be strengthened in some areas in order to close regulatory gaps and to eliminate opportunities for regulatory arbitrage. Specifically, US Congress should review qualification standards for “eligible contract participants”, the category of participants authorised to trade derivatives over-the-counter. One of the major lessons learned from the most recent financial crisis is that some smaller and less sophisticated institutions need protection from abusive practices by their swaps intermediaries. There is a requirement for more stringent business conduct standards in this area.

Also, Schapiro identifies a need to review protection extended to customer and counterparty assets in the event of insolvency. The resolution regime should provide legal restrictions on how counterparty assets held by OTC derivative dealers and other

key market participants are treated in the instance of an insolvency, indicating the degree to which counterparties have prior claim on the other assets of the estate. Without legal certainty, there is potential that the insolvency of an OTC derivative dealer or other major OTC derivatives participants could result in further market disorder and systemic risk.

Pushing OTC derivatives trading on exchange?

These sentiments align with a gradual push from financial supervisors globally for derivatives, when possible, to be traded on exchange and to be cleared centrally. We have noted that, in the US, the Commodity Exchange Act and federal securities laws promote the general principle that, unless there is an applicable exemption, futures and other derivatives should be traded on a regulated derivatives exchange.

The CFTC’s Gary Gensler states, for example, that market transparency and efficiency will be improved by moving the standardised part of the OTC markets onto regulated trade execution facilities. Exchanges, he suggests, greatly improve the functioning of the existing securities and futures markets and there is need to bring a comparable level of transparency and efficiency to the OTC swaps markets. Centralised trading venues bring greater transparency and they promote competition by encouraging market-making and the provision of liquidity by a larger number of participants. A greater number of market makers brings better pricing and lowers risk to the system. Further, clearing houses will be better able to price the risk of over-the-counter derivatives with the benefit of transparent trading markets. If clearing houses are unable to see the posted price of transactions, they will be less well placed to mark to market the derivatives they clear and, thus, less able to manage their risk and protect the public.

But how far should the industry move with this drive towards exchange trading? Though ‘standardised’ derivatives contracts can be traded on exchange, many bespoke contracts are traded OTC for good reason, meeting customer’s needs for a customised

and flexible product. With this in mind, arguably the exchange-traded derivative marketplace can only ever complement the OTC marketplace, never replace it?

ISDA's Robert Pickel indicates that, while standardisation is an important goal in the OTC derivatives world, it is also important to retain customisation of derivative products. US businesses pervasively use customised contracts to manage operational risks and it is critical that Congress preserve these companies' ability to do so. Customised products exist only because end users find them useful, and indeed necessary, in their day-to-day operations. In fact, says Pickel, the privately negotiated derivatives business has grown because standardised contracts are only of limited use in hedging.

ness," says Pickel. "By mandating solutions in these areas, there is a danger that policy makers limit the versatility offered by OTC derivative transactions, making it harder for firms to manage risk effectively."

The CFTC's Gensler accepts that there will be continued requirement for bilateral trading of customised contracts. In his testimony to the US House Committee on Agriculture regarding the Over-the-Counter Derivatives Markets Act of 2009, he states: "So that corporations can effectively hedge their risk, tailored, or customised, products should be permitted to trade bilaterally, with the dealers being regulated for these transactions. Standardised products, however, should be moved into transparent trading venues and regulated clearinghouses."

The need for reform parallels the challenges that the US faced as a nation in the 1930s. In 1934, President Roosevelt proposed to US Congress the introduction of legislation that extended regulatory control of Federal Government over the activities of exchanges dealing in securities and commodities with a view to improving investor protection and eliminating "unnecessary, unwise and destructive speculation". Congress responded by enacting the Securities Act of 1933, the Securities Exchange Act of 1934 and the Commodities Exchange Act of 1936. The same type of comprehensive regulatory reform is needed to remedy regulatory weakness in OTC derivative markets.

Initiatives that seek to standardise the terms of all OTC swaps are counterproductive. Product uniformity is not beneficial to US companies when they have risks unique to their businesses and need customised risk management tools to mitigate these risks, and when accounting rules require customised products that are closely tailored to an end user's specific risks.

Thus, as an industry association, ISDA believes there is a need for caution in applying rigid, mandated solutions. "Whether we are talking of pushing 'standardised' contracts on exchange or mandating central clearing of derivatives contracts, it is key that firms retain the flexibility afforded by use of customised, privately-negotiated derivative contracts in order to manage the specialised risks that they encounter in their busi-

ness," says Gensler. However, Gensler indicates that there is a pressing need to address an issue that has moved to the centre of the derivatives reform debate, namely the end-user exemption. All standardised transactions, regardless of whether they are between two Wall Street banks or between a bank and a corporation, should, he notes, be subject to a trading requirement and a clearing requirement. "I have heard the argument that end-user transactions comprise only a small part of the standardised markets, and thus might not need regulation," says Gensler. "I will note, however, that statistics from the Bank for International Settlements released last month indicate that dealer-to-dealer transactions comprise 40 per cent or less of the market in most contracts. Thus, an end-user exemption could leave up to 60 per cent of standardised transactions out of the



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transparency and clearing requirements.” For instance, in the single-currency interest rate markets, dealer-to-dealer transactions comprise only 34 per cent of the notional value. In over-the-counter foreign exchange derivatives, dealer-to-dealer transactions comprise approximately 39 per cent of the market. In the equity-linked and commodity derivatives markets, dealer-to-dealer transactions comprise only 40 per cent of the market.

A parallel debate has been taking place in the European Union. In line with these deliberations between financial supervisors and policy makers worldwide, the European Commission issued a consultation document in October 2009 entitled *Ensuring Efficient, Safe and Sound Derivatives Markets*. This represents a preliminary step in its drive to establish a comprehensive regulatory approach to OTC derivatives which embraces different classes of traded derivative (ie interest rate, credit, equity, commodity derivatives) under a common framework, thereby seeking to minimise opportunities for regulatory arbitrage across different derivative classes.

Central counterparty clearing

This document recognises that not all OTC derivative contracts will be eligible for central counterparty clearing, either because

mitigate the risk of potential default; and to discourage participants from employing non-standardised contracts when these could have been standardised and cleared via a CCP. Bilateral non-cleared OTC derivative contracts will be subject to higher capital charges and the Commission is currently working with the Basel Committee on Banking Supervision to revise the Capital Requirements Directive to this effect.

Significantly, the European Commission recognises that non-standardised, bespoke OTC contracts are employed widely by non-financial corporate entities in order to hedge risks that they face across their daily business activities. Given that such corporate entities may be hit hard by the requirement to post high levels of collateral against their use of non-standard contracts, the Commission is considering a proposal that will enable such firms to continue to transfer risk using OTC derivatives but without posting additional collateral. However, the Commission accepts that introducing such a waiver may be fraught with complexity. Currently, there is no clear legal definition of what represents a ‘non-financial corporate entity’. Moreover, the Commission is wary of introducing loopholes that may erode the transparency of legislation and consistency of application, providing avenues that firms may exploit for their own commercial advantage.

Efficient market supervision and prompt disclosure are best served by having information on trades held on a centralised basis, specifically through a single, consolidated trade repository per asset class. In contrast, a system where regulators receive multiple sets of information from multiple information providers will not serve the information needs of regulators or markets, particularly in times of financial stress. Instead, this may tend to obscure, rather than to expose, risk.

they are specific to the type of exposure sought by the company concerned, or because the instrument is insufficiently liquid to clear centrally. In this context, firms entering into non-standard derivative contracts must post initial margin proportionate to the counterparty’s credit risk and variation margin contingent on changes in value over time. The objective is twofold: to

At European level, this reform agenda is subject to public consultation prior to vote before the European Parliament. Werner Langen, Member of the European Parliament and Rapporteur on the European Parliament’s consultation on derivatives markets, presented a draft report on 11 February 2010 to the European Parliament’s Economic and Monetary Affairs

Committee (ECON). A vote on this resolution is expected in Q2 2010.

As part of a wider international review of standards for financial market infrastructure (eg payment systems, CCPs and securities settlement systems), the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) is conducting an assessment of how the *2004 Recommendations for Central Counterparties* should be applied to CCPs handling OTC derivatives. When approached for comment, an IOSCO spokesperson told FSR that it was still too early to make a public statement on the findings of this evaluation process. However, we expect to provide analysis of this review in the FSR Q2 2010 issue.

In a US context, if Congress does determine ultimately that commercial end-users' transactions should be exempt from a clearing requirement, the CFTC's Gensler

not offer an exemption from a transparency requirement.

Somewhat provocatively, Gensler contends that such a transparency requirement is one of the things that Wall Street likes the least. "After all, requiring banks to bring their transactions to trading venues would shift the information advantage from a small group of derivative dealers on Wall Street to the broader market," he says. "It is only dealers that benefit from keeping standardised trades off transparent trading venues, because dealers can internalise the transaction information. The banks and dealers profit from access to trading information while businesses, municipalities, consumers and others pay the costs."

In the context of these deliberations, FSR asked ISDA's Robert Pickel whether policy makers recognise the importance to financial and non-financial corporates of being able to employ privately-negotiated derivatives in managing risk across their



Susan Hinko,
Global Head of Industry
Relations, TriOptima

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is emphatic that the range of exemptions should be narrow. Exempting transactions with non-dealer financials may expose the public to risk by leaving the broader financial system substantially interconnected through their standard derivatives transactions. At minimum, legislation should mandate that trades between dealers and other financial firms be cleared through regulated clearing houses. Hedge funds, for example, should not be exempt from a clearing requirement with respect to their OTC transactions. Also, any commercial end-user exception from clearing should

business. "I think generally that they do," he responds. "The US Treasury proposals have acknowledged that privately-traded derivative transactions will continue to play an important and legitimate function in the strategies that companies employ to manage risks across their business. However, during these policy deliberations there has, at times, been too much emphasis on promoting standardisation of derivatives contracts for standardisation's sake." Indeed, in determining whether a derivative contract should be eligible for clearing through a CCP, the level of product

and legal standardisation are just two in a number of criteria that must be taken into consideration. We must also consider, for example, the level of liquidity in the instrument concerned and whether it can be valued accurately, thereby enabling efficient margin management at the clearing house. This is crucial to ensure that moves to encourage central clearing deliver their proposed goal of improved credit risk management, rather than creating a concentration of risk at a clearing house that handles large numbers of transactions in instruments that it cannot value accurately and may not be able to liquidate in instance of default.

In line with these commitments, the G14 pledged in a September 2009 letter to William Dudley, President of the New York Federal Reserve, to issue monthly performance metrics that will enable financial

steps may result, at least in the short-term, in a rise in the overall cost of trading derivatives for asset management firms. Dr Chris Sier, Director of the Financial Services Knowledge Transfer Network and industry consultant on derivatives operations, reports that, ultimately, any additional costs of trading incurred through trading on exchange and putting up margin at the clearing house will be borne by asset management firms and their institutional customers. Paradoxically, this may push buy-side customers away from an exchange-traded, centrally cleared environment back towards OTC trading and bilateral management of their post-trade, pre-settlement risk exactly when policy makers and financial supervisors are working to encourage a migration in the opposite direction. Indeed, for an asset management company that is managing a liability driven invest-

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supervisors to monitor progress of industry efforts to promote central clearing and to extend the range of derivative products eligible for clearing, taking into account risk, liquidity, default management and other relevant factors. Alongside this, the G14 members will be working with eligible CCPs and national regulators to extend the set of counterparties eligible to clear via a CCP, including efforts to extend clearing access for buy-side constituents.

Implications for buy-side firms

We have seen efforts by financial supervisors to push trading of 'standardised' derivatives contracts on to exchanges and towards a centrally cleared environment. However, there has been some concern within the buy-side community that these

ment (LDI) mandate on behalf of a pension fund customer, the derivatives exposure that it requires to structure its investment strategy can in many cases be assembled through swaps and other vanilla instruments listed on exchange. However, when the aggregate cost of trading and clearing is taken into account, many buy-side firms may continue to structure equivalent protection using privately-traded derivatives. With this in mind, Sier believes there is need for further research into the business case around CCP-clearing for OTC derivatives. Financial supervisors are eager to promote the benefits of multilateral netting and improved counterparty risk management in an environment where trading firms have less capital than in the past to support their trading activities. However, it is important to quantify the relative cost structures

associated with exchange-traded versus privately-traded contracts and the associated cost of central counterparty clearing. Only then can we have clear idea whether this approach will be attractive to buy-side traders and their institutional customers.

The European Commission, in its *Efficient, Safe and Sound Derivatives Markets* consultation paper, reflects on the fact that requiring a product to be cleared via a CCP will alter margin calculations when compared with clearing the same product bilaterally. Under bilateral clearing, margins are applied to the portfolio of all products with a particular counterparty. In contrast, the CCP applies margin multilaterally per

been evaluating whether there is need for EU-focused central clearing arrangements – and potentially also EU-based trade data repositories – that can sit alongside Federal Reserve-approved North American-based clearing systems. The Commission fears that a dominant system based on foreign soil would leave the EU with no legal recourse over disputed trades and collateral re-allocation in the event of a default. But some industry observers have questioned whether dedicated EU utilities are necessary and in the best interests of the industry – encouraging further dissipation of collateral across multiple risk pools, distinct by asset class and region, as the global clearing environment becomes increasingly fragmented.

The European Commission has been evaluating whether there is need for EU-focused central clearing arrangements – and potentially also EU-based trade data repositories – that can sit alongside Federal Reserve-approved North American-based clearing systems. The Commission fears that a dominant system based on foreign soil would leave the EU with no legal recourse over disputed trades and collateral re-allocation in the event of a default.

product range cleared. Thus, moving to a CCP may imply higher margins – and this margin difference may be especially pronounced for illiquid products. However, the Commission suggests that an increase in required margin needs may be an appropriate price to pay for the benefits that a CCP brings in terms of systemic risk reduction. The European Commission advises in its consultation document that in most cases it is be appropriate to allow a CCP to decide on its own eligibility criteria – rather than establishing rigid guidelines at EU level – given that users of the CCP, via the CCP's risk committee, will be able to influence decisions concerning which products should be eligible for clearing and how the CCP's participation and margin requirements should be structured.

On the need for EU based trade data repositories

In shaping policy direction for the European Union, the European Commission has

Robert Pickel explains that, as an industry association, ISDA does not take a view on where central clearing entities should be located, nor on the risk management models that these should employ. ISDA accepts that different alternatives will emerge for clearing OTC credit derivatives, interest rate derivatives and other categories of privately-traded derivative contract. Ultimately, it will be for the market to determine whether it can support multiple competing CCPs or whether there is need for concentration – and ultimately competitive pressures will drive the final outcome in this regard.

Similarly, in terms of the development of a trade reporting repository for credit, interest rate and equity derivatives, ISDA has not taken a view on whether the European Commission should develop Europe-based repository arrangements. This said, ISDA believes it important that the industry avoids data fragmentation whenever it is practical to do so. It makes sense, when possible, to have a centralised repository

per product category rather than a proliferation of trade repositories around the world. "We witnessed a situation at AIG prior to its rescue by the US government in 2008 – and comparable situations at other troubled companies – where it was difficult for financial supervisors to build a consolidated view of risks associated with a firm's use of OTC derivatives and structured products," says Pickel. "This scenario might be repeated if we see multiple repositories of trade information appearing around the world."

Peter Axilrod, Managing Director for Business Development at the Depository Trust & Clearing Corporation (DTCC) – which in 2007 launched the Trade Information Warehouse, the global trade repository for the OTC credit derivatives markets (see, for example, FSR, Q3 2008, pp 56-75; FSR Q1 2009, pp 46-9) and has been commissioned to deliver a trade repository for OTC equity derivatives by the end of July 2010 – has highlighted the value of a global cooperative oversight framework involving US and non-US regulators and has warned against the potential dangers of fragmentation of contract data and dissipation of regulatory responsibility.

DTCC indicates that efficient market supervision and prompt disclosure are best served by having information on trades held on a centralised basis, specifically through a single, consolidated trade repository per asset class. In contrast, a system where regulators receive multiple sets of information from multiple information providers will not serve the information needs of regulators or markets, particularly in times of financial stress. Instead, this may tend to obscure, rather than to expose, risk. For DTCC, the task of providing meaningful transparency to regulators and to the public at large requires that all OTC derivatives are cleared through a regulated central counterparty or registered in a regulated depository. However, a system relying on five or six clearing houses for cleared trades and multiple trade repositories for non-cleared trades which report independently to the regulators runs the risk of fragmenting this key information, preventing any single entity from having an overview of the entire market.

Axilrod points out that in the US, where responsibility for financial supervision of different classes of instrument lies with the SEC and CFTC, there is potential for gaps in information, reporting delays or inefficiencies in sending data from one supervisory authority to another. The absence of a consolidated trade repository, and most notably one that is impartial and indifferent to how a trade is executed and whether (or how) it is cleared, will make it difficult for regulators to gather a comprehensive view of market activity. And a more damaging scenario is that this might give firms opportunity to mask large and systemically dangerous trades from regulators by spreading their clearing activities across multiple clearing houses.

Processing credit events

It is little more than two years since DTCC processed its first credit event through the Trade Information Warehouse (TIW) when the Canadian printing company Quebecor World filed for bankruptcy protection in Canada and the US in January 2008. Subsequently, the TIW has supported automated processing and settlement for a number of major credit events, including Lehman Brothers, Washington Mutual and Icelandic banks Landsbanki, Glitnir Banki and Kaupping Banki. The Lehman bankruptcy resulted in the transfer of roughly US\$5.2 billion in net funds transfer from net sellers to net buyers of credit protection, set against a gross outstanding of US\$72 billion in CDS contracts drawn on Lehman at the time it defaulted. Subsequent to the WaMu credit event, approximately US\$1.4 billion in net funds was transferred from net sellers to net buyers of credit protection, set against gross notional outstanding in single name CDS written on WaMu of US\$41 billion at the time of default.

Subsequently, more than 80 credit events have been processed through this infrastructure. Also, we have seen have seen important changes under ISDA's Big Bang Protocol and Small Bang Protocol designed to push standardisation of CDS contracts, how they are cleared, and how they are handled in instance of a credit event. This has included the introduction of a determi-



Mark Schoen,
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nation committee to decide when a credit event has occurred, hardwired auctions to establish a binding price for cash settlement, and standardisation of coupons and effective dates to facilitate netting (see FSR, Q2 2009, pp 16-7).

But how effective is this framework for CDS auctions in case of a credit event? And what further amendments to the framework outlined in the ISDA Auction guidelines and Big/Small Bang Protocols are required to streamline the calculation and allocation of entitlements when a credit event is declared? "ISDA does not anticipate major amendments to this existing framework in months to come," responds Robert Pickel. "On the basis of experience from the 80+ credit auctions that have

an estimated US\$1.3bn worth of credit default swaps.

In line with this process, a growing number of derivative trading firms are conducting regular portfolio compression in order to reduce the overall size and the number of line items in their credit portfolios, but without changing the risk parameters of the portfolio. When a credit event occurs, eliminating these unnecessary trades is beneficial since it removes the costly administrative process of an auction settlement for these trades. TriOptima's portfolio compression service, for example, has been applied during administration of credit events (including the Thomson credit event, the first Restructuring Credit Event to be settled under the terms of the Restructuring

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taken place so far, we have had opportunity to test the process and to make refinements as necessary." In November 2009, ISDA witnessed the first instance whereby – according to the procedure set down for determining whether a credit event has taken place – a determination committee decision was referred for external review. This related to CDS in Mexican cement manufacturer Cemex. Subsequently, the review confirmed the determination committee's decision and procedures were set in train for closing out the event through a credit auction.

Alongside this, we have seen the first credit event declared in Japan. On 30 December 2009, the Credit Derivatives Determinations Committee for Japan resolved that a Restructuring Credit Event had occurred with respect to Aiful Corporation and that an auction would be held. This auction was conducted on 25 March 2010, clearing up

Settlement published by ISDA on 27 July 2009 and implemented via the Small Bang Protocol) to eliminate as many trades in the defaulted entity as possible prior to auction settlement. In supporting administration of the Thomson credit event, TriOptima completed two extra portfolio compression cycles for Thomson single names and one for Thomson-related index tranche transactions. In the single name cycles, banks terminated 15,000 trades with notional value of US\$35.6 billion; in the index cycle, more than 5200 iTraxx index tranche trades were eliminated with notional value of US\$215 billion (see box pp 70-71).

More recently, TriOptima announced that it had successfully compressed the portfolios of banks holding both credit default swaps (CDS) covering Aiful debt and Aiful-related iTraxx Japan CDS. When a restructuring credit event had been determined by the ISDA Japan Credit Derivatives

Determinations Committee, TriOptima offered two Aiful-related compression cycles. In the Aiful single name CDS cycle, 13 banks eliminated ¥111 billion of the notional amounts outstanding. In the iTraxx Japan CDS cycle, 26 banks eliminated ¥3.88 trillion of the notional amounts outstanding. This assisted the industry in reducing operational risk and cost and credit risk, as well as facilitating a smooth auction settlement process because there were fewer trades to settle.

The collective efforts of the industry over the past five years have confirmed that it can achieve major advances when key constituencies genuinely work together on a focused set of goals, comments Mireille Dyrberg, TriOptima's Chief Executive Officer EMEA. Buy-side, sell side and industry associations have pooled their expertise and resources to develop infrastructure that will support lifecycle event processing across OTC credit derivative, interest rate and, increasingly, equity derivatives. We have seen more widespread use of central clearing subsequent to the collapse of Bear Stearns and Lehman Brothers. Indeed, prior to the Lehman default, 35 per cent of all privately-traded interest rate swaps (IRS) were cleared centrally through a facility such as LCH.Clearnet SwapClear. Since Lehman, this figure has now risen to 43 per cent. Also, we now see the dealer community conducting regular portfolio compression through termination cycles offered by TriOptima and other providers. In late 2007, gross notional exposure for IRS was approximately US\$62 trillion. During 2008, gross notional outstanding was reduced by more than 50 per cent, with US\$30.2 trillion in credit default swaps terminated on triReduce over this 12 month period.

Significantly, in October 2009 TriOptima was selected by sell-side and buy-side firms comprising ISDA's Rates Steering Committee to deliver a trade reporting repository for OTC interest rate derivatives. This trade repository was launched in early January 2010. Henceforward, reports will be made available to financial supervisors on a monthly basis from the trade repository detailing outstanding trade volumes and gross notional outstanding in the OTC interest rate derivative marketplace, along

Driving standards in portfolio compression and portfolio reconciliation

TriOptima's CEO for EMEA, Mireille Dyrberg, and Global Head of Industry Relations, Susan Hinko, speak to FSR about key innovations that are helping firms to eliminate risk in their derivatives portfolios

The industry has made sizeable advances over a number of years in reducing OTC derivative notional outstanding, either by closing out contracts bilaterally that are equally offsetting or by taking advantage of the efficiencies extended by multilateral termination arrangements.

Mireille Dyrberg, Chief Executive Officer EMEA at TriOptima, observes that it can be a laborious process to close out large numbers of trades through bilateral arrangements. However, TriOptima's triReduce portfolio compression service offers the benefit of multilateral terminations across a wide community of global and regional dealers, enabling firms to streamline their balance sheets and to reduce operational costs by eliminating trades. A primary virtue of triReduce, notes TriOptima's Global Head of Industry

Relations Susan Hinko, is that it does not simply mitigate risk in processing OTC derivative transactions but eliminates this risk – enabling firms to tear up offsetting trades and to remove these completely from their portfolio of outstanding contracts.

Multilateral terminations for interest rate swap transactions almost doubled during 2009, rising from US\$13.4 trillion in notional value eliminated during 2008 to US\$25.8 trillion during 2009. Since introducing the triReduce service for euro-denominated interest rate swaps in 2003, TriOptima has extended this facility to 22 currencies globally. In October 2009 TriOptima began to terminate trades within SwapClear with a GBP cycle that eliminated US\$500 billion in notional outstandings. This will continue on a regular basis in 2010, starting

with the EUR termination cycle that reduced outstandings in the clearing house by US\$4.55 trillion.

In 2005, TriOptima broadened this coverage into the OTC credit derivatives space, supporting terminations for single name and index CDS swaps for USD, EUR, GBP and JPY. During 2009, it eliminated US\$14.5 trillion in credit default swap notional through its termination cycles, along with US\$12 trillion in credit index trades and a further US\$2.5 trillion in European, Asian and Japanese single name and credit tranche transactions.

TriOptima launched a terminations service for OTC energy derivatives in 2004. Following a temporary lull in OTC energy derivatives trading activity following the Enron bankruptcy, appetite for this service has grown significantly over the past 18 months as trading parties attempt to limit their counterparty exposure and to manage their capital needs more efficiently. Three energy compression cycles were completed in 2009 in oil, European power and US Nat Gas, with the schedule ramping up in 2010 as firms look to make good on their commitments to the regulators to reduce notional outstandings.

Portfolio reconciliation and dispute resolution

Experience from Lehman Brothers and other major credit events has reinforced the need for firms to have a clear profile of their exposure to

trading counterparties and to resolve any discrepancies or disputes at an early point.

Developed in consultation with several leading major dealers, triResolve is structured to reconcile any OTC derivative transaction that is covered by a collateral agreement, enabling firms to match their positions electronically with counterparties on a daily basis, verifying that counterparty mark-to-market valuations are aligned with internal estimates and that valuations falling outside of agreed tolerance limits are resolved on an early basis. Piloted in 2006 by a small group of dealers, triResolve was launched formally in 2007. Today it has all of the G-14 dealers, as well as a significant number of buy side firms, asset managers, smaller financial institutions, and asset servicers; and it reconciles 5.8 million trades, most of them daily. This has transformed portfolio reconciliation from a reactive, dispute driven activity to a proactive exposure management process that delivers a consolidated view of counterparty exposure down to the transaction level.

Mireille Dyrberg explains that when TriOptima first released its triResolve service, many users were attracted by the collateral management benefits of the service. However, triResolve is now being applied increasingly for non-CSA trades, with the service being deployed as a workflow tool to identify and manage exceptions across the entire OTC derivatives

back office. Through TriOptima's linkage with MarkitServ and other key industry utilities, users can upload their trade confirmation and other information to enhance the effectiveness of the reconciliation and exception management process.

Interoperability is now key for any service provider and something that TriOptima takes seriously across each of its product offerings. Indeed, market participants have made it clear in industry forums that they do not wish to input trade data into multiple regional industry data repositories – they have elected for product differentiation among repositories – and for this reason it is important that the TriOptima service is interoperable with leading electronic confirmation platforms, data repositories and the functions offered by other leading service vendors. For example, TriOptima takes an overnight batch file from DTCC into triResolve which is appended to the existing data record, ensuring that matches identified on triResolve correspond with confirmations arriving from electronic confirmation platforms and that any discrepancies are addressed. In turn, when trades have been closed out, TriOptima sends corresponding notification to DTCC and to the trading parties involved to ensure that trade records held in users' internal systems align with the centralised record of contract at the DTCC Trade Information Warehouse. •

with breakdown by currency and maturity profiles. Full anonymity has been maintained around counterparty confidentiality to ensure that participating firms are in no way compromised through submitting their trade data through this reporting process. Initially, 14 major dealers submitted data for their non-cleared OTC interest rate derivatives portfolios, spanning trades with all G14 major dealers, buy-side firms and other organisations. Beginning in March, the reports include cleared trades.

In parallel with these initiatives, key OTC derivative market participants have been working closely with national regulators to improve standards of portfolio valuation and collateral management – a feature of broader efforts to limit credit risk and to reduce operational and capital costs. This trend is reflected in a sharp rise in demand for TriOptima's triResolve portfolio reconciliation facility, which currently handles 5.8 million trades, equivalent to more than 70 per cent of all non-cleared OTC deriva-

in a normalised format, then the process of matching up trades becomes manual, haphazard and prone to error. With this in mind, ISDA's Collateral Committee published quality standards, entitled Market Minimum Standards for Collateralised Portfolio Reconciliation, in January 2010 in order to guide industry best practice in this area.

Supporting OTC derivative processing needs of asset management customers

In responding to the impact of the global financial crisis and the shock created by the Madoff default, asset management companies have restructured management of their OTC derivatives in a number of ways. There has been a push from asset managers for greater transparency around where fund assets are held and how they are valued. For a number of years there has been an ongoing drive across the hedge fund industry for independent valuation of fund assets. However, Mark Schoen, Head of Product Man-

Prior to the Lehman default, 35 per cent of all privately-traded interest rate swaps (IRS) were cleared centrally through a facility such as LCH.Clearnet SwapClear. Since Lehman, this figure has now risen to 43 per cent. Also, we now see the dealer community conducting regular portfolio compression through termination cycles offered by TriOptima and other providers. In late 2007, gross notional exposure for IRS was approximately US\$62 trillion. During 2008, gross notional outstanding was reduced by more than 50 per cent, with US\$30.2 trillion in credit default swaps terminated on triReduce over this 12 month period.

tive transactions worldwide. Potentially, demand for port rec tools such as triResolve will continue to accelerate, given the commitment of signatories to the 1 March Fed letter to reconcile portfolios with more than 1000 trades at least monthly by June 2010.

In its December 2009 Portfolio Reconciliation Feasibility Study, ISDA identified data quality as an issue of primary concern in improving the efficiency of the portfolio reconciliation process. In cases where firms do not provide sufficient data, they cannot provide data to an adequate standard, or are unable to provide data

agement, EMEA at Northern Trust, reports that this trend has gathered momentum as additional importance has been attached to pricing transparency and asset security with the onset of the global economic crisis.

Also, asset managers have been exploring opportunities to wrap their investments in a tightly regulated fund structure such as that extended by UCITS. For example, in light of the high standards of transparency and investor protection extended under the UCITS brand, a growing number of hedge fund managers have explored opportunities to employ leverage and use of

Northern Trust launches Hedge Fund Monitor service for performance and liquidity analytics

To support the challenge of providing daily independent pricing for complex, bespoke OTC derivatives, Northern Trust stepped into a strategic alliance with valuations specialist Numerix in November 2009. This has been an important step in helping the Chicago-based bank to meet customer demand for independent pricing and associated transparency reporting around OTC derivatives and structured products. Through this relationship, Northern Trust has capacity to price almost any complex derivative-based product employed by the buy-side customer. This has also enabled Northern Trust to develop an innovative suite of transparency reports, providing details of valuation models used to value complex derivative-based assets, along with calibration tech-

niques and market data inputs into the pricing process. This is key in helping customers to meet reporting requirements to auditors and financial regulators, as well as providing clear breakdown of valuation procedures if there is need to resolve potential disputes with a counterparty.

At Northern Trust, this independent pricing capacity is supported on the core Summit platform that the bank has installed to support its OTC derivatives processing capability. Mark Schoen, Head of Product Management, EMEA at Northern Trust, explains that having employed Summit on an ASP basis for four years, Northern Trust took a decision to bring the Summit system in house and make it its core processing engine for OTC derivatives. In turn, this

Summit derivatives platform connects to Northern Trust's Global Invest One fund accounting engine, to its Fund-Master core custody platform, and to parallel engines supporting treasury, performance and risk analytics and other key elements of the integrated asset servicing package that Northern Trust offers to institutional customers.

By employing this modular structure around Northern Trust's core Summit OTC derivative processing hub, this extends the flexibility offered by specialised systems (Markit Trade Manager, Lombard Colline to support collateral management, Numerix to support independent pricing and transparency reporting for OTC and structured products) while providing the centralised data management and reporting required to, for example,

OTC derivatives extended under UCITS III. Specifically, UCITS III permits management companies to employ derivatives (up to 100 per cent NAV) and to apply leverage (up to 200 per cent of NAV) in structuring fund products. For asset managers that have investment strategies that fit within these parameters, this approach can be attractive in providing the UCITS badge of good governance to the fund, while potentially extending distribution reach to investors that are comfortable with investing in UCITS but may be unwilling to invest in a traditional hedge fund or they may be prevented by their investment guidelines from doing so.

In line with this trend, some asset man-

agers have been re-registering funds from offshore centres such as Cayman to domiciles that are more tightly regulated – whether this be major UCITS centres such as Luxembourg or Dublin, or locations that may emerge as alternative investment domiciles of the future including Malta and Switzerland.

As asset management companies have increased their use of OTC derivatives, they have faced the decision of whether to build and maintain their own derivatives processing infrastructure – which might require £30-50 million investment and lengthy testing to be battle ready – or to buy in service support from an asset servicing specialist. For industry consultant Dr

provide daily UCITS VaR reporting and/or daily position reconciliation with key counterparties. Such flexibility is crucial in helping buy-side customers both to meet their external reporting obligations to financial regulators, but also to meet internal risk monitoring and attribution commitments demanded by internal compliance teams and chief risk officers.

During the past 18 months, Northern Trust has invested heavily in extending electronic connectivity for buy-side OTC derivative transactions into Northern Trust's mid- and back office service platform. Given the long-standing reliance of many buy-side firms on fax and other non-electronic media to communicate trade information, a priority for Northern Trust has been to ensure that key economic terms for a trade can be received electronically, thus facilitating reconciliation with counterparties, STP connectivity through to key electronic confirmation platforms (including MarkitWire and Deriv/SERV) and automated transmission of this trade information through subsequent steps in the transaction lifecycle. To

reinforce this process, Northern Trust installed the Markit Trade Manager and PortRec solutions in mid-2009 in order to offer electronic trade confirmation and position reconciliation on behalf of customers that have outsourced their OTC derivative investment operations to Northern Trust.

Hedge Fund Monitor

To support the growing number of institutional customers that are building hedge fund exposure through separately managed accounts or fund of hedge fund arrangements, Northern Trust has launched a Hedge Fund Monitor tool to provide a centralised source of performance and liquidity analytics for a customer's hedge fund exposure. This will enable investors to evaluate their exposures to individual organisations, whether serving as prime broker, fund administrator, or in providing finance for hedge fund investments held in portfolio. Also, this will enable the customer to identify potential liquidity barriers – known as “gates” – that might constrain its ability to redeem funds invested in a hedge fund vehicle during

specified time windows. Gates are set up by hedge fund managers to limit redemptions from the fund with a view to preventing a run on the fund, which could have a negative impact on operations as the manager may be forced to sell off positions to generate cash to meet redemptions.

Mark Schoen notes that the funds of hedge funds industry faces many challenges in today's market, with the task of monitoring and projecting liquidity at the top of the list – as evidenced by the growing number of hedge funds that we have seen imposing gates, particularly over the last 12 months. In 2009, Northern Trust launched a new feature within its Hedge Fund Monitor tool that enables fund of hedge funds managers to assess the impact of gates on their liquidity in real time. All such gating terms can be incorporated into the liquidity calculations, automatically giving funds of hedge funds information about how much and when they can access cash from their underlying hedge fund investments in a manner fully integrated with core fund administration and custody records. •

Chris Sier two primary considerations shape this strategic decision, namely: the performance of the technology platforms used to support asset managers' OTC derivative processing activities; and the rules and procedures that govern how these processes will be managed. At present, there are shortcomings in both of these areas.

On the technology side, buy side firms continue to be served relatively poorly by platform technology. Though technology vendors such as Calypso and Murex do offer dedicated platforms for processing OTC derivatives, in many cases these have been developed with sell-side needs in mind and are now being marketed to buy-side customers as a means of extracting extra

value during their product life. The result, suggests Sier, may be that a platform is insufficiently flexible to support trade capture, confirmation, valuations, collateral management and other key elements in the trade lifecycle from a single hub – and, as a result, the OTC derivative processing function becomes fragmented into a series of parallel, segregated processing functions which ultimately must be co-ordinated and reconciled.

In turn, for asset management companies that are using derivatives in UCITS III type structures, it may be hard to find a platform that will accommodate multiple UCITS (which may take corporate or contractual form) and to support the trade processing,

Societe Generale Securities Services extends mid- and back office support for OTC derivatives and structured products

Societe Generale Securities Services has established an integrated middle and back office product for OTC derivatives and structured products, delivering independent valuation of OTC and structured products, along with related collateral management, performance and risk attribution and regulatory and compliance reporting. Though many institutional clients continue to purchase these services on a modular product-by-product basis, Philippe Rozental, Head of Asset Servicing, Societe Generale Securities Services (SGSS), indicates that a growing number are seeking an integrated product that spans key elements of the OTC derivative transaction life cycle as they look to rationalise mid-and back-office costs in this challenging economic climate. This is particularly true for a middle office, independent valuation and collateral management combination.

Since launching these mid- and back office solutions for OTC and structured products four years ago, SGSS has expanded its client list to more than 50 companies, spanning a mix of buy- and sell side firms. Roughly

50 per cent of this customer base is made up of institutional clients, notably pension and insurance funds, hedge and mutual funds, with approximately two-thirds located outside of SGSS' French home market. This momentum has continued into 2010, with the Asset Servicing division confirming a number of high-profile mandate wins in the early weeks of the year.

In January 2010, SGSS reported that it had been chosen from a RFP of more than 20 applicants to deliver OTC derivative valuation services to the National Asset Management Association (NAMA) in Dublin. NAMA is a parastatal body established by the Irish Government in 2009 to purchase distressed assets (particularly property-backed loans and other structured products) in order to help Irish financial services companies to repair balance sheets in the wake of the global financial crisis. "The strength of SGSS' financial modelling team and the strong track record that we have established in modelling and valuing complex OTC derivative based products has been integral to our winning

this mandate from NAMA to service value main Irish Banks complex product portfolio," explains Rozental.

Several weeks previously, SGSS announced that it had finalised the migration of BT Pension Scheme's OTC derivatives business onto its service platform. This reflects a drive from institutional customers to improve the accuracy with which they can value OTC and structured products held in portfolio. "Though some buy-side customers do continue to rely on counterparty marks, the majority of our customers are substantially more sophisticated in how they price hard-to-value OTC-traded assets," says Rozental. "With SGSS support, they have the reference points necessary to challenge counterparty valuations which might fall outside of established tolerance limits and thus to avoid posting more collateral against their open positions than is truly required. The service will support daily portfolio reconciliation with key counterparties – as increasingly demanded by financial authorities – and will extend a flexible array of collateral management reporting.

risk management and regulatory reporting commitments that this entails. Though most service providers claim to provide this level of flexibility to their asset management customers, in reality few are able to do so at the current time. Instead the service is often silo driven and hosted on

ageing, legacy technology designed principally to meet sell side priorities.

Northern Trust's Mark Schoen confirms that for a buy-side firm that is trading OTC derivatives in significant volume, the capital cost of maintaining its own mid- and back-office to

Product development and geographical extension

In refining its valuations and risk management services, SGSS has worked in partnership with a number of external vendors – including Xenomorph, Numerix, and Algorithmics – in order to develop what it believes to be a best of breed architecture that meets diverse buy- and sell side client needs. In 2007, SGSS signed a five year agreement with Xenomorph to advance its data management for its derivatives modelling and pricing service. In doing so, SGSS has adopted Xenomorph's TimeScape production data management system and data validation services, thus enabling the company to reconcile and cleanse multiple sources of market and instrument data that it uses to drive pricing models and to populate other reference databases across SGSS' asset servicing operations.

In parallel with this development, SGSS has employed Algorithmics' AlgoRisk service to support risk analytics across complex derivatives portfolios. In line with the regulatory reporting needs of its clients, SGSS is able to support customers in providing daily VaR and cVAR estimates of maximum probable loss, along with a broad array of stress testing and scenario analytics.

In planning for the future, SGSS is responding to feedback from buy- and sell-side users by refining its OTC product in a number of areas. In its OTC valuations service, SGSS

is working to strengthen its valuations capability for asset-backed and mortgage backed securities. "During the past three years, we have had limited incentive to reinforce our capability in this area given that the market for market data to value ABS/MBS correctly was very poor," explains Rozentel. "However, we are now seeing trading interest returning gradually in this segment and customers are looking to SGSS to assist them with pricing and with managing collateral and cash flows associated with this activity. Given the depth of our financial engineering team, SGSS is well positioned to reinforce our expertise in this area internally, but we could also consider partnership with external valuation specialists to ensure that we offer an industry-leading and complete solution in this area."

In a trading segment where buy-side clients have long relied heavily on fax and other non-automated media to communicate trade information (particularly for voice-brokered trades), SGSS has been working with customers to support electronic trade capture. By ensuring that key economic terms in an OTC derivative contract can be received in electronic format from the customer and passed electronically for trade confirmation and processing of other key functions across the trade lifecycle, this will provide foundation for improved STP rates and a tangible reduction in operational risk. To facilitate this

process, SGSS offers full electronic links to key industry affirmation and confirmation platforms.

Also, SGSS is enhancing links between its OTC processing services and its liquidity management services. SGSS will provide the client with integrated solutions to optimise the collateral of OTC derivative and structured products, including the reinvestment of the cash received as collateral through various and flexible instruments.

Having now established a strong footprint in Western Europe, SGSS is reviewing potential to extend its coverage in North American markets, thereby supporting the activities of transatlantic customers that already maintain significant use of OTC and structured products in Europe and wish to manage their North American activity using SGSS as their common service provider.

More broadly, SGSS has secured some important business wins in the Nordic region, including the OTC business of Ilmarinen Mutual Pension fund, the leading Finnish pension scheme. Looking further eastwards, the company is exploring opportunities to extend its OTC valuations and risk management services to institutional investors and corporates in Central and Eastern Europe. •

support this activity can be prohibitive. The majority of boutique and highly specialised money managers do not have the necessary capital and expertise to support their OTC derivative processing requirements internally and to upgrade technology as their investment priorities evolve. Consequently, many

of these firms are seeking an external partner to support selective elements of the OTC derivative processing lifecycle. For the largest asset managers, some will continue to service elements of their OTC derivatives processing internally, but many are now reviewing the benefits of a full or partial outsource.

To meet the challenge of providing daily independent pricing for complex, bespoke OTC derivatives, Northern Trust stepped into a strategic alliance with valuations specialist Numerix in November 2009. Schoen indicates this has been an important step in helping the Chicago-based bank to meet customer demand for independent pricing and associated transparency reporting around OTC derivatives and structured products. Through this relationship, Northern Trust has capacity to price almost any complex derivative-based product employed by the buy-side customer. This has also enabled Northern Trust to develop a flexible suite of transparency reports, providing details of valuation models used to value complex derivative-based assets, along with calibration techniques and market data inputs into

Head of Asset Servicing at Societe Generale Securities Services (SGSS), indicates that a growing number are seeking an integrated product that spans key elements of the OTC derivative transaction life cycle as they look to rationalise mid-and back-office costs in this challenging economic climate. This is particularly true for middle office, independent valuation and collateral management combination.

Indeed, rather than seeking an ASP solution of the form offered by many OTC valuation companies, Rozental identifies demand from customers for a 'service-based' approach, through which SGSS is able to deliver operational cost reduction through hosting multiple clients on its mutualised IT platform, but to combine this with high quality client

On the technology side, buy side firms continue to be served relatively poorly by platform technology. Though technology vendors do offer dedicated platforms for processing OTC derivatives, in many cases these have been developed with sell-side needs in mind and are now being marketed to buy-side customers as a means of extracting extra value during their product life. The result may be that a platform is insufficiently flexible to support trade capture, confirmation, valuations, collateral management and other key elements in the trade lifecycle from a single hub - and, as a result, the OTC derivative processing function becomes fragmented into a series of parallel, segregated processing functions which ultimately must be co-ordinated and reconciled.

the pricing process. This is key in helping customers to meet reporting requirements to auditors and financial regulators, as well as providing clear breakdown of valuation procedures if there is need to resolve potential disputes with a counterparty.

Societe Generale Securities Services (SGSS) has established an integrated middle and back office product for OTC derivatives and structured products, delivering independent valuation of OTC and structured products, along with related collateral management, performance and risk attribution and regulatory and compliance reporting. Though many institutional clients continue to purchase these services on a modular product-by-product basis, Philippe Rozental,

support through a relationship management team that has a direct line to SGSS' in-house financial modelling specialists and to its operations and risk management teams. There is an important demand for transparency and audit trails capacity. Since launching this mid- and back office solutions for OTC and structured products four years ago, SGSS has expanded its client list to more than 50 companies, spanning a mix of buy- and sell side firms (see box on page 76-7).

Northern Trust's Mark Schoen notes that it can be a complex and resource-heavy operation for an asset manager to handle these valuation and collateral management responsibilities in house. For illiquid structured instruments, there may be limited



Philippe Rozental,
Head of Asset Servicing, Societe
Generale Securities Services

consensus regarding which pricing models should be applied, and which data inputs should be utilised, to provide a model valuation. A large asset management firm might employ 5-6 staff dedicated to taking in multiple pricing data feeds, scrubbing and validating this data and interpolating points on the curve where price data might be missing. This is a necessary first step before this cleansed data can be used to drive the various front office investment models, performance/risk attribution and fund accounting engines that the firm might employ. Customers holding hard-to-value assets in portfolio will be required to verify to financial supervisors that they have employed a robust methodology to provide fair valuation of their exposure. Given the complexities involved, it is understandable that increasing numbers of asset managers and institutional clients are seeking the assistance of an external asset servicing specialist to facilitate this process

In selecting an appropriate provider, asset managers will typically be seeking a service partner that has proven expertise in processing the key steps in an OTC derivative transaction – and, equally importantly, that can deliver strong economies of scale through hosting a number of sizeable, well established asset management companies on its platform. But so far, notes Chris Sier, this balance has been hard to achieve – and it remains a shortcoming of a number of global asset servicing specialists that they have failed to construct a service platform that can accommodate the specialised OTC processing needs of their asset management clients while delivering scale benefits that can be shared across this group of customers.

Significantly, at the current time no established service provider has been willing to provide liability cover to protect the customer against potential losses sustained in handling its OTC derivative activity. For a global custodian or fund administrator that has sufficient confidence in its ability to quantify and manage operational risk, Chris Sier believes that this could represent a key area in which it could differentiate its service from that offered by its competitors. Given the complexity involved in quan-

tifying operational risks associated with OTC derivatives and structured products, a preferred solution for many buy-side firms would be to outsource this activity to a well-established service provider which understands the processes involved and is willing to insure the customer against risk of loss. At this time, however, no service provider is willing to provide such indemnity. The implication, for the asset manager, is that it is required to maintain an internal risk management capability in order to monitor the risks borne in the operations that it has outsourced to its appointed service provider. This involves clear replication of effort and resource.

A potential alternative, notes Sier, is for the asset manager to buy an insurance policy from a risk underwriter. However, this remains a relatively young science. Risk underwriters are currently honing their expertise in quantifying risks associated with OTC derivative processing based on what remains a relatively short history of loss data for buy-side firms.

This said, although the data history for buy-side losses remains relatively short, the operational risks involved have been analysed extensively within sell side firms in order to meet risk reporting requirements under Basel II. As such, a sizeable body of historical loss data has now been compiled for this user segment and deployed within (for example) Operational Value at Risk calculations to estimate maximum probability of loss. This body of analysis will provide a valuable starting point in enabling risk insurers to understand what the probability distribution is likely to look like for buy-side firms.

“We believe it important for the industry to work collectively, through sharing operational loss data on an anonymous basis, in order to build collective understanding of loss probability in processing OTC derivatives,” concludes Sier. In practical terms, this analysis will be particularly valuable to service providers that have opportunity to differentiate their product from their competitors by assuming liability for any operational losses sustained in processing OTC derivatives on behalf of asset management customers. ■