Plenty has been achieved in the field of OTC derivatives processing in the last few years, particularly with credit derivatives. However, more progress still needs to be made across the major derivatives asset classes, as Simon Boughey explains.

All part of the process

A quick glance at the Markit quarterly metrics report for December 2007 indicates that significant progress in the world of trade processing for the three major derivatives asset classes has been accomplished. Nevertheless, a lot remains to be done as well.

The New York Federal Reserve Bank first turned its spotlight upon the credit derivatives industry in September 2005. It was here that the worst dangers of counterparty risk through unconfirmed trades appeared to lie.

Privately, regulators were horrified by the stories of vast amounts of paper tickets floating around the back offices of banks with no-one laying claim to them for months. Should a credit event occur at one counterparty before hundreds of trades with another were confirmed, the industry was in for a whole lot of pain.

In the two and a half years since that meeting between the New York Fed and the representatives of the leading credit derivatives banks, trade processing has changed enormously. These 18 banks, now known as the G18, have introduced electronic confirmation and processing on a wide scale and the backlog of unconfirmed trades has reduced greatly – although there was a blip last autumn when trade volumes went through the roof as the sub-prime crisis blew its gale through the financial markets.

The proportion of credit default swap (CDS) trades that were confirmed electronically was 90% of the overall total at the end of 2007, compared with only 50% in September 2005. Moreover, almost 100% of all deals were electronically eligible; that is to say, they could be processed electronically.

But it is very different in equity derivatives. Only 20% of the overall deal volume was confirmed electronically at the end of 2007, although this number had doubled over the previous eight months.

The average electronic deal volume was 1000 trades per month, while 5000 non-electronic trades were going through – and it had been up to 7000 in October.

The problems of the equity derivatives world were first highlighted by the New York Fed in one of its meetings with the G18 in November 2006. The reduction of the trade backlog and the adoption of electronic processing appeared to be going well in CDS, so the regulators swung their guns round on to equity derivatives.

The banks once again agreed to get their house in order. They noted in a letter to New York Fed president Timothy Geithner that “equity derivatives show the longest elapsed time between trade date and confirmation execution for any derivatives asset class”. Among other things, they pledged to reduce the backlog of unconfirmed trades by 25% by 31 January 2007.

But a note of concern could be detected in the statement the Fed made in May 2007. “There remain significant
challenges to automating equity derivatives infrastructure. Both executing industry standard master credit agreements (MCAs) and transporting fully to electronic platforms require significant time and resources," it said, also noting that the reduction in backlogs achieved in January 2007 was not maintained.

In October 2007 the G18 and the Fed agreed to a new three-phase plan to clean up the industry. Six new MCAs would be published by 31 August 2008, new and existing MCAs would be executed between dealers and high volume clients, and — importantly — at least 50% of eligible trades with top 20 clients would be confirmed electronically by 31 March 2008.

At the time of writing, it is unclear whether this last target will be hit. "Those are aggressive targets for such a complex market to automate. Everyone’s going to have to work really hard to get there," admits Gina Ghent, first vp, equity derivatives business development at Depository Trust and Clearing Corporation (DTCC), the electronic trade matching service.

Tom Mahoney, coo, equity derivatives, Americas at BNP Paribas, is a bit more bullish. "Well, BNP will make that number, for sure. Overall, I think the 50% figure will be hit. These targets usually are. They are only set after a lot of discussion with the Fed, and sometimes the Fed comes back and says they are too aggressive," he says. Further, Chip Carver, ceo Swapswire, comments: "Since the introduction of the three-phase plan in October 2007, the take up of Swapswire for equity derivatives has accelerated and we are seeing a lot of momentum in the market."

Structural differences

But, even if this number is met, there are clearly structural differences between the equity derivatives market and the credit derivatives market that makes the adoption of electronic trade confirmation more problematic in the former. "Equity derivatives is much more diffuse, with many more dealers. There is much more dealer-client dealing, there is a lot of Asian business, there are fewer standard documents and there have been fewer electronic tools," summarises Jeff Gooch, evp and head of valuation and operations resources to fill these gaps," says Ron Tannenbaum, co-founder of GlobeOp Financial Services. As the buy-side resource investment demands remain unknown and as these areas are not core fund competencies, many funds turn to third-party service providers and fund administrators."

Equally, clients’ monthly deal volume does not always justify the extra expenditure that it would entail. Overall, DTCC’s Ghent says: "The equity derivatives market presents more challenges for the industry. There is a vast array of different products and multiple global regions in a market with high client participation. The buy-side may face additional challenges of resource and technology constraints, which can lengthen the time it takes to execute a confirmation."

Mahoney agrees that the willingness of participants to adopt the hedges made by the G18 to progress towards an electronic solution varies, and that this is problematic. It is also a completely global business, and a New York bank sometimes has difficulties persuading a client outside the US that they should step up to the plate. "Some of the banks have large global client bases beyond the jurisdiction of the New York Fed and some clients located in Europe or Asia feel no pressure to make the investment. There’s not a lot you can do about this," he explains.

Mahoney adds that some banks have discussed a cash settlement of trading with clients that refuse to play ball, but that there is not a great deal of willingness to take this step. "It only hurts you, as they go off and trade with someone else," he says.

Signs of progress

Nevertheless, there are some signs of progress in equity derivatives, insist bankers. They claim that the bigger banks are becoming increasingly committed to electronic trading. But, even if this number is met, there are some signs that the process is stymied by other factors. The equity derivatives market has a much longer history than the credit derivatives market, and the potential for increased control and the improvement in visibility of deal documentation, this is not so," says Markit’s Gooch.

But getting the documentation in place is a laborious task. Once again, the difficulty of attaining communion between dealers and clients delays what would be a key step in the process of executing Master Confirma-

Agreements – a prerequisite for electronic matching," confirms Ghent. Sources close to the process add that hedge funds are often the most recalcitrant in the negotiation process. The many caveats can hold up the process significantly.

As the world of equity derivatives has become more fragmented and more segregated. There is more need here," she says. ISDA on course

Despite the difficulties, Darras says ISDA is on course to have its six new MCAs in place by 31 August 2008, as spelled out by 31 August 2008, as spelled out in the G18-DD’s three-phase plan. It has also circulated to members a pre-publication draft for a US equity derivatives options MCA and is “close to finalising” a US interest rate swaps form. The next documents in the waiting room are a Japan options form, an European index swaps form and an Asia-ex Japan options form.

Sources in the market add that the French banks – which to a large extent invented the equity derivatives market in the late 1980s and early 1990s, when they were still reluctant to throw their weight behind a standardisation of the market, as it would curtail their competitive advantage. This feature can be witnessed throughout the derivatives market, particularly where a few leading players dominate flow. The leading US banks have been reluctant, for example, to invest in electronic trading in CDS, with the result that it is much more developed in London than in New York. Equally, electronic trading in interest rate derivatives has only begun to show progress partly because the major dealers have decided to dilute their opposition to the process. "The French banks have thought it was not in their interest to have the market standardised. They didn’t want to become fungible, and have only acceded when the Fed insisted," says a source in New York. "Some traders have been more reluctant to give up various things," concedes another source in trade processing.

Others disagree, however. "I don’t think that the French banks have

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“Post-SocGen, it is clear that you need to tie out trades with your counterparty and agent reconciliation needs to be in place.”