Editor's letter

Credit derivatives have caught the eye of the regulators – and not for the right reasons. The Federal Reserve summoned major dealers to its doors to explain how they intend to resolve the worrying backlog in credit derivatives confirmations; the Financial Services Authority in the UK has issued warnings about the same problem; and an industry group headed by Goldman Sachs chairman Gerald Corrigan has even recommended banks stop trading until they clear the backlog.

The cause of the problem is the sort of thing many markets would love: massive and rapid take-up of new instruments – in this instance, in the form of credit default swaps (CDS). The latest volume reports from Isda showed $12.43 trillion outstanding at the end of the first half – up 48% from year-end 2004 and 128% from this time last year. The growth spurt has put pressure on back-office processes and IT. The complications inherent in CDS trades mean most confirmations are still paper-based – with obvious risks of human error or lost paper trails. And if trades are not confirmed speedily (and some are currently taking months) dealers cannot be sure of their payment obligations or hedging needs. Effective risk management is impossible.

The top derivatives banks have told the Fed they reckon they can sort this out by January 1, 2006, and a huge part of their plan rests on the success of a range of IT initiatives: notably two new bank-to-client dealing platforms from MarketAxess and TradeWeb alongside existing inter-dealer services from GFI and Creditex; upgrades to SwapsWire's service, which matches trades in dealers' unconfirmed portfolios; new customers for the Depository Trust & Clearing Corporation's matching service; and potentially even a new CDS exchange should Eurex meet its end-of-year deadline to launch a credit derivatives futures contract. As the dealers rush to meet their self-imposed deadline, *Credit*'s roundtable seeks to help clear the fog surrounding the subject.

Nikki Marmery, Editor

Cover photograph: Eyewire

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Credit (issn 1466-5018) is published monthly by Incisive Financial Publishing Ltd.

Annual subscription
£875/US$1,575/€1,313: 1 year
£1,575/US$2,835/€2,363: 2 years
£2,231/US$4,016/€3,348: 3 years
Periodicals postage paid at Rahway NJ.
US mailing agent:
Mercury Airfreight International,
2323 Randolph Avenue, Avenel, NJ 07001.

Printed in the UK by Wyndeham Grange, Southwick, West Sussex.

Dealing with the weighty backlog

As the credit derivatives dealers put their plan into action to resolve the backlog of credit derivatives confirmations, *Credit* magazine brings together key figures in the industry to discuss what has been achieved so far – and what is still left to do

Nikki Marmery, editor, *Credit* magazine (NM): The first step in the trading process is point-of-trade, so it seems logical to kick off there. Thomson TradeWeb has just launched a new bank-to-client system for CDS index trading. So, Lee, maybe you could start by telling us how electronic marketplaces – essentially a front-office service – could help solve the back-office problem.

Lee Olesky, president of Thomson TradeWeb Europe **(LO)**: When you capture a trade electronically, it's a lot easier to process the trade. There's no question about accuracy; there's little question about timeliness, and you can move that trade through to the point of settlement. We've been doing this for years at TradeWeb and these days we're doing about $200 billion per day in transaction volume among different asset classes. We started focusing on the derivatives business this year. We launched a product in interest rate swaps and most recently [in late October] started our beta trading with CDS indices.

One of the points with electronic execution is that you're able to move things through the post-trade process more easily. Our system allows a dealer and a customer to execute electronically and move the trade directly over to [matching service] DTTC's Deriv/Serv to confirm the trade with certainty and efficiency. With an electronic process, it's also easier to introduce more parties. With an assignment, where you essentially have three parties involved in the trade, you can communicate that information electronically instantly to all the relevant parties.

NM: Was it difficult to persuade the buy side to trade online?

LO: Change is always a challenge. Things don't just happen. It takes time for different parties in the market to adjust. There are early adapters who tend to try new things aggressively and move more quickly; then there are middle level and slow adapters. The trend has been overwhelmingly clear that automation and efficiency is going to continue to play a big factor in all the markets; we expect credit derivatives to be no different.

"It's a combination of having the right technology, the right operations in place and really committing resources and energy"

Francesco Cicero, GFI Group

NM: What about from the dealer's point of view, Daniel? Has JPMorgan found it difficult to entice clients to online systems?

Daniel Berman, head of European credit product management at JPMorgan **(DB)**: It's early days. Solutions such as TradeWeb's are relatively recent in the CDS market. We haven't had online trading in the indices for very long and it's still something that is being actively marketed for the first time to many clients. If you look at the experience from other markets – interest rate swaps, government bonds, corporate bonds, equities or any other market that has had online trading for a longer period – you see certain kinds of clients and certain kinds of trades are more likely to move online sooner than others. For instance for corporate bonds, a fairly high percentage of our tickets, by number of tickets, are executed electronically – although many of those trade sizes are smaller.

Chip Carver, SwapsWire

So you find that retail clients are very happy to trade online and that seems an obvious place for it to happen first. Some of the larger institutional trades take longer to move online and that's to do with the type of liquidity and the efficiency gained from being online.

NM: **Belal, your firm executed the first trade on TradeWeb's service – you're clearly not shying away from electronic trading. What are the advantages that Solent sees?**

Belal Ahmed, senior derivatives analyst and head of business development at Solent Capital **(BA)**: It's efficiency – and every firm needs that to stay ahead of the game. The more trades that are straight-through processed (STP), the more trades are getting done and the less time traders have to worry about whether their trades are failing due to DTCC and back-office issues, which take a lot of time and are very expensive to clear. It's cost efficient, effective and it puts us ahead of the game in a constantly changing market.

NM: **Are there trades or types of trades that you would continue to do over the telephone?**

BA: There's a lot of information that can be gained by talking to your clients and talking to other dealers. I don't think the market will become totally electronic. There will still always be that element of human interaction and that's necessary. Each trade is a separate entity of its own; the larger trades are the more bespoke trades so they need a lot more discussion. There are non-standard terms, which at the moment we're finding that TradeWeb and the DTCC are struggling with. Maybe there needs to be a bit more progress in adaptation for non-standard trades. But by and large, we're looking to put everything through electronically – although it will take time.

DB: It might be worth pointing out that there are two aspects to electronic trading: trades that are actually agreed on screen, where there's a price provided by a dealer and the client hits or lifts the price; and where you agree a trade verbally and book it through an electronic system. Certainly, I think everybody would want to book their trades electronically because there's a massive efficiency gain. The first instance, however, will be different for different trades: large or small, standard or non-standard.

NM: **Francesco, how does that fit in with what you have experienced in the inter-dealer market?**

Francesco Cicero, head of e-trading, Europe and Asia at GFI Group **(FC)**: The point about 'hybrid dealing' is an interesting one. GFI has been one of the strongest and earliest advocates of hybrid brokerage in the inter-dealer market: we've always believed in having the best technology *and* the best brokers. It's unlikely that 100% of trades would ever happen electronically. There might be a trade you don't want to show around, the big trades where you don't want to scare the market away. Also at different stages during the trading day you have different needs to satisfy, so it's important to have all the tools, people and workflows in place so you can capture the liquidity for all those different stages. Then, with the process of confirmation, the trade should be booked as quickly as possible. If it's electronic that can happen within a tenth of a second; if it's by voice it will take a few more minutes. It's a combination of having the right technology, the right operations in place and really committing resources and energy.

NM: **What advice would you give to those people who are at the beginning of the process of automating CDS trading for the buy side?**

FC: Talk to each other and commit resources. Everyone has different needs; maybe if we have more conversations there might be more standardisation and we could channel everything through specific channels rather than having all of these one-to-one conversations. I guess we are still at an early stage so it's still very fragmented. At some point we'll get to a second stage and there'll be more standardisation. This is the way it has to go now.

NM: **Moving back to the dealer-to-client platforms, how many do you think the market can support for credit derivatives? There are now two – TradeWeb and MarketAxess – in the same space. Is it a good idea to have two? Should there be more?**

BA: The more you have, the more risk there is of trades failing. There are so many different systems and so many dealers working on different platforms. The whole process of going through the DTCC, for example, is to standardise everything and make a level playing field for everybody. The more you fragment the market, the more risk there will be that prices will be different.

DB: I would expect there to be more than one. Again, if you look at other markets – corporate bonds, for example – there are a number of different multi-dealer platforms and many single-dealer platforms. There's a debate as to which of these two models will be more successful, but I think we will end up with a few for the next couple of years while the market decides what it wants. This is going to be a continually developing environment because the product set is changing very quickly.

FC: In the inter-dealer market, a small number, say 10%, of customers would look at just one screen that logs them into all the different platforms. The remaining 90% of the market would still operate on a one-to-one relationship with a broker. The same thing might happen for the buy side: a broker or marketplace might maintain all the different relationships for the top customers.

LO: The market likes competition. At the same time the market likes concentration of liquidity. In all the different markets around the world, there tends to be one place where there is most of the liquidity; not all liquidity, but most liquidity. I assume there will be a dominant position and one of the platforms will have the lead. But I also assume that it will be competition that drives innovation and distribution and the fight for liquidity. I agree with Daniel that there will be more than one platform and I think that will be a good thing for the market.

Lee Olesky, Thomson TradeWeb Europe

"We should be clear that the previous environment needed to be changed"

Daniel Berman, JPMorgan

NM: Moving on from the point of trade, we should look at integration of all these different services. I'd like to bring you in here, Chip. How do all the front-office and back-office systems fit together?

Chip Carver, chief executive of SwapsWire **(CC)**: An ideal world would be one particular provider drawing in everybody who's involved in the market: dealers, buy side, inter-dealer brokers, electronic brokers between the buy side, and also adding in the people who provide confirmation, payment services, clearing, collateral and mark-to-market services. For interest rate swaps and CDS, the DTCC and ourselves are trying to act as that centre. Our approach is a bit different in that we don't want to rebuild a lot of the services that already exist. We're happy to have other people provide the clearing aspect. The DTCC approach is to try and provide clearing. Either way it can work. Integration will occur naturally; you see that in other markets – a central place that reduces the number of interfaces that dealers and buy-side clients need.

NM: How has SwapsWire worked to solve the particular problem of the credit derivatives confirmation backlog?

CC: We view this as a process where the guy who knows the trade best is the guy who executed the trade – the dealer, the customer, the inter-dealer broker or whoever it might be. We bring all of those people into the process very early on. When we looked at the CDS market we identified that the back-office process is a problem, and secondly that what's hurt the market tremendously has been assignments.

So we've developed a matching process that allows people to put their backlog of trades onto our system. We've developed sophisticated matching capabilities that allow them to find the trade that should be its buddy. On the assignment side, we've designed a system that allows that assignment to take place and is driven by the person who is exiting the trade, normally the buy side. That's the person who knows everything about the transaction; they know the original trade and they know how they got out of it. That functionality is relatively new and the dealers are taking to it fairly quickly.

LO: I echo Chip's point. The problem, if it's tackled at the time of trade, is no longer a problem. If you've got complete matching of all the elements of the trade then you've solved the problem. What we're doing to take it to the next step for post-trade processing is handing it off to DTCC Deriv/Serv.

For the added complexity of an assignment, which is essentially a three-party situation where you're taking a trade with Dealer A and assigning it to Dealer B, what we're doing is developing a function that lets each of the parties know about that action at the time it's being executed. We have a product called Swap Tracker, which is a position-keeping tool that has all the elements of a transaction. As soon as that is moved into an assignment, a message goes out to all parties involved in the process. Then it's sent on to a centralised place, in this case DTTC Deriv/Serv.

NM: **What about you Francesco? Presumably on an inter-dealer platform the dealers send their own trades to the DTCC?**

FC: There is still a part of the process where we need to communicate with both counterparties of a trade and we have a service that is being rolled out to customers now. We notify them in real time if it's an electronic trade and with a bit of delay if it's a voice trade. We know that by the end of the day, trades have been checked, verified, affirmed and accepted. Very rarely in the next day or two, something comes back that was not correct; we tend to resolve all these issues within a day. Of course, what happens on the two counterparties' side is a different story. We see a great opportunity of getting more involved with the DTCC or SwapsWire. It's our responsibility as one of the leading brokers, the minimum we can do.

NM: **Daniel, from your perspective what are the advantages of the two modes of matching trades at the moment, either in real time through the DTCC or uploading portfolios to a service like SwapsWire?**

DB: Firstly, we're very supportive of any solutions that facilitate STP. We've made a commitment to get our frequent trading clients onto one of these systems as part of our commitment to the Fed. In terms of the difference between the solutions, the back-loading of portfolios is important; it's something that hopefully doesn't have to happen continuously because once you've back-loaded the portfolio and are confirming new trades via an electronic platform then you shouldn't have a portfolio of trades that need to be uploaded again. After that there are a range of solutions and different solutions will work for different clients. Some people, for instance, will prefer T-Zero; others will prefer SwapsWire. Some people will trade via TradeWeb and will use TradeWeb's own middle-ware platform to confirm trades. From our perspective, as long as each of these solutions meets the STP criteria, i.e. it interfaces well with us and it is able to confirm trade details on the day of trade in a satisfactory manner, then we'll be supportive of any of those solutions.

NM: **Belal, which systems do you use?**

BA: We're not as big as the banks so we don't have all different departments that can deal with just settlements and confirmations. Something that can take care of all that in one step at the time of trade is very important to us. I couldn't say exactly which platform would be the best for us, but something that would reduce the number of steps is key.

NM: **So, Chip, the same question to you that I asked Lee. How many post-trade servicing processes does the market need?**

CC: Competition in this market is very good, but it makes it more difficult for the dealers and the buy side because they have to integrate more platforms. Global heads of operations at dealers tell us if they had a choice they'd have one firm providing over-the-counter (OTC) confirmation processing and STP for all their markets: that would make their lives a lot simpler. They also recognise that that's unlikely to happen any time soon – maybe never. What we've done with our services is we've broken them down and allowed people to pick what they like from them. For instance, broker confirmations and trade capture: you could take that just from SwapsWire and confirm trades in a different system. Likewise, we don't want to recreate a payment system but we're happy to integrate with the likes of the London Clearing House for the DTCC. The key is that these buy-side services should work together so that it feels close to seamless.

"At times the CDS market has chosen the easier path, rather than the strategic path, to resolve some of its issues"

Chip Carver, SwapsWire

NM: **At the moment the focus is heavily on the documentation issue for credit derivatives. Are there any other issues the market needs to look at, such as the operational pressure the quarterly roll system brings?**

Francesco Cicero, GFI Group

DB: There are two aspects to the quarterly roll in terms of potential operational bottlenecks: one is that you have a large number of trades being executed on a couple of days each quarter. Clearly that means there are a lot of trades to confirm, and this is going to be tackled by exactly the kind of solutions that we're discussing. Secondly, it means there are a lot of cash payments that have to be made on one day. From the cash perspective, at least for us, it's really not a problem. We have a very sophisticated system for making cash payments, which has a huge capacity.

In terms of the counter to the implicit proposal to change the mechanism of quarterly rolls, I would argue that they have added greatly to liquidity. They've also made books much easier to manage for both investors and dealers in that trading on two consecutive days, you're effectively trading in the same product with the same maturity date. There are strong reasons for investors as well to be happy with the current quarterly roll mechanism. The real question is more, can we resolve some of the bottlenecks that people have in settling so many trades on one day, or confirming so many trades in one day, on a cash payment side?

CC: One of the keys to the development of the interest rate swap (IRS) market was flexibility in terms, such as payment dates. On our system, to confirm an IRS trade you can change about 110 fields. In the IRS market, the ability to change those things has been particularly valuable. Large dealers can handle those amounts of cashflows going through, but as the market continues to grow there is a potential bottleneck for other institutions. Some of the other dealers, we've certainly heard, are struggling under these payment scenarios. There are other alternatives: you could have a constant maturity date, but perhaps alter the payment dates for the cashflows.

I'm not sure the quarterly payment date has been particularly helpful for liquidity; it's caused more problems. At times the CDS market has chosen the easier path, rather than the strategic path, to resolve some of its issues. Over time people should consider moving off those payment and roll dates to lessen some of the burden that occurs in the market today.

NM: **Belal, do you think this is a problem for the buy side?**

BA: It's a problem for the buy side only because the sell side has a problem with it. On many occasions we find that these breaks occur because on certain roll dates the whole department decides to take a holiday just to avoid this bottleneck of settlements! More flexibility in payment dates would be very helpful but – coming back to another point – if we can standardise booking systems and the STP system, then that would also help alleviate the problem.

NM: **What about other areas that need standardisation, such as messaging? Is that a problem, Francesco?**

FC: It is an issue. There are two aspects that particularly affect us: one is FpML [Financial Products Markup Language], which is supposed to be the standard. But even in its latest form it doesn't cater for all needs. We try to speak one common language with all customers, but then there's something that FpML doesn't provide for: for example, tranches. We need to come up with alternatives otherwise we cannot provide a truly standardised STP solution for the customers.

The other issue is that some customers say, very reasonably, 'we only want to receive trades for entities we can recognise'. Generally we recognise them using a Red [Reference Entity Database] code to identify them. The problem is that Markit [which distributes the Red codes] does not provide identification for all entities that can be traded. The front office is so much more flexible that there are contracts they do not have a code for.

CC: We're a big advocate of FpML and I agree that, at times, it moves slowly. It's problematic for us because when we've developed a new product we've had to guess where we think FpML's going to end up and then go back and alter it, which causes integration problems. On the Red identifier side, one of the things that we've done is allow the banks to upload their codes for deals where the Red database doesn't exist. If they want to they can expose that back to the inter-dealer brokers so that when you send it out to them, you can use, say, the Merrill Lynch code for that particular entity.

LO: Whenever you have a standardised language that is supported in a sense by volunteers, it's going to be a challenge to keep everyone moving forward. It's not just FpML: this happens in a lot of other areas. It will always be a challenge when you have standards like this that are voluntary rather than driven by a business initiative.

NM: Do you think banks are doing enough to solve the language problem?

FC: Today, yes. Banks are really putting money into this project. They have to. The only unfortunate thing is that there are still a lot of one-to-one conversations in the intermediary market. That's probably inevitable now but it's not desirable in the long term. The FpML problem might go away once everything goes through one channel.

NM: Are there differences for what we're discussing between the experiences of the markets in the US and in Europe?

CC: For uptake of our product, it's Asia that we have to sell to the least. We started there later and now the region represents 25% of our volume. Europe has been better than the US in general in taking up some of our initiatives. The interesting thing is I would say close to 50% of the dealers are not global in their systems across regions; selling into the US, Europe or Asia at a particular firm can be three distinct jobs. That's an additional challenge.

Belal Ahmed, Solent Capital Partners

LO: I guess the difference is the customer base. There are significant differences in the customer bases in Europe and the US. For CDS in particular, it's a much more concentrated market in Europe than it is in the US, and the actual make-up of the buy side is different. Another example is in the government bond market: in Europe you have several central banks which play an active role with different currencies; in the US it's simpler with one issuer. In the US you have a much clearer group of leading banks, whereas in Europe there are more banks, more competition, as well as regional and currency issues.

> "If an assignment is tackled at the time of trade, it is no longer a problem"
>
> Lee Olesky, Thomson TradeWeb Europe

FC: In North America there's a higher variety of participants. Europe is more standardised from the point of view of which instruments are traded. The US is more innovative, which means it's more difficult to put instruments on a screen. In Europe it's much easier to create electronic markets. What's interesting is how an increasing percentage of banks are addressing the issue globally. With some of them we are talking to North American counterparties, although maybe the first market to be rolled out might be European or vice versa. It seems Europe is slightly more proactive. The inter-dealer market in North America is still a little bit conservative; they prefer to trade by voice.

NM: Let's return to the issue of assignments, that is, where a counterparty, most likely a hedge fund, assigns a trade it wants to exit to a third party. This causes obvious problems when you come to confirm that trade because there are three people involved. How do your systems approach this issue?

CC: At SwapsWire, we start with the hedge fund, which is usually the one getting out of the trade. So execution takes place, whether electronically or by voice. The trader then assigns the trade and the buy-side client pulls up the transaction that's been confirmed on SwapsWire and is sitting on our database. They then send it to the incoming party and to the remaining party. Each person then signs off on the trade and when all three have signed off, the assignment is complete.

LO: When we were talking to our customers we found there were no tools for the buy side to accomplish the tri-party arrangement. So we built Swap Tracker. It's a position-keeping tool that allows a buy-side customer to have all of the detail of past transactions in front of them and to operate the assignment process from that. You can then send electronic messages to both the party you're doing the assignment trade with and the party that you had the previous trade with. Once this is all agreed then the information flows to DTCC Deriv/Serv to adjust the position.

NM: This is the issue that Isda is trying to resolve with its Novation Protocol. Daniel, as one of the dealers involved with this, can you give us a brief summary of what the protocol demands?

DB: The protocol that was published a few weeks ago demands the stepping-out party – which is generally speaking going to be the client – will request of the remaining party that they are allowed to step out and that the trade can be assigned to another dealer. So they need to make that request, and it can be done on email or it could be done via one of the electronic solutions we are talking about. The remaining party needs to consent to that request and message back both the stepping-out party and the stepping-in party to confirm that consent has been given. If that's all done by 6pm Eastern Standard Time then the trade

Daniel Berman, JPMorgan

is deemed to have been novated or assigned. If it hasn't been done, then the stepping-out party and the dealer do a new trade with the same details as the trade that the client was attempting to assign. Either way, by the end of the day the trade will have been done. The question is will it have been done as a successful novation as the client intended, or will it need to be done as a new trade because consent hasn't been received.

NM: What were some of the difficulties that occurred without this new regime, pre-protocol?

DB: I guess the backlog pre-protocol was resulting in many trade assignments not being executed, i.e. confirmed as assignments within a reasonable time period, and as a result the risk management systems of both clients and dealers were not always showing the correct information. That's a significant issue from a risk management perspective and a credit risk perspective for both sides: clients and dealers. The aim of this protocol is to remedy that and ensure that, by the end of the day of trade, all parties that would be subject to an assignment know exactly what trade they have on and with whom.

NM: Belal, I'm going to make you speak on behalf of the whole hedge fund industry now! We've heard that more than a thousand institutions have signed up for the Novation Protocol [as of early November], but hedge funds seem to be dragging their heels. Why are hedge funds less keen to sign up to the protocol?

BA: We see this as too removed from the actual trade. The sell side has set up a website with group addresses so you can notify your counterparty of assigned trades, but it's still very removed from the trader. You notify someone in middle office and it's unclear whether that novation has actually been recognised or what the process is at the banks. That's why we're a bit sceptical. We don't always get the notification back that the novation has taken place. They put a lot of onus on the hedge funds to do the notification, but there's nothing coming back saying, 'yes, this novation is agreed'.

That's why there's a general lag with the hedge funds. It's as if the blame for novations failing is falling with the hedge funds. If we have notified and the counterparty hasn't responded, then a new trade is placed, which leads to increased risk. You create an assignment to get the trade off your books; now you might find that you have two trades on your books in place of one.

NM: Do you think it has been developed to favour the dealers as opposed to the buy side?

BA: In certain respects it's looking more that way at the moment. I think it needs a bit more refinement and cooperation from the counterparties and dealers to react to notification from the hedge funds. Once that process has matured maybe it will work better.

NM: Is there scope, Daniel, to include more discussion with hedge funds about how the Novation Protocol could be refined or developed?

DB: We always discuss it with our clients when we're trying to agree this kind of protocol, which as you know has been done across all dealers with Isda backing. If we fail to produce consent in a timely fashion, we'd expect our clients to tell us that and to reward us on the basis of our good performance. With any new process you need to work on efficiency and the communication trail. The previous environment needed to be changed in terms of the time lag between trade and tri-party agreement. This was the best solution we could come up with in the time available.

NM: Thank you all for your time.