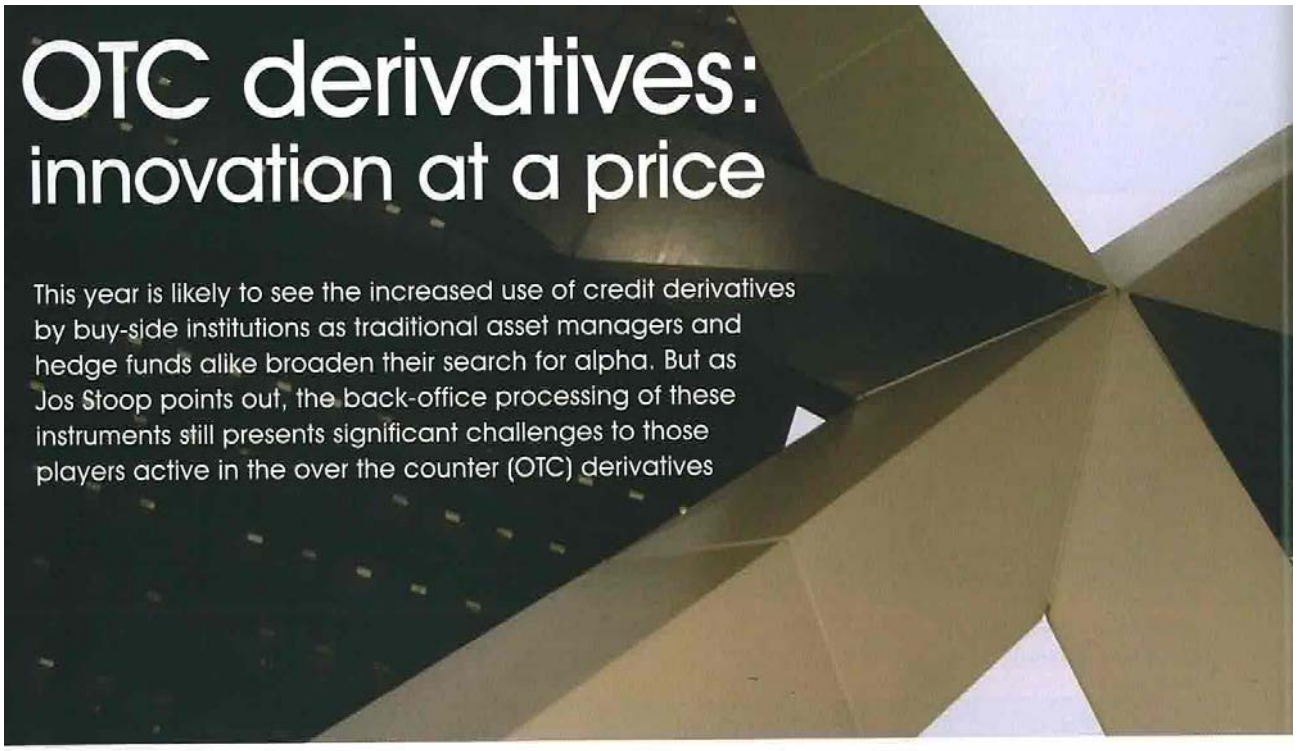
January 2007

processing by Interwoven's Jos Stoop

Big Interview: Alpha Asset Management's Kevin Shames

OTC derivatives: innovation at a price



This year is likely to see the increased use of credit derivatives by buy-side institutions as traditional asset managers and hedge funds alike broaden their search for alpha. But as Jos Stoop points out, the back-office processing of these instruments still presents significant challenges to those players active in the over the counter (OTC) derivatives

Recent figures from the International Swaps and Derivatives Association (ISDA) highlight yet another phase of expansion in the OTC derivatives market. The notional value of outstanding credit derivatives increased to a record $26,000 billion by the end of the first half of 2006, which represents considerable growth in market size and illustrates how derivatives have become an integral part of today's financial markets.

The growing use of derivatives by the buy side has been a major contributor towards this impressive expansion. However, as these complex instruments become increasingly main stream, their impact on the financial markets is correspondingly heightened. There are therefore a number of challenges that accompany the benefits of a growing derivatives market, and these are compounded by the buy side developing its exposure at such a rapid rate.

Further automation is being introduced in the vanilla credit markets and, to a lesser extent, in the interest and equity-derivatives markets, mainly due to pressure from the FSA in the UK and the US Federal Reserve. As a result, the backlogs of outstanding trade confirmations that had grown to unmanageable levels are being reduced significantly, along with the associated risk.

There are a number of initiatives that are driving and facilitating automation, such as the introduction of ISDA's Novation Protocol – an electronic messaging protocol developed by ISDA for trade assignments – and increased use of DTCC's Deriv/Serv matching platform for new trades.

However, while this is good progress for certain instruments, there are many challenges associated with the industry's rapid growth, which mean that manual processes are still very prevalent. In particular, the continuous introduction of new instruments proves to be an unavoidable sticking point. Due to the bespoke nature of these new instruments, automation becomes a very real challenge, with almost all processes for new products being carried out manually.

The problem with innovation

Ensuring that clean and validated data is populated in each field of an OTC derivatives contract is a lengthy and complicated process for many institutions. Only when products become established – as is the case with the credit derivatives market – are suitable systems developed and installed; the issue is compounded because the OTC derivatives market is, by its very nature, driven by innovation, with new products being developed at an impressive pace. The industry is therefore faced with

a perpetual situation where automation fails to keep pace with product innovation.

Another issue for a good number of new entrants on the buy side is that their knowledge of the structuring of many products is a long way behind sell-side institutions. The average buy-side firm can therefore be attempting to automate products with a level of experience and understanding that is significantly less than on the sell side, which has been using derivative instruments for many years.

Straight-through processing (STP) has been hailed as the 'Holy Grail' within OTC derivatives. However, with the current focus on automation there is the danger that systemic risk is introduced, which occurs when the processing of a derivative product is automated but all aspects of the product itself are not fully understood. This can cause an institution to make assumptions regarding their processing that allow it to be falsely reassured about its level of risk exposure. Other than unexpected losses, resulting failures in this area may also attract renewed attention from the regulators.

'The industry is faced with a perpetual situation where automation fails to keep pace with product innovation'
Jos Stoop

The more the OTC derivatives market becomes a focus for the buy side, the higher the potential for the industry's success to become its downfall. The challenge lies with automating products that by their specialist, highly structured nature, are difficult to standardise. This raises many important issues, particularly in the automated workflow for derivatives trades, which typically requires processing messages in a wide variety of formats. Current processing systems are only capable of handling messages in a limited number of rather strict and inflexible formats, forcing many other data formats to be processed in some manual fashion, such as phone calls, emails, spreadsheets, custom reports, paper tickets and confirmations.

Given these limitations, the standardisation of the communication infrastructure – one that allows flexible data formats rather than waiting for an industry-wide standardisation of the data itself – is a more readily achievable method of automating OTC derivatives processing.

Allowing trade messages to contain any data format – both structured and unstructured trade data – as well as attachments and any custom message content sent between financial parties, removes the restrictions imposed by existing message protocols. A peer-to-peer connection reduces the number of parties that must agree on the actual trade data protocol, making it easier to achieve a working solution.

Providing a direct peer-to-peer infrastructure, including features that ensure all trade data is securely captured, transferred, actioned and audited, allows for more efficient communication of these complex trades between trading parties. In addition to trade data transfer, connectivity should allow the exchange of comments, status information, contracts or any other details concerning derivatives processing. This level of flexibility is the key to volume insensitivity and efficiency, as well as ensuring technology can keep pace with a fast-evolving market by linking up the processing environments of a firm's operations departments.

The challenges facing the derivatives industry as it grows are numerous. The regulators are paying close attention as investors increase exposure to these highly structured instruments. Complex derivatives contracts and the explosive growth of the market mean that technology must be specifically developed to meet these challenging requirements. Fundamental changes have taken place, but more significant developments are already underway from which a high level of technological innovation is to be expected.

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