

## Derivatives Processing Making Rapid Strides, But Standards Issues Remain to Be Worked Out

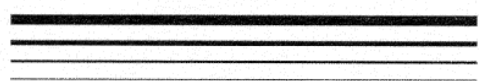
NEW YORK — Post-trade processing of credit derivatives, having suffered from years of under-investment, is just now starting to catch up with a market that grew a lot faster than expected. “Now we’re on a level that people are comfortable and the [trade processing] infrastructure is in place,” says Mas Nakachi, Senior Analyst at **Calypso Technology Inc.**, provider of a trading platform for credit derivatives, among several types of securities traded there. “It’s an upfront cost. Once [firms] put this infrastructure in place, for the foreseeable future, it will scale for the volumes they envision.”

Although the **Depository Trust & Clearing Corporation (DTCC)** has become the accepted industry solution with its Deriv/SERV solution, a range of venues are coming online or are already operating, making efficient and economical straight-through processing (STP) of credit derivative trades all the more challenging. “The biggest challenge is to make sure everyone has agreed and is on an industry accepted protocol,” says Harrell Smith, Senior Analyst at Celent Communications, a consultancy. “They always have to be able to operate seamlessly with each other. They have to agree on a single protocol.”

Key credit derivatives processing companies are, in the inter-dealer market: **Creditex**, **GFI Group** and **ICAP BrokerTec**; for multi-dealer, **MarketAxess** and **Thomson TradeWeb**; for data, **Markit Group Ltd.**; and for post-trade, **Communicator Inc.**, **Interwoven Inc./Scrittura**, **SwapsWire**, **Thunderhead**, **T-Zero**, **Trioptima AB** and **DTCC Deriv/SERV**.

The percentage of credit derivatives trading volume transacted electronically in the US is estimated at between 3 to 8 percent. The European percentage, on the other hand, is 35 to 45 percent, notes Brad Bailey, Senior Analyst at financial industry consultancy **Aite Group**. In the next 12 to 18 months, according to Bailey, firms’ investments in credit derivatives operational improvements will focus on short term, patchwork solutions and adding staff, translating into medium and long-term increases in IT spending. “The market is young enough to offer innovators a great payoff, yet mature enough to have standards developed for the bulk of the traded credit products as well as diminishing margins

# Global Investment



# Technology<sup>®</sup>

July 24, 2006

Page 2 of 3

“The driving forces of the market — pressure to increase operational efficiency, reduce costs and standardize trade processing — have set the framework for electronic trading to increase.”

DTCC’s Deriv/SERV will be the de facto clearinghouse and repository for credit derivatives transactions.

to invite technological innovations to increase operational efficiencies,” says Bailey. Major multi-dealer-to-client players first introduced limited trading in credit derivatives indices about one year ago in the third quarter of 2005, notes Bailey. “However, the driving forces of the market — pressure to increase operational efficiency, reduce costs and standardize trade processing — have set the framework for electronic trading to increase,” he says.

DTCC’s Deriv/SERV will be the de facto clearinghouse and repository for credit derivatives transactions, according to Bailey. Deriv/SERV plans to begin uploading new trades into its system in October. “As it develops a framework for handling older trades already in the system and the ability to process payments through the system, the utility of DTCC in this market will become more and more apparent,” he says.

New venues to handle credit derivatives bring new features and sophistication into the marketplace, but can create “noise,” according to John Burchenal, Managing Director of Asset Class Expansion at **Omgeo**, the trade-matching utility. “It’s hard for any given [venue] now to get their message heard, because there are a limited number of back-office [professionals] trying to sort out and understand all this,” he says. “Those who understand derivatives processing and document management around all derivatives are in high demand right now because they’re the ones that have to sort all this out.”

SwapsWire recently increased staff in customer service and account management to support a rapidly growing client base and allow current clients to maximize trade date confirmation. “The fact that we are growing our client teams is a testament to the success of the SwapsWire platform,” says Chip Carver, Chief Executive Officer, SwapsWire. “We continue to break volume records.”

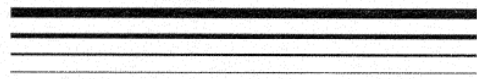
Most major swaps dealers are using SwapsWire for trade capture and confirmation, notes Celent’s Smith. “SwapsWire remains the industry standard,” he says. For processing, however, DTCC is still the utility platform of choice, adds Smith.

Thomson TradeWeb began running a CDS execution platform in October 2005, which now has 10 global dealers and about 60 customers. The platform uses the traditional TradeWeb request for quote model, and connects to Deriv/SERV. “We built into our system a real-time reconciliation tool so our system is checking with Deriv/SERV in real-time for position status, making sure that trades are either confirmed, or if unconfirmed for a mismatch, it determines the mismatch details,” says Billy Hult, Managing Director at TradeWeb. “So we have real-time reconciliation as part of the TRADEtracker software.”

TradeWeb’s CreditXpress STP solution for derivatives is being integrated with Omgeo’s trade matching products, notes Peter Delano, Senior Analyst, Investment Management, at financial industry consultancy **TowerGroup**.

New providers of credit derivatives processing services likely have some maturing to do, according to Kathy Ball-Toncic, Managing Director at **InvestTech Systems Consulting**, where her responsibilities include business development and post-trade automation consulting. She points out the dominance of DTCC’s Deriv/SERV. “I don’t see any of the new entrants gaining a lot of market share yet,” says Ball-Toncic. “That’s likely to change, but Deriv/SERV is

# Global Investment



# Technology®

July 24, 2006

Page 3 of 3

**“SwapsWire remains the industry standard [for trade capture and confirmation]. For processing, however, DTCC is still the utility platform of choice.”**

**An industry-wide unique identifier for credit derivatives would go a long way toward tracking positions and achieving full lifetime management of trades.**

processing about 70 percent of over-the-counter derivatives. That’s a pretty substantial piece of the market. By the end of 2005, the notional value of that market hit \$17 trillion. Deriv/SERV, unlike many other DTCC initiatives, is quite successful globally, with a third of their customers based in the UK, Europe, Asia-Pacific, Australia and Latin America.

“The remaining 30 percent may not be automated enough to use an automated service,” she adds. “That may not be the entire remaining 30 percent, but if they don’t start strong from the inception of the trade, it’s difficult to handle the downstream pieces in an automated way.”

Buy-side firms are currently trying to determine how to best automate their processes for credit derivatives, according to Ball-Toncic. “Many buy-side firms can be very automated internally,” she says. “The credit derivatives market points out the real need to not stop inside their four walls but to focus as much on what happens to the trade after it leaves their site, and ensure it’s automated with all the counterparties.”

Hedge funds no longer deserve criticism as lagging in automation in the credit derivatives market, explains Ball-Toncic. “That’s rapidly changing. They have a significant piece of this market,” she says. Hedge funds are also helping drive up the volume for credit derivatives. “Every time a phenomenon like this happens, it’s like playing ‘Whack-a-mole,’” says Ball-Toncic. “One problem gets solved but another one pops up somewhere else, because they’re such complex instruments and there seem to be new hybrids coming all the time — or new takes where you figure out how to automate one and then a new one crops up.”

An industry-wide unique identifier for credit derivative trades would go a long way toward tracking positions and achieving full lifetime management of these trades, according to Smith.

Settlement operations for credit derivatives will focus less on documentation, according to Mark Beeston, President of T-Zero. “The benefits of capturing a trade accurately up front are not just evident in improvements in your ability to match confirms, but also in ability to match cash flow payments to make margin and collateral movements work correctly, to value books or funds correctly and correctly assess counterparty and market risk,” he says.

Most technological initiatives are revolving around DTCC, according to Nakachi. “The general market consensus is that the vanilla products — such as single-name credit derivatives and index products — are increasing in scope, but eventually index tranches and other standardized products will also widen their scope in the market,” he says. “The market wants as much STP as possible so it can focus on the manual bespoke products, which are always going to exist, because those are the products where the innovation occurs. But you can’t standardize something that isn’t. That’s the broad trend.”

Trading of credit derivatives will never be slowed down for lack of technology, according to Celent’s Smith. “Trading firms are making far too much money in the credit derivatives business,” he says. “They assumed operations would be addressed at some point in the future, but it’s seen as an operational issue as opposed to a front-office issue.” □