CCP CONVERSION: *an implementation battle looms*

Regulators are reforming the over the counter derivatives markets. Firms will be forced to use central counterparties to clear standard contracts and to report all trades to official repositories. *Bill Hodgson* and *Kevin Samborn* warn that firms face enormous work on their IT systems to comply.

Introduction

Regulators in the USA, Europe and Asia have begun to overhaul the regulatory framework surrounding the OTC derivatives markets. Proposals by the US Treasury include clearing of standardized OTC contracts by central counterparties (CCPs), encouraging the movement of contracts to regulated exchanges or trading venues and compulsory reporting of all derivatives transactions, both standardized and customized, to a trade repository. The European Commission has made it clear that it too intends to encourage greater standardization in order to facilitate centralized clearing and exchange trading of many OTC contracts. Asian authorities are planning similar moves. Financial organizations need to act now to standardize both products and systems if they are to meet the looming regulatory challenge.

What is standard?

Regulators and legislators are still discussing the details of forthcoming regulations. One of the most important concepts in their proposals is the need to standardize product definitions, something that is itself subject to continued debate.

No full definition of what constitutes a standardized contract has been agreed, although Mary Schapiro, chairman of the US Securities and Exchange Commission, has said: "There should be a presumption that if an instrument is accepted for clearing by a fully regulated clearing house, then it should be required to be cleared."

Despite a lack of clarity around certain aspects of the financial authorities' plans, the general direction of regulation is clear. It is also increasingly apparent that banks will need to enhance their IT systems and rethink business processes to cope with these changes.

Among the most significant challenges faced by financial firms will be the requirement to feed standardized contracts directly to a CCP for clearing, normally via MarkitSERV or ICE Link.

Introducing CCP clearing will make it necessary to post and receive margin on trades, obliging companies to review their banking and collateral systems. Most firms will also need to interact with a trade compression service.

Dealers that are not yet members of a clearing house will be most affected by this change, as they will have to implement an interface with a centralized clearing service.

Other firms, such as dealers' corporate clients, will also have to make changes. These will be less onerous than those imposed on financial firms, as users of corporate derivatives will access the CCP indirectly, via a third party clearing member.

Practical impact

The proposed measures will have a practical effect for banks and their IT departments. The effect will depend on banks' current IT set-ups, the types of systems in use and, in particular, whether these are software packages supplied by specialist vendors or proprietary systems developed in-house.

Where vendor platforms are employed, such as Calypso, Murex, Summit or Reuters, upgrades are likely to be necessary. For firms that have long relied on older installations, it may be necessary to proceed immediately with deploying the vendors' latest offerings.

For banks using customized technology, even more changes may be needed. Companies with their own proprietary pricing routines are likely to raise questions when reconciling position marks with the central counterparty.

In such cases, the most practical solution will be to use market standard valuations, which is most easily achieved by substituting proprietary analytics with off the shelf pricing libraries from specialist firms such as FinCAD, Numerix or Pricing Partners.

Even though this is the most straightforward way to tackle the challenge, introducing new technology still has non-trivial implications in terms of time and cost.

Banks will need to rethink the way they book transactions in their trading systems if they are to connect successfully to a CCP. For example, whether using vendor or proprietary software, a bank will need a common trade capture platform that can channel all relevant transactions into MarkitSERV or ICE Link.

Companies using several different trade capture systems in various locations will have a problem. Possible solutions include establishing one trade capture platform as a master system, or creating an intermediate tool to aggregate all trades before sending them on to MarkitSERV or ICE Link.

and fed to Markit Wire. This process might also cause one component of the trade to be eligible for clearing, such as the vanilla leg, and the other to remain outside, leading to unbalanced risk positions via the CCP margin calls and the OTC Credit Support Annex margin calls. This issue will be especially relevant for structured trades.

Companies will need to ensure that floating rate indices correspond to standard conventions. Markit Wire will be unable to pair up transactions with the relevant counterparty trades should the correct conventions not be used.

Naturally, eliminating these widely used workarounds will not be easy. Work will be needed to adapt proprietary technology and vendor platforms will have to be upgraded.

An end to the workaround

Firms will also have to eliminate some workarounds, very commonly used in the past, to facilitate connection with the CCP. Certain workarounds, developed to counteract the shortcomings of banks' own IT systems, could affect the trade matching process within MarkitSERV.

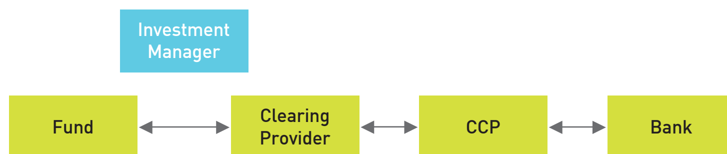

Figure 1: CCP Process Flow

An example of a common workaround is booking an exotic derivative as a combination of simpler vanilla products. To avoid the difficulty of representing a complex transaction in existing IT systems, a trade is often broken into two or more simpler components (for example, a callable swap is booked as a vanilla swap and a swaption).

This may be a useful expedient for bank staff – as the process generates the proper cash flows and valuation – but it creates serious implications when it comes to feeding contracts to a central clearer. If single trades are not represented, but are broken down into their components, they no longer correspond with counterparty trade records, meaning that a clean CCP submission cannot be readily achieved. Banks will need to internally represent those required structures, or adopt a more practical approach to trade capture.

Other workarounds will also have to be eliminated. One is the practice of booking swaps as trades with multiple legs. In the future, banks will need to be certain that trade legs are readily identifiable to a particular confirmation, so that deals can easily be reassembled as a single trade

Feeding time

Banks will need to create feeds into and out of MarkitSERV. This will be especially complex where the 'give-up' process for transforming bilateral trades into cleared trades involves multiple participants.

The new model for client clearing involves executing a bilateral trade and then giving up the trade to a clearing provider that faces the CCP on behalf of the user. The original trade booking must be captured electronically in MarkitSERV or ICE Link in order to reach the CCP.

Both MarkitSERV and ICE have workflows supporting submission to clearing. This requires integration into a clearing provider's systems and procedures, plus training for the staff on the new service model. Becoming a clearing provider will bring an OTC back office team into a new externally facing role, with increased expectations for customer service standards and exception management. This in turn is likely to require up-skilling people and developing systems in order to manage the service.

Firms will also need to ensure that the margin on client trades can be posted, recorded and tracked alongside their own direct margin.

Regulators have made it clear that all transactions, including both standard and customized trades, will have to be reported to a central trade repository, with operators appointed by ISDA.

DTCC will provide this service for credit derivatives, TriOptima for rates trades and a partnership of DTCC and MarkitSERV for equity derivatives.

The goal of the three announced trade repositories is to assemble together all OTC contracts in each asset class, for the benefit of global regulators requiring a single, consolidated source of market data. The repositories have high standards to be met for submission, including the use of FpML, either incremental or bulk data upload, and consistent counterparty identification.

A first step for banks will be to modify their systems to enable the contribution of basic data to the trade warehouse. Companies will be obliged to standardize their representation of more sophisticated products and extend the use of FpML, should more details be required.

This will in turn require extensive alterations to IT systems, including mapping to FpML, and will entail significant extra expense. As the ability to correctly model exotics across institutions is an area in which groundbreaking work is still being undertaken, it is an emerging and therefore challenging area for regulators and market participants alike.

ICE provides trade netting during the submission workflow, adding further operational complexity in reducing multiple positions in an index down to a single net position. TriOptima provides a third party trade tear-up service for credit and interest rate contracts, which also restructures banks' trade portfolios, both in and outside the relevant CCPs.

Get ready for work

The most challenging new requirements for the OTC derivatives markets are likely to be enforced from 2012, according to the current regulatory timetable. Industry leaders understand that 2010 will be a key year for work to meet the demands of the new regime. Financial organizations need to focus on standardizing products now and on setting up systems to feed these contracts to MarkitSERV or ICE Link.

The core requirement that firms submit details of OTC contracts – both standard and non-standard transactions – to trade repositories may seem like a relatively straightforward task. However, the regulatory landscape is still evolving. The BME in Spain recently said that it intends to build a trade repository and the European Union expressed a preference for a warehouse based in the EU for OTC products.

Moreover, if regulators want to see complete economic details relating to exotic derivatives a whole new level of complexity will result.

Firms that lay the groundwork for meeting the regulatory demands of the future will have a substantial competitive advantage in the coming years.

Bill Hodgson
is a Director based in London and leads the central clearing practice for Sapient. Prior to Sapient Bill worked on building the Trade Information Warehouse at DTCC and was Head of Product Development for LCH Clearnet's SwapClear.
bhodgson@sapient.com

Kevin Samborn
is a Director based in Boston, working on valuation initiatives for clients. Before joining Sapient he worked at Numerix, a pricing analytics software company, specializing in structured notes and their hedges.
ksamborn@sapient.com