



Highlights of [GAO-07-716](#), a report to congressional requesters

Why GAO Did This Study

Over-the-counter (OTC) credit derivatives are privately negotiated contracts that allow a party to transfer the risk of default on a bond or loan to another party without transferring ownership. After trading in these products grew dramatically in recent years, backlogs of thousands of trades developed for which dealers had yet to formally confirm the trade terms with end-users—such as hedge funds, pension funds, and insurance companies—and other dealers. Not confirming these trades raised the risk that losses could arise.

GAO was asked to review (1) what caused the trade confirmation backlogs and how they were being addressed and (2) how U.S. financial regulators were overseeing dealers' credit derivative operations, including the security and resiliency of the information technology systems used for these products. GAO analyzed data on credit derivatives operations that dealers submitted to regulators, reviewed regulatory examination reports and work papers, and interviewed regulators, dealers, end-users, and industry organizations.

www.gao.gov/cgi-bin/getrpt?GAO-07-716.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Yvonne Jones at (202) 512-8678 or jonesy@gao.gov.

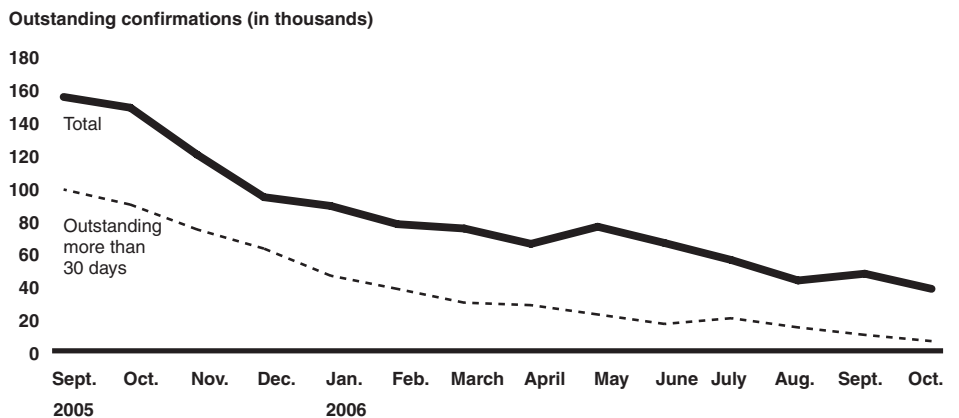
CREDIT DERIVATIVES

Confirmation Backlogs Increased Dealers' Operational Risks, but Were Successfully Addressed after Joint Regulatory Action

What GAO Found

After trading volumes grew exponentially between 2002 and 2005, the 14 largest credit derivatives dealers—including U.S. and foreign banks and securities broker-dealers—accumulated backlogs of unconfirmed trades totaling over 150,000 in September 2005. These backlogs resulted from reliance on inefficient manual confirmation processes that failed to keep up with the rapidly growing volume and because of difficulties in confirming information for trades that end-users transferred to other parties without notifying the original dealer. Although these trades were being entered into the systems that dealers used to manage the risk of loss arising from price changes (market risk) and counterparty defaults (credit risk), the credit derivatives backlogs increased dealers' operational risk by potentially allowing errors that could lead to losses or other problems to go undetected. In response, a joint regulatory initiative involving U.S. and foreign regulators directed the 14 major dealers to work together to reduce the backlogs and address the underlying causes. By increasing automation and requiring end-users to obtain counterparty consent before assigning trades, the 14 dealers reduced their total confirmations outstanding more than 30 days by 94 percent to 5,500 trades by October 2006, as shown in the figure below.

Outstanding Confirmations at 14 Major Dealers, September 2005 to October 2006



Source: GAO analysis of Markit Group data.

Through ongoing supervision and examinations, U.S. banking and securities regulators became aware of the credit derivatives backlogs as early as late 2003 and had been monitoring efforts taken by each dealer to reduce its backlog. Under the joint regulatory initiative, regulators obtained aggregate data from the dealers that allowed regulators to better monitor how backlogs were being resolved. Recognizing the potential for similar problems to arise in other OTC derivatives markets, regulators began obtaining similar data for other OTC derivative products in November 2006.