

PWG PROGRESS SUMMARY ON OTC DERIVATIVES OPERATIONAL IMPROVEMENTS

In 2005, the supervisors of major U.S. and foreign over-the-counter (OTC) derivatives dealers expressed concern over the rapid growth of the credit derivatives market and the resulting operational risks. In addition to the high and growing level of unconfirmed trades, participants were assigning trades without informing the original counterparty, and there were a large number of processing and payment errors. These issues underscored that existing infrastructure was not sufficiently scalable to support the rapid growth of the market. Regulators embarked on a collective effort to improve participants' management of their OTC derivatives operations.

To address these issues, major credit derivatives dealers focused on improvements in automation and on developing and standardizing legal documentation such as standard contract terms in order to make more products eligible for electronic processing. These efforts led to the following accomplishments:

- Since 2005, dealers have reduced by 92% the backlog of credit derivative confirmations outstanding more than 30 days while trade volumes have increased by more than 300%.
- Market participants adopted a protocol which requires participants to request original counterparty consent before assigning trades to a third party, to ensure that market participants know their counterparties at all times. The industry has also mandated the practice of assigning trades to be done via electronic platforms by year-end 2008.
- DTCC launched Deriv/SERV, which electronically matches and confirms OTC credit derivatives. Additionally, DTCC launched the Trade Information Warehouse (TIW), a central repository with a legal copy of all electronic transactions which facilitates the processing of various events that can occur throughout the life of the trades.
- Market participants implemented an automated settlement process that allows the netting of quarterly CDS payments across multiple counterparties. The rate of payment errors has declined by more than 50% since this process was established

Over time, dealers' efforts have been expanded to other OTC derivatives asset classes including equity, interest rate, commodity, and foreign exchange. Participation in these initiatives was also broadened to include major buy-side firms and industry associations.

Additionally, the focus on improvements in trade processing efficiency was broadened to include front office trade capture. The following improvements were achieved:

- Market participants have dramatically increased the rate of electronic processing for OTC derivative products. Between November 2006 and September 2008, electronic processing increased from 47% to 92% for credit derivatives, from 9% to 24% for equity derivatives, and from 30% to 56% for interest rate derivatives.
- For electronically eligible credit derivative trades, major dealers have improved the timeliness and accuracy of trade submission and matching with the majority of trades submitted and matched on or near trade date.

Market participants have also broadened their focus to include enhancements in market design and risk management as follows:

- Market participants, together with regulators, have accelerated efforts to achieve central counterparty clearing in credit default swaps. A well-regulated and prudently managed CDS CCP can provide benefits to the market by reducing the systemic risk associated with counterparty credit exposures.
- Market participants are continuing their efforts to reduce the number of outstanding credit derivatives trades through multilateral trade terminations, or tear-ups, in order to reduce aggregate counterparty credit exposures and operational risk. To date in 2008, dealers have eliminated notional amounts of outstanding credit derivative trades by \$24.4 trillion, or more by than one-third, through multilateral trade terminations.
- DTCC has begun publishing aggregate data on credit default swaps in an effort to increase market transparency.
- Standard methodology is being developed to manage the failure of a major counterparty, and market participants achieved a successful and orderly close-out of their trades with Lehman Brothers.
- The industry is working to include language in the legal framework to mandate participation in an auction that will facilitate orderly resolution of CDS settlement following credit events.