GLOBAL FINANCIAL MARKETS INSTITUTE

Article

2013

The Impact of OTC Clearing on Operations Departments

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Interest Rate Swap Futures: An Introduction

Since the G20 Summit in 2009, Operations Departments of financial services firms have been hard at work re-engineering work flows, upgrading and implementing new systems, and acquiring new skill sets to support the requirements of the Dodd-Frank mandate for clearing OTC Derivative contracts.

Some of these changes were in the works prior to Dodd-Frank, as the OTC Derivatives industry experienced increasing volumes supported by an infrastructure that was not scalable. A veritable "paper-work crisis" created the acknowledgement that wide-spread changes were needed, and Operations departments forged ahead with efforts to increase capacity, with a view toward lowering the cost of the "Trade Lifecycle" of an OTC derivative and increasing the focus on risk management and control. For example, in 2003, DTCC launched an automated platform for the post-trade matching of credit default swaps called DTCC Deriv/SERV, in the interest of enhancing risk management, operational efficiency and transparency in the OTC Derivatives space. Trade participants had to design new procedures for interfacing with the platform as well as managing the workflow internally.

In this paper we will look at similar operations functions in the trade lifecycle of an OTC Derivative that have been subject to a major impact with the advent of Dodd-Frank and one of its requirements, i.e., centralized clearing of OTC Derivatives.

Prior to these regulatory changes taking place, most Operations departments were neatly divided between staff and technology that supported listed derivatives, primarily standardized contracts for options and futures, and those that supported OTC Derivatives. The operation to support Listed Derivatives is highly scalable with plenty of automation and STP (Straight Through Processing) to enable a lower cost-per-trade due to less manual effort. Seamless interfaces to derivatives exchanges and clearing houses are provided by stalwart technology gateways. The Operation requires a highly-knowledgeable staff familiar with the demands of these exchange-traded contracts and how they are cleared. OTC Derivatives, on the other hand, have been supported by a separate group of Operations staff and technology that was very often structured within vertical silos by product type (e.g., Equities vs. Rates vs. Credit etc.). Because these OTC contracts are complex and subject to a high level of customization, more manual effort is required to deal with significant product and contract differences. Due to the distinct nature of an OTC Derivatives, it is difficult to achieve consistently high levels of STP comparable to Listed Derivatives, and the lifecycle requires Operations to have specialized product knowledge. While the use of paper documentation in areas such as Confirmation has been reduced dramatically with the deployment of automated matching platforms such as DTCC's Deriv/SERV back in 2003, it hasn't disappeared entirely.

Things have rapidly changed with this approach to organizing Operations and the trade work flow since the introduction of Dodd-Frank. It is more common now to see a blending of Operations units between Listed and OTC products. Familiarity with the requirements and processing of a Centralized Clearing Platform is now a requisite skill to support clearing OTC products. Additional product knowledge of swaps, for example, is required by Listed Derivatives staff in order to understand the nuances of these contracts. In addition, it appears that while the industry continues to transition to a more centrally cleared environment for OTC derivatives, Operations departments are expected to be able to provide support for a "Parallel Universe" where some swaps are centrally cleared, and others are un-cleared or bilateral in nature. Experience in supporting the trade lifecycle for both Listed and OTC derivatives has become a valuable commodity in the post-Dodd-Frank Operations department.

An industry Operations manager was heard comparing the challenges of the current environment to "trying to build the airplane while the factory is being built around you". In other words, the target environment has been in transition, with changes taking place while rule-writing occurs, and the industry infrastructure for clearing OTC derivatives continues to evolve. This much is certain for Operations: connecting the dots from the front-to-back of the trade lifecycle has never been more important. Key components include:

Trading Venues for OTC Derivatives

Because of the bilateral nature of OTC Derivatives, trade details were funneled to Operations functional areas from internal trading desks. The challenge now is how to broaden the scope of Trade Capture to also include trades that might be executed on SEF's (Swap Execution Facilities) or derivatives exchanges. The recent trend of the "futurization" of swap contracts increases the demand for flexible solutions to interfacing the front-end to the back-end of the trade lifecycle.

OTC Trade Data Reporting Requirements

Strategic and collaborative efforts among industry Business Managers, Operations and IT staff, and service providers have ramped up to address the requirements for trade detail reporting to approved Swap Data Repositories (SDR's) within the prescribed time limits. Increasing the demand for creative solutions has been the fact that these requirements can vary by the type of product and industry participant but apply regardless of whether the swap is bi-lateral or centrally cleared.

Affirmation Platforms

Affirmation Platforms provide a means of managing the operational risk of problems caused by discrepancies in trade details between counterparties. Particularly with OTC Derivatives such as swap contracts that call for a series of scheduled payments over the life of the swap, getting the details agreed to early on in the lifecycle, such as rates, fixing/reset/payment dates and standing settlement instructions (SSI's) is essential. Operations ensures that trades are directed to the appropriate Affirmation Platform and from there to the relevant clearing house.

Clearing Houses

There have been many attempts to launch centralized clearing for certain OTC Derivative contract types since the late 90's, well before the new regulatory mandates for centralized clearing in Dodd-Frank and EMIR. Some of those attempts did take hold, for example with the launch in 1999 of SwapClear, a platform for clearing plain vanilla interest rate swaps provided by LCH.Clearnet. After the G20 Summit in 2009, and subsequent regulatory initiatives such as Dodd-Frank and EMIR, the volume of OTC Derivatives subject to centralized clearing has been on the increase. Besides, LCH.Clearnet, ICE and CME are two other examples of central counterparties (CCP's) for OTC Derivatives, and there are more!

Operations and IT has had to build and re-engineer workflows to accommodate the need to link to a variety of clearing houses as well as manage and optimize the use of collateral. In some cases, firms have been able to leverage components of the internal infrastructure which were designed to meet the requirements of Listed Derivatives. In other cases, brand new applications and procedures have been implemented with the goal of transitioning toward a more "horizontal" model for Operations, with less reliance on product-specific silos.

Ever-present themes for re-engineering efforts have been targeted at increasing controls and managing risk, while delivering cost-effective solutions for supporting the business. Operations departments are expected to continually innovate and think creatively, in order to meet the challenges of this new world of centrally cleared OTC derivatives.

About the author

Charlotte is a broadly accomplished financial services professional with 20+ years of comprehensive experience in the securities operations and information technology -- as well as training and development. Her successful career includes the direction of business projects as a client manager for listed and OTC equities and fixed income trading.

She has been active as a consultant in recent business process re-engineering efforts, for both Buy-side and Sell-side firms.

In this manner, she has noted what are the major concerns and "hot buttons" that she is seeing in her field, and for which financial firms are seeking more information and learning. Here are some of the drivers that are creating this interest:

- The clearing mandate that is part of Dodd-Frank regulation has a significant impact for Operations
- The impact is evident in re-engineering efforts of trade lifecycle processing for OTC Derivatives
- The impact is also on how Operations Departments are organized
- Interfacing between internal processing systems and the industry infrastructure has never been more important
- Major areas of concern are Risk Management and Control, enhancing STP levels, and managing the cost-per-trade

At GFMI, we are proud to have Charlotte on our instructional team, as her presentation skills and industry knowledge are non-par among her peers. Delivering complicated knowledge in a clear, concise manner, with outstanding energy and interaction, Charlotte is known among our clients for creating successful and engaging learning events.

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