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Auditors Drive Derivatives Into the Arms of 'E'

By Shane Kite, Correspondent

Requests from counterparties, auditors and regulators have spurred the launch of risk management solutions that make reporting of trade confirmations for debt-linked derivatives transactions more accurate, automatic and transparent.

Investment managers and dealers are focused on assessing their positions and measuring portfolio exposures. Regulators and auditors are interested in determining the capital adequacy and financial health of individual firms. But all of them have an interest in measuring how these activities impact the stability of the overall global markets as the trading of structured products hits unprecedented volumes.

Says Leo Schlinkert, CEO of Communicator, "It's one of the top ten questions they get asked in an audit: How many unconfirmed swaps do you have on your books?"

Schlinkert's firm rolled out a version of its Compliance Hub product with what it calls an "ISDA confirmation module" to its investment manager clients last fall. The tool acts as an electronic hub through which institutional investors can hash out outstanding confirmations with their dealers, as well as facilitate approvals and perform internal reviews of swaps trades.

Confirmations are affirmed using electronic signatures. Institutions connect to the module using a secure Web connection and a Web-based "viewer" that lets sell-side counterparties analyze buy-side revision requests, as well as signed or outstanding confirmations. The platform also supports block-trade allocations for various products, including interest rate, currency, commodity, credit and equity swaps.

"We accept faxes and physical delivery, but we usually almost immediately digitize it and make it electronic," Schlinkert said. This facilitates post-trade automation for both sides of the transaction, he says.

Communicator began developing the ISDA confirmation module last summer at the request of investment giant Pimco, which runs the world's largest fixed income fund. The Newport Beach, Calif.-based asset manager was seeking to automate and streamline post-trade confirmations from its derivatives swaps desks.

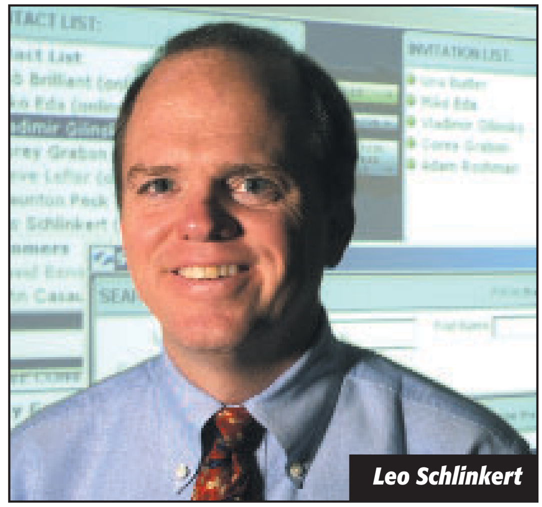
To accomplish this, Pimco asked the vendor to adapt Compliance Hub's counterparty document service, which the firm was using to store various transaction documents, including letters of attestation meant to affirm entities as authorized traders or qualified institutional buyers (QIBs).

Pimco's confronting of the marketwide problem of unconfirmed swaps seemed to spur other buy-side firms to do the same. Other money managers followed suit and went live on the confirm module. "It's the fastest growing part of Compliance Hub," says Schlinkert.

About "a half dozen" new accounts have signed on to use the service since its launch, Schlinkert adds. Currently, about 15 dealers use it.

White Plains, N.Y.-based Communicator is privately owned, but was founded in 1999 by Salomon Brothers, Goldman Sachs and Morgan Stanley as a centralized portal linking the buy-side into various single-dealer trading screens. Though original investors retain warrants in the firm, 19 broker-dealers currently access various services of Compliance Hub, and about 2,000 buy-side firms link to the platform, Schlinkert said.

A subscription fee is charged to both buy-side and sell-side clients for the service, and



Leo Schlinkert

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—Leo Schlinkert, Communicator

regulators are provided access to such documents as QIB certificates through the Compliance Hub Web site, said Serge Shinkar, the product manager for Compliance Hub, who helped develop the swaps confirm tool.

Other efforts at funneling derivatives trades through centralized hubs have mostly focused on processing sell-side confirmations, including the platforms of firms like Swapswire and DerivServ. The latter service, which is owned and run by the Depository Trust & Clearing Corp., brought several hedge funds into its membership for the first time last year.

Now multidealer corporate bond platform MarketAxess says it intends to offer credit derivatives trading in the second half of this year over its electronic platform. In announcing the move earlier this month, MarketAxess CEO Rick McVey cited straight-through processing demands and "positive forces on transparency in credit derivatives" as driving the overall credit markets (*Securities Industry News*, Feb. 9). McVey also cites the need for secure and reliable client permissioning on the new system.

The market certainly needs more automation: The number of unconfirmed derivative swaps trades is often several times greater than the number confirmed. Almost 70 percent of confirmations are still done on paper or through the fax machine. And extended settlement dates of derivatives, which can take months, only complicate this process.

"Each of the customers that we talked to would have a spreadsheet of how many derivatives swaps that they would have unconfirmed," Schlinkert said. "They'd say, 'Okay, deals that are zero to 30 days, I have 106 unconfirmed; from 60 to 90 days I have 193 unconfirmed; and 90 days plus, I have 472 unconfirmed.'"

"The problem is the portfolio manager agrees to the trade with the salesman on the sell side, but their operations units can't get together to get all of the details of the trade agreed upon and confirmed for many, many months,'" he said. "The key thing they told us is that this now is on the radar screen of both their auditors and the regulators."

The reporting requirements for over-the-counter (OTC) derivatives products, which are mostly privately negotiated one-off deals, remain insignificant. For many years, they did not exist at all. While they're actually new or primary issues, derivatives don't fall under the Securities and Exchange Commission's purview of new securities offerings, though the SEC's proposed Regulation AB has begun an electronic filing process and first-time regulatory regime for asset-backed securities (ABS), a structured product class with a $1.8 trillion market.

Yet the growth of derivatives volume is outpacing all other sectors. This has led regulators to increasingly request reporting from dealers on derivatives data and trading activity, partly because structured products have reached down into the most traditional sectors of the financial markets, including in commercial mortgage loans, most of which are now structured as derivatives-based offerings.

Says a CEO of a privately owned Midwestern-based food distributor with a regional footprint: "It used to be when you got a commercial mortgage loan it was at a fixed rate, and then it was mostly floating, now they're derivative-based loans. If I get out early, in five years, if the interest rate goes up, I'll get money back—they would pay you money to get out. If the interest rate goes down, I owe money."

The big boost in trading these derivatives, meanwhile, continues unabated, fueled by the boomtown growth of leveraged hedge funds. The total notional outstanding of credit derivatives was $5.44 trillion by mid-2004, according to the International Swaps and Derivatives Association (ISDA). That's a 44-percent growth rate over the prior two quarters, following a 33-percent increase recorded in the second half of 2003.

Debt-linked derivatives have overrun the overall sector, totaling $169.9 trillion in "notional outstandings," including credit and interest rate products, as well as related cross-currency swaps and options, as of the first half of last year—this, in a total market of $173.69 trillion.

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For the most part, regulators have heeded the industry's requests to remain laissez faire in their approach to oversight and surveillance of the burgeoning and lucrative market. While it remains unclear whether the recent dustup between banks over collateralized debt obligations (CDOs) trades of years past will swing the pendulum back toward stricter supervision, market auditors have been requesting more data in general.

Effective Dec. 31, the Federal Reserve began collecting semiannual data on credit default swaps, the swiftest growing sector of the derivatives market, and requiring more detail—a measure the G-10 central banks have agreed is needed for improved macroeconomic oversight.

"This finer disaggregation of counterparty types, as compared to the disaggregation for other types of OTC derivatives, would enable central banks and other data users to get a clearer picture of how credit default swaps transfer credit risk within the global financial system," the Fed said in its filing for the change.

The central bank's outstanding positions data includes notional, gross positive and gross negative market values of credit default swap contracts for protection bought and protection sold by instrument type and counterparty type. Categories include banks and securities firms; insurance, reinsurance and financial guaranty firms; special purpose entities; hedge funds; and "others." Notional values are filed per the sector and credit rating of the underlying reference entity, and by the remaining maturity of outstanding credit default swap contracts.

In the same vein, the SEC amended the reporting requirements it places on OTC derivatives dealers last August to permit a "supplemental report" filing as part of their annual audits. This audit, the SEC said, could be "based on agreed-upon procedures rather than auditing standards" and could focus on internal risk management control systems.

In October 1998, after the implosion of Long-Term Capital Management, the SEC began requiring dealers to report OTC derivatives data on a quarterly basis, including credit concentration data and VAR computations.

Both the Treasury Department and the IRS have also decide to issue guidance on the tax treatment of credit default swap payments from U.S. entities to foreign persons.

The dealing desks have already begun to address the regulatory posturing. For instance, UBS announced last week it had created a new structured products group to bolster deals requiring complex regulatory, tax, accounting or corporate financing analyses. ■