

Point of View:
FINANCIAL SERVICES

CREDIT DERIVATIVES IN CRISIS:
ALLEVIATING THE BACKLOG



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The unprecedented growth in transaction volume in the credit derivatives market, coupled with inefficiency and errors in the trade confirmation process, has led to serious delays in the completion of trades. Indeed, crisis is not too strong a word to describe the situation. BearingPoint lays out a strategy for alleviating the credit derivative backlog. The strategy encompasses multifaceted process re-engineering, training and certification of personnel, and development of enhanced technology solutions that support more efficient trade processing, reducing operational risk.



INTRODUCTION: UNDERSTANDING THE POTENTIAL FOR OPERATIONAL RISK IN THE CREDIT DERIVATIVE TRADE PROCESS

The credit derivatives market has experienced extraordinarily rapid growth in transaction volume over the past few years. Unfortunately, this robust expansion is not without its downside.

One of the biggest problems is technology infrastructure. Development has not kept pace with transaction growth. As a result, continued reliance on inefficient manual processes has created backlogs, which in turn create substantial operational risk for banks and industry participants.

As Timothy F. Geithner, president and CEO of the Federal Reserve Bank of New York, said in a late 2005 speech, “The growth in volume and complexity of new instruments has advanced, as it typically does, ahead of improvements in the trade processing infrastructure and risk management and control practices.”¹

Given the magnitude of the problem, it is critical that market participants understand the potential consequences of the backlog and how to address them.

This BearingPoint *Point of View* explains the mechanism for confirming credit derivative trades and why the process is full of inefficiency that has contributed to substantial operational risk. We discuss how implementing a comprehensive solution can help firms avoid the most potentially adverse consequences, leverage new developments in technology, and take a fresh look at processes and people to support business stability and success in the long term.

THE GROWING APPETITE FOR CREDIT DERIVATIVE PRODUCTS

Once the exclusive domain of the world’s largest banks, the credit derivatives market has grown in recent years, largely through the entrance of new participants such as hedge funds. Indeed, hedge funds have become such a factor that some sources estimate they now account for approximately one-third of the structured credit market in Europe.

For many, the simple suggestion of a growing appetite for credit derivative products instantly raises haunting memories of the saga surrounding Long-Term Capital Management (LTCM). LTCM was the notorious hedge fund that almost single-handedly pushed financial markets into disarray in 1998 after it incurred substantial trading losses triggered by adverse movements in the credit markets. The result was a \$3.5 billion bailout led by the U.S. Federal Reserve.

It comes as no surprise, then, that the widely publicized downgrade of both General Motors and Ford Motor Co. debt in 2005, followed by the bankruptcy filings of Delta Airlines, Northwest Airlines and Delphi, again spotlighted a corner of the financial markets that has been quietly exploding for years.

Broadly defined, credit derivatives are financial contracts that allow market participants to assume either a positive or negative exposure to an entity’s credit to facilitate hedging and speculation. Banks in particular use credit derivatives to hedge credit risk and reduce risk concentrations on their balance sheets, thus freeing up regulatory capital.

¹ Timothy F. Geithner, Remarks at the Institute of International Bankers Luncheon in New York City, October 18, 2005.

The credit derivatives market has experienced exponential growth in transaction volume over the past few years (see Figure 1), along with increased complexity of instruments traded. This growth is confirmed by statistics compiled by the International Swaps and Derivatives Association (ISDA), which indicate the market ballooned 128 percent from 2004 to 2005, reaching a notional amount of \$12.43 trillion in contracts outstanding in the second quarter of 2005.¹ It is estimated that leverage has escalated to the point that there are approximately eight times more outstanding derivative contracts than bonds available to fill them. This is a frightening thought considering the market is currently without a permanent cash-settlement process.

FIGURE 1. AVERAGE WEEKLY NUMBER OF TRADES

	2003	2004	2005
Credit Derivatives	79	103	206

Source: International Swaps and Derivatives Association, Inc. (ISDA), *2005 Operations Benchmarking Survey and FpML Use Survey*.

At the root of the situation is the increasing popularity of credit-default swap (CDS) and collateralized debt obligation (CDO) instruments (see Glossary), which have become a foundation of the market despite their relatively high complexity. The popularity of these instruments is driven by their flexibility as a risk management tool and role as an alternative approach to the bond market, allowing for the short sale of corporate credit.

OPERATIONAL RISK EXPOSURE

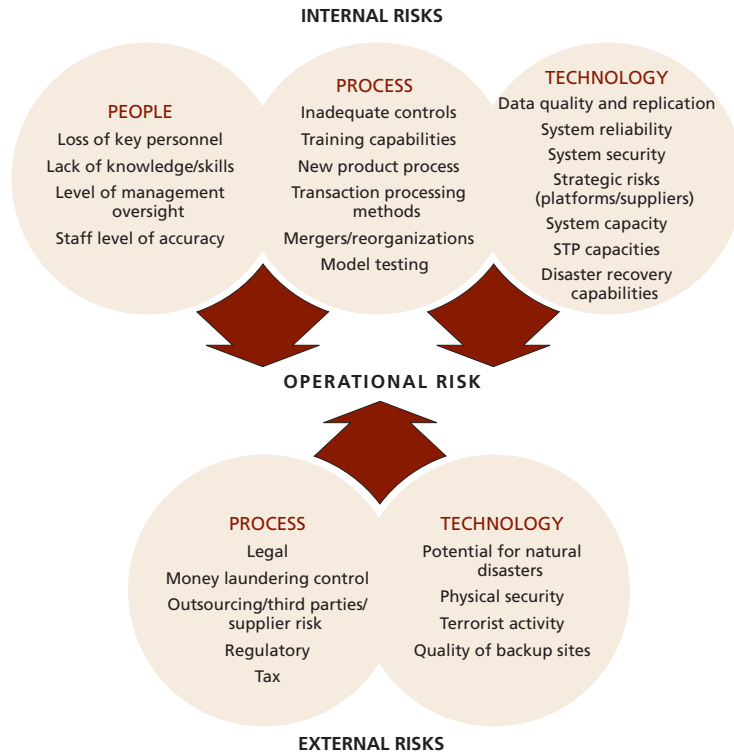
Unfortunately, this rapid expansion has created significant operational pressures that have attracted the attention of government officials and industry observers (see Figure 2). Indeed, the Federal Reserve Bank of New York was concerned enough to invite 14 of the largest financial institutions to discuss what it considered the key issues raised by the market's burgeoning transaction volume.

These issues, flagged by both the New York Federal Reserve and the United Kingdom's Financial Services Authority (FSA), specifically relate to the processing of trades within the back offices of dealers and hedge funds, where the sophistication of processing systems has not kept pace with market growth. The current settlement process for these instruments is operationally resource intensive due to the reliance on manual procedures. Complicating the matter is the need for internal reviews and reconciliation of these complex transactions—a process that has typically taken several days to complete and severely strains back-office operations.

Although contract terms are now typically specified using templates and legal definitions produced by the ISDA, credit-default swaps remain largely customized contracts, often with more than five pages of confirmation documentation. Progress in standardizing the contract has actually stimulated additional interest from market participants—the buy side in particular—contributing to the accelerating volume.

¹ ISDA, *2005 Operations Benchmarking Survey and FpML Use Survey*.

FIGURE 2. SAMPLE OPERATIONS LOSS EVENTS

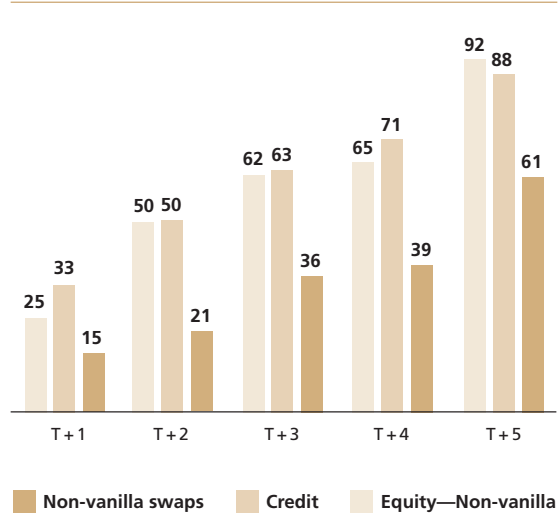


Source: BearingPoint, *The Basel New Capital Accord and the Challenge of Operational Risk Management* (Part 3 of 3).

Because of standardization, market participants are able to generate contracts more quickly and with greater certainty, reducing some of the previously existing legal risk.

Along with increasing the likelihood of processing and data entry errors, the reliance on manual processes puts market participants at risk of being overwhelmed by transactions in the event of a corporate default. Figure 3 illustrates the average time required to complete confirmation documentation. According to the ISDA, only 88 percent of transactions are confirmed within the preferred five-day time period, with the remaining 12 percent idle for extended time periods.

FIGURE 3. CUMULATIVE PERCENTAGE OF TRANSACTION CONFIRMATIONS ISSUED



Source: ISDA, *2005 Operations Benchmarking Survey and FpML Use Survey*.

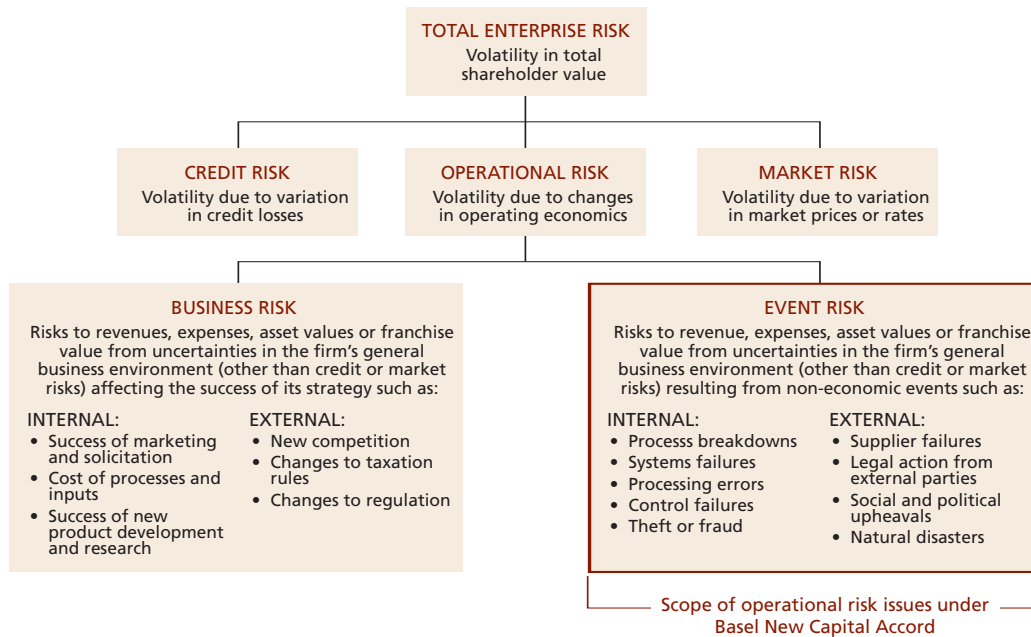
To make matters worse, confirmation delays increase when contracts are reassigned to third parties, as the paperwork for such transactions takes much longer to complete than in other circumstances.

In the case of hedge funds, assignments are performed as a means of exiting a position prematurely, often solidifying a profit. It is estimated that such assignments now make up approximately 40 percent of CDS trades. The resulting operational risk, not to mention increased counterparty risk, clouds the risk profiles of participating firms. Regulators want to protect the market from future instability by ensuring that sellers have sufficient funds to meet their outstanding obligations.

The Bank for International Settlements (BIS) defines operational risk as the “risk of loss resulting from inadequate or failed internal processes, people and systems.” The immaturity of many processes supporting credit derivative trading directly impacts a financial institution’s ability to comply with the Basel II Accord,¹ as banks strive to calculate risk exposure accurately. The difficulty in accurately quantifying a bank’s derivative positions has a severe impact on credit and operational risk calculations, and therefore a firm’s entire enterprise risk model (see Figure 4).

Such inaccuracy may result in the institution receiving a less favorable capital-adequacy requirement. Furthermore, since there is no way for outsiders to know how much risk banks have taken on, there is

FIGURE 4. TOTAL ENTERPRISE RISK UNDER THE BASEL II ACCORD



Source: BearingPoint, The Basel New Capital Accord and the Challenge of Operational Risk Management (Part 3 of 3).

¹The Basel Committee on Banking Supervision, *The International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, commonly known as Basel II.

fear that a market participant could experience a series of severe credit events, such as correlated defaults, which would result in its failure, putting considerable strain on the entire financial system. A more in-depth look at operational risk as it pertains to the new Basel Accord can be found in BearingPoint's white paper series, *The Basel New Capital Accord and the Challenge of Operational Risk Management*.

There is growing concern that credit risk may be too concentrated among the top trading partners, which not only issue new derivative contracts but also trade and back them. According to Fitch Ratings in its *Global Derivatives Survey for 2004*, "the top 10 firms account for more than two-thirds of the debt-insurance contracts bought and sold."¹

Moreover, although financial institutions have traditionally used credit derivatives for hedging purposes, regulator and rating agency studies have found these instruments are now commonly used for profit generation, leveraging their flexibility in search of higher yields, thus influencing a transaction's risk level.

MARKET IMPACT

Over the past few years, credit derivatives have proven a highly popular tool for monitoring and managing credit risk exposure. The dynamic nature of credit derivatives helps financial institutions improve their risk profile through risk transfer. However, despite such practical uses, "the growing presence of lever-

aged players in credit markets and the possibility that investment strategies may be less diverse than anticipated make it difficult to predict how credit markets will function under more stressful conditions."²

This concern is heightened by a lack of market transparency. Most statistics on the global credit derivatives market are developed through extensive use of participant surveys and estimates, not standardized data sources. These surveys often do not include statistics from all market participants.

Of particular concern is the lack of data available for some of the industry's most influential participants: large hedge funds. With minimal regulatory oversight, funds have been reluctant to produce data surrounding their investment practices and often do not participate in industry surveys. Such poor disclosure increases the potential for inaccurate calculation of systemic risk in the market, creating a significant hurdle for market regulators in risk monitoring.

A corporate debt default is the triggering event in many credit-default swap contracts. A paramount concern is that, in a worst-case scenario, a potential string of corporate defaults could pose a significant systemic risk to financial markets, creating cascading flow-through effects on both interest rates and the economy as a whole. Contributing to this fear is the relatively low diversification of reference entities upon which the most popular credit derivative contracts are based, not to mention the declining quality of large amounts of corporate debt.

¹"Credit Derivatives Led by Too Few Banks, Fitch Says," *Bloomberg News*, November 18, 2005.

²BIS Quarterly Review, *International Banking and Financial Developments*, September 2005.

Higher interest rates could also play a role, substantially affecting the ability of corporate issuers of sub-investment grade bonds to service their debt. “In previous cycles, defaults have escalated two years to five years after record high levels of debt issuance,” according to Oxford Analytica. “[T]he record number of issuances in 2003–04 foreshadows increased defaults at the end of 2005 and into 2006.”¹

Reinforcing this view, “Standard and Poor’s expects speculative grade default rates to continue to rise gradually over the next year.”²

All of this is occurring amid speculation of further downgrades to North America’s largest automakers. “Fallen angels default at almost twice the rate of companies that never had investment-grade ratings, and seven of 10 stay junk,” Standard and Poor’s said in a March study analyzing 24 years of data.³ Echoing this statement, “An increasing number of investors are betting that General Motors Corp. (GM), the world’s largest auto maker, may be forced to seek bankruptcy protection within the next six to 12 months.”⁴

This problem is magnified by the momentum-based investment strategies often carried out by hedge funds, further concentrating risk within the market. Indeed, this situation will only worsen as the banking industry continues on its path of consolidation, reducing the total number of market participants available to hold positions. Resulting losses could be accompanied by additional litigation if trades are not processed accurately after such an event, a peril likely to be illustrated in the ongoing bankruptcy proceedings of Refco Inc.

The story of LTCM offers evidence of the dangers of this highly leveraged market. To execute its main convergence trading strategy, LTCM chose to leverage its \$5 billion in capital with \$125 billion in debt, attempting to capitalize on tight price discrepancies between related securities, including foreign government debt. LTCM’s failure was spurred by the Russian government’s default on its financial obligations and the resulting flight to liquidity by other portfolio managers attempting to exit similar positions. It is this lack of strategic diversity that ultimately threatened the stability of the financial markets.

OPERATIONAL OVERVIEW OF A CREDIT DERIVATIVE TRADE

Note: This section includes information from the International Swaps and Derivatives Association report, “Moving Forward: An Implementation Plan—2004.

In considering how best to tackle the confirmation backlog, it is important to first review existing trade support processes.

The operations accompanying credit derivative trading occur in four distinct streams: trade capture, verification, confirmation and legal execution. As indicated earlier, the process is littered with manual reviews and documentation requirements, with support personnel often communicating through traditional channels, such as telephone and e-mail, to administer the negotiated contract. Figure 5 presents these streams as they apply to the life cycle of a typical credit-default swap transaction—the most common type of credit derivative. The streams are described in greater detail on pages 8 and 9.

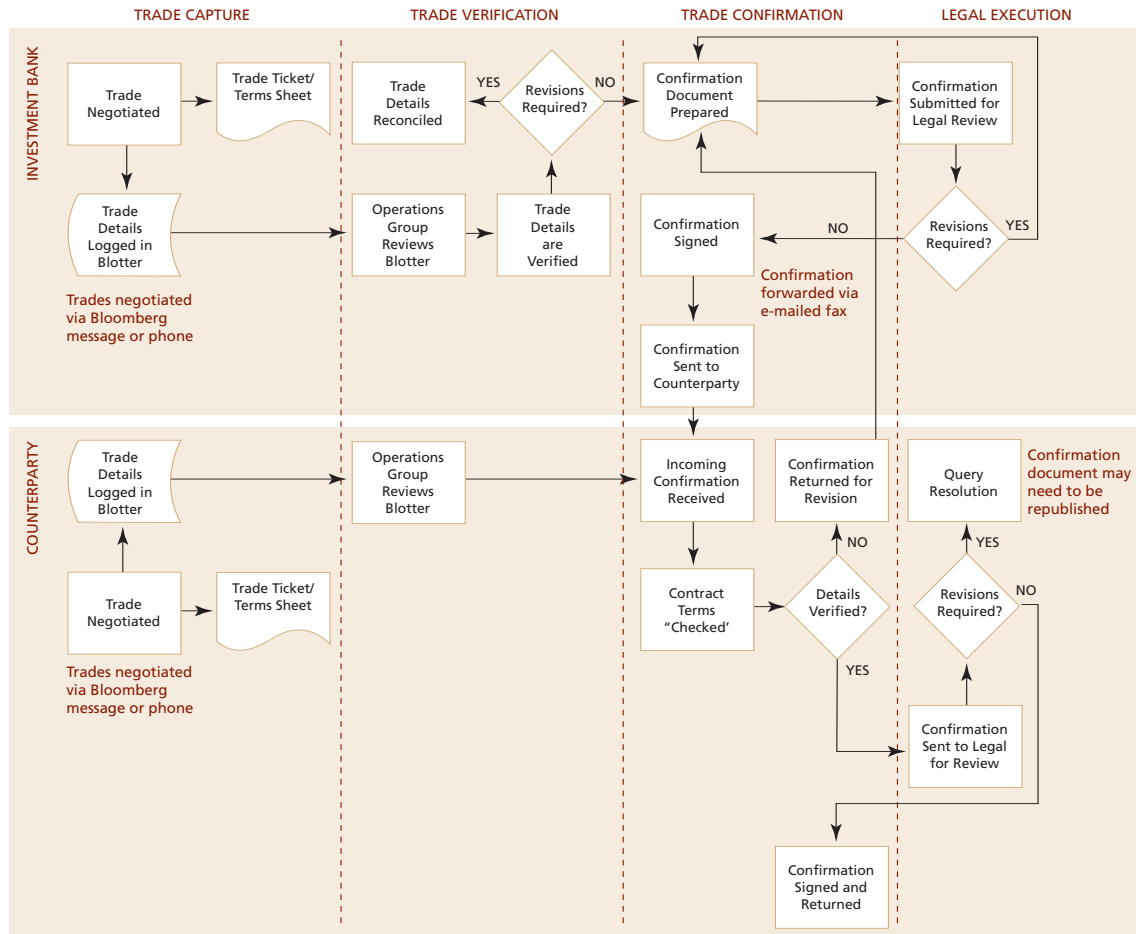
¹ Oxford Analytica, “Corporate Loan Defaults: A Rising Possibility in 2005,” *Forbes.com*, February 21, 2005.

² BIS Quarterly Review, *International Banking and Financial Developments*, September 2005.

³ “Hertz, Clear Channel Among \$88 Billion Falling Into Junk Market,” *Bloomberg News*, October 4, 2005.

⁴ “Investors Fear GM May Be Heading for Chapter 11 Protection,” *Dow Jones Newswires*, November 15, 2005.

FIGURE 5. CREDIT-DEFAULT SWAP TRANSACTION PROCESS (HIGH-LEVEL)



TRADE CAPTURE

This initial stage of the process follows the negotiation by credit traders of contract terms, which are typically arranged via telephone or using the Bloomberg MSG function. Trade capture records the primary informational components needed to complete a credit derivative contract, including the reference entity, counterparty name and related details as identified through review of trade tickets and term sheets. Daily trading activity is booked and summarized in the trade blotter. Most errors occurring in this stage of the process result from inaccurate transcription of contract terms from trade tickets and term sheets. Figures 6 and 7 highlight the relatively high pro-

portion of errors occurring as a result of front-office functions, as reported in the ISDA's *2005 Benchmarking Survey*.

TRADE VERIFICATION

The trade verification stream ensures that both counterparties acknowledge the trade and have accurately recorded the main details. Since a CDS, unlike other financial instruments, does not have standard terms and conditions, verification is more complex, requiring all contract details to be reviewed manually. Much progress has been made in this area due to the adoption of the ISDA's master agreement terms, which turn what were once customized contracts

FIGURE 6. AVERAGE FRONT-OFFICE ERROR RATES

	2003	2004	2005
Credit Derivatives	20%	18%	9%

as a percentage of deal ticket volume

Source: International Swaps and Derivatives Association, Inc. (ISDA), *2005 Operations Benchmarking Survey and FpML Use Survey*.

into quasi-commodities. However, a significant percentage of CDS transactions contain terms that vary from standards, making verification labor intensive. This task is typically performed over the telephone or by e-mailed spreadsheet, often involving both operations support personnel and the credit trader. Trade verification is performed simultaneously by both counterparties as each firm's internal systems are reconciled.

TRADE CONFIRMATION

Trade confirmations serve as proof that a trade has been completed and represents the terms of the trade as booked into the issuing counterparty's system. Confirmation documents are traditionally issued in hard-copy form via e-mailed fax, courier or post. Upon receipt of the confirmation document, a counterparty performs a checking process (see Glossary) in which trade terms are manually reconciled against that firm's internal records. Because confirmations are legal documents, they must be republished if an error is detected at any point in the process. This often causes severe processing delays.

LEGAL EXECUTION

The legal execution stream evaluates and clarifies all legal language prior to confirmation sign-off, a process known as query resolution (see Glossary). Legal execution occurs once both parties agree to the full terms of the trade as represented in the confirmation document, requiring signatures from both parties.

FIGURE 7. PERCENTAGE OF TRADES REQUIRING REBOOKING

	2003	2004	2005
Credit Derivatives	14%	9%	7%

as a percentage of deal ticket volume

Source: International Swaps and Derivatives Association, Inc. (ISDA), *2005 Operations Benchmarking Survey and FpML Use Survey*.

Unfortunately, this stage of the credit derivative life cycle often suffers the most severe delays due to a series of events, including routine review of even standard terms, clarification of nonstandard clauses, definition of the triggering credit event and the common need for hard-copy documentation. If an error is detected during this stream, the confirmation document must be republished with the agreed-upon revisions, requiring many of the previously completed steps to be undertaken again.

ALLEVIATING THE CONFIRMATIONS BACKLOG

Given the above environment, it is imperative that market participants understand the potential business and financial system consequences of this problem and be prepared to take steps to address them. We can turn to a combined set of solutions to mitigate these potentially adverse risks, leveraging developments in technology, as well as a renewed focus on processes and people to secure long-term business objectives.

In an October 4, 2005, letter to the New York Federal Reserve, the credit derivatives industry's major dealers outlined a series of initial steps designed to tackle the backlog of outstanding confirmations. These included:

- Development of metrics to measure industry progress.

- Implementation of a guide to support the ISDA Novation Protocol.
- Establishment of target dates and levels by which to reduce confirmation backlogs.
- Creation of a plan for industry usage of Depository Trust and Clearing Corporation (DTCC) confirmation and settlement functionality.
- Creation of a plan for improvement of the CDS settlement process.

In addition, the group pledged that by January 31, 2006, the volume of confirmations outstanding more than 30 days will be reduced by 30 percent from September 30, 2005, levels, and more recently stated that backlogs will be further cut to 50 percent by the end of April 2006. This was considered an aggressive target by most estimates.

While outlining these measures is an important first step in addressing the operational inefficiency and current confirmation backlog in the credit derivatives market, additional commitment is required to insulate the market from the risks outlined earlier.

TECHNOLOGY

Despite the massive growth in the credit derivatives market to date, the market's long-term potential is restrained by the lack of appropriate infrastructure and systems technology.

Most trade processing systems currently employed by the industry's most active dealers have been developed in house, driven by the opportunity for competitive advantage through enhanced processing and analytical capabilities. This has been a significant factor in major dealers' continued preference for proprietary technology, despite a growing

list of vendors eager to participate in the market. Critics have argued that such vendor offerings have not kept pace with advancements in in-house systems as the industry races to adapt to the rapidly changing menu of derivative products. However, soaring trade volumes and increased product standardization are heightening the appeal of automation among market participants, providing vendors with the opportunity to fill the void.

Among developments being rolled out to address the market's needs is DTCC's Deriv/SERV service, identified by major dealers as a key strategic component to address the current confirmation backlog. This system facilitates the matching and confirmation of over-the-counter (OTC) derivatives, alleviating the risks associated with manually performing these functions through traditional fax or phone communications. However, Deriv/SERV is currently only available for standardized CDS products, leaving the more complex transactions still to be processed manually.

T-Zero, launched in July 2005, is another high-profile offering emerging to address deficiencies associated with the trade capture stage. T-Zero electronically captures and redirects all trade details, assignments, allocations and other relevant trade details. It facilitates the electronic reconciliation of trade details between counterparties, while allowing issues to be resolved via a real-time messaging system.

The market's optimism for such a tool is reflected in T-Zero's recent acquisition of several major clients. "The service already has the support of some of the large banks. Goldman Sachs was first on board in September, followed by JPMorgan in October. Deutsche Bank is the latest to sign up and others are expected to follow."¹ Other industry vendors,

¹ David Setters, "Hedge Funds and Derivatives: A Maturing Relationship," sponsored by ABN-AMRO.

meanwhile, are developing competing solution offerings.

Major dealers that have previously chosen to embrace automation are already witnessing operational benefits. As volumes continue to grow, product standardization expands, putting pressure on margins. Automation is a primary tool in restoring margins through operating cost reduction. In fact, a survey of 16 banks conducted by market intelligence firm Z/Yen Limited “showed huge volume growth in the OTC derivatives markets... These volume increases together with new technology and the take up of cross-market industry utilities led to big reductions in the market average operations cost per trade for credit derivatives, which fell 42 percent from \$401 to \$233.”¹

Despite this encouraging news, industry adoption of such solutions is only beginning. For the credit derivatives market to achieve a meaningful level of automation, sufficiently mitigate growing risks and derive the greatest return on investment from technology investments, a series of challenges must be overcome.

First, as technology improves, operational risk may actually increase due to system conversions. Conversions often create risks involving people, technical processes between old and new systems, and the integrity and consistency of underlying data. Complicating matters are the absence of technology able to handle nonstandard contracts—a leading contributor to extended confirmation processing times—and a fragmented regulatory environment. Although banks are subject to the pressures placed on them by regulators such as the Federal Reserve and the United Kingdom’s FSA, these same regulators are not responsible for the actions of the largely unregulated hedge fund industry. These oversight

differences could become a significant stumbling block for any coordinated solution agreed upon by the banking industry consortium.

This is a major issue for dealers whose client list includes hedge funds—a market segment significantly contributing to the explosion in transaction volume, yet typically with much smaller budgets for technology investments. Achieving meaningful automation becomes difficult unless most of a firm’s trading partners also choose to invest, since a contract can only be processed as fast as the slowest counterparty.

PROCESSES

Although initial adoption rates for various technology offerings appear promising, banks and asset managers alike cannot afford to wait for adoption to reach a critical mass before deciding to examine their internal operations seriously. Differences of opinion between the hedge fund industry, banks and regulators concerning how best to address trade practices are proving to be early challenges to any unanimous solution.

Unfortunately, credit derivatives carry risks that do not allow market participants the luxury of time. It is therefore essential that firms take immediate steps to improve the efficiency of internal confirmation processes, while simultaneously pursuing the ultimate objective of automation.

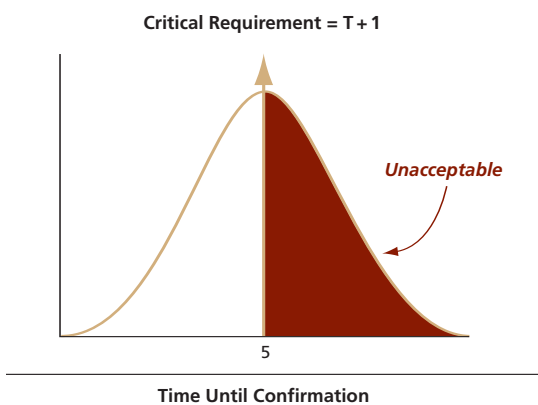
By initiating a critical review of credit derivative trade processes under the guiding principles of Lean Six Sigma, market participants can independently begin to reduce the time required to complete contract confirmations, while simultaneously helping mitigate the risks associated with the transition to automation.

¹ “Rising Volumes and New Technology Push Down OTC Derivatives Processing Costs,” *Finextra.com*, October 18, 2005.

The Lean Six Sigma approach focuses on eliminating process “waste” by identifying bottlenecks and process steps that do not add value. The additional application of Six Sigma principles allows participants to determine accurately which factors affect transaction time. These principles have already been embraced by many of the world’s top financial services firms, including Bank of America, JPMorgan and Citigroup, leading to performance improvements in other areas of the business.

The implementation of such an approach supports the industry’s drive toward automation and a T+5 standard by identifying operating inefficiency that can be addressed immediately, helping reduce wait times between tasks and streamlining the process (see Figure 8). In addition, market participants are better equipped to handle those trades involving complex nonstandard contract terms—instruments that automation solutions are still struggling to address.

FIGURE 8: IDENTIFYING OPERATIONAL INEFFICIENCY



However, to make sustainable confirmation process improvements, participants must first intimately understand these processes, as a process actually followed can differ greatly from that which is understood to exist.

An initial step would be to trace the physical flow of the value stream through the creation of process maps. A process map allows for a consistent understanding of the process, facilitating the identification of core value-added activities, cloudy decision points, bottlenecks and redundancies. Redundancies can include unnecessary verification, approval steps and document handling, as well as cumbersome communication channels.

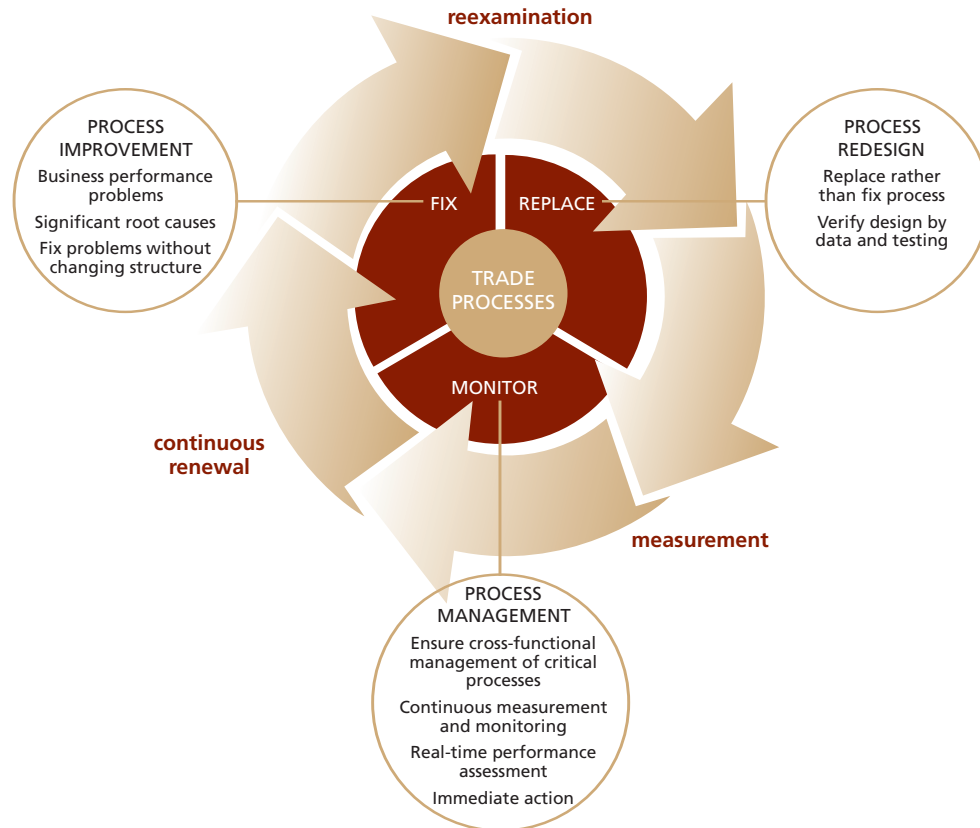
The objective of such an initiative is to remove tasks that have inadvertently been added to the core process over time, sometimes referred to as simply “how things are done.” What’s more, a well-implemented process review can provide enhanced visibility, facilitating work prioritization (see Figure 9). According to *Wall Street and Technology*, “20 percent gains in process improvements are routinely achieved simply by understanding current processes better.”¹ Such an approach may be particularly valuable in such processes as legal execution, where automation alternatives are largely unavailable.

PEOPLE

To facilitate the clearing of unconfirmed derivative trades, the 14 leading dealers not long ago began a process referred to as bilateral “lock-ins.” Lock-ins are meetings in which operations staff are sequestered to cancel or finalize outstanding contracts. It is common for these procedures to drag on for more than a day.

¹ “BPM: It’s All About Efficiency,” *Wall Street and Technology*, November 18, 2005.

FIGURE 9: IMPLEMENTATION OF A PROCESS REVIEW



Although such procedures may be a necessary evil in reducing the current backlog, they place a significant burden on resources, as staff must continue to address new volume generated by ongoing trading. In fact, these new requirements only add to the demands placed on the already swelling back offices of major dealers. Figure 10 highlights the change in the ratio of front-office to trade processing personnel according to the *ISDA 2005 Benchmarking Survey*. Relying on staff not only fails to provide a sustainable solution to operational issues, it may actually increase error rates throughout the process by increasing the ratio of inexperienced personnel, while placing unreasonably high demands on core staff.

This effect is seen in the increased cost incurred for operations personnel. According to Z/Yen, “demand for staff increased, which has brought a significant rise in the cost per head. The average fully loaded operations cost per head has risen from \$123,000 to \$133,000 per annum, and this is fairly consistent across all products, though there is a small premium for credit derivatives staff.”

FIGURE 10. STAFFING RATIO (FRONT-OFFICE/ TRADE PROCESSING PERSONNEL)

	2003	2004	2005
Credit Derivatives	1.3	1.5	1.1

Source: International Swaps and Derivatives Association, Inc. (ISDA), *2005 Operations Benchmarking Survey and FpML Use Survey*.

For this reason, adequate training, including an understanding of the entire value chain, must remain a component of any operational strategy. From an industry perspective, standardized credit derivative courses offered by recognized organizations such as the NASD and CSI, a Canadian financial education provider, would be a step toward ensuring a minimum level of comprehension.

THE NEED FOR A MULTIFACETED SOLUTION

Credit derivatives are an ever-more popular tool for monitoring and managing credit risk exposure. However, the system is already overloaded. Errors and delays in processing transactions have led to a backlog of crisis proportions. Industry observers warn that, in a worst-case scenario, a falling domino effect created by a chain of corporate defaults could pose a significant systemic risk to financial markets.

No simple solution will do. Rather, what is required is a holistic approach to the confirmations backlog that puts equal emphasis on technology solutions, process improvements and the personnel implications of making the process run smoothly.

To learn more about how our FS solutions can empower your company, [Let's Talk](#).

GLOBAL MANAGEMENT AND TECHNOLOGY CONSULTING FOR TODAY'S BUSINESS ENVIRONMENT

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GLOSSARY

Basel II Accord—The new international capital-adequacy framework developed by the Bank for International Settlements (BIS).

Checking—The manual tick-back of trade terms of an incoming written confirmation against a counterparty's own system records.

Confirmation—The written acknowledgement provided by a broker indicating that a trade has been completed.

Collateralized debt obligation (CDO)—An investment-grade security backed by a pool of bonds, loans and other assets. CDOs do not specialize in one type of debt, but are often non-mortgage loans or bonds.

Credit-default swap—A contract structured so that one counterparty pays a constant payment or “insurance premium” to the other counterparty in exchange for protection from a specified credit event on a particular reference asset.

Query resolution—The negotiation of legal language or fallback provisions owing to the customized nature of over-the-counter derivatives.

Synthetic credit-default obligation (CDO)—A portfolio of credit-default swaps. Risks and payments on these securities are divided into tranches to align better with investor needs. Similar to a CDO, with the difference that synthetic CDOs are pure derivatives, referencing only a notional value.

Trade blotter—According to investopedia.com, “A record of trades and the details of trades made over a period of time (usually one trading day).” The blotter is usually created through a trading software program that records the trades made through a data feed.



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