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The Evolution of Standardization in the OTC Derivatives Market

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Transactions resembling derivatives date back to antiquity; however, the over-the-counter (OTC) derivatives industry, characterized by privately-negotiated bilateral trades, really only began to take shape thirty years ago. While banks have been trading in foreign currency, gold and treasuries for much longer, it was in the 1980s that they started creating derivative products that could be custom designed to decrease risk exposure specific to certain transactions and market participants. The rapid and steady proliferation of derivative products was met with great enthusiasm from financial institutions, corporations and investors, and the OTC market took off.

The OTC derivatives industry has grown and evolved dramatically since its emergence in the 1980s. This article will provide a brief overview of three areas in which specific initiatives have brought, or will bring noticeable changes to the industry.

Documentation – Initially, OTC trades were memorialized in voluminous bespoke documents that were both cumbersome and time-consuming to negotiate. The industry responded to this inefficiency by developing an extensive set of standardized documentation that simplified and facilitated the execution and confirmation of transactions and master agreements.

The confirmation process – Derivatives trades are typically executed between traders by telephone or electronic messages and later confirmed with a written document. There was a period of time where a large number of trades were not confirmed in a timely manner, therefore creating backlogs of unsigned confirmations. The industry responded by committing to reducing the backlog of unconfirmed trades by establishing more efficient and automated electronic confirmation processes.

Mitigation of credit risk – Failures and bail-outs of several major participants in OTC markets have increased parties' interest in reducing their exposure to counterparty credit risk by either clearing and settling their trades through a central counterparty or clearinghouse or implementing enhanced measures to protect the collateral they post for the benefit of OTC counterparties.

Documentation

The International Swaps and Derivatives Association, Inc. (formerly the International Swaps Dealers Association) (ISDA) was created in 1985 by a small group of swap dealers and was tasked with developing standard terms for derivatives transactions. ISDA now represents the OTC industry as a whole. Its most significant contributions have been the development of the 1992 ISDA Master Agreement and the more recent 2002 ISDA Master Agreement (which incorporated revisions in response to various events in the late 1990s such as the 1997 crisis in Asia, the 1998 Russian debt default and the failure of Long Term Capital Management). Although the 2002 ISDA Master Agreement is more recent, a number of buy-side firms still prefer the 1992 version as they consider the later version to be too "dealer-friendly".

An ISDA Master Agreement creates a legal framework for a wide variety of OTC derivative trades between the parties, including trades involving different products, jurisdictions and currencies. ISDA's Master Agreements contain largely standardized legal and credit terms relevant to the parties' trading relationship and can be varied by the parties in a supplemental schedule. The standard form of the "Schedule" includes an optional "Credit Support Annex" that provides a mechanism for collateralizing (or margining) trades. ISDA has also published standardized transaction confirmations and definitions of key

terms used to document individual trades in different products. The creation of standardized Master Agreements and confirmations has increased the efficiency, and decreased the cost, of negotiations, as parties need only agree on the adjustments they seek to make to the standard forms and terms. Once a Master Agreement is in place, the parties can focus on the terms of their derivative transactions. Each trade under a Master Agreement is evidenced by a confirmation.

Each Master Agreement combined with the trade confirmations concluded under it forms a single agreement. There are two very specific benefits to the single agreement structure:

- The first benefit is that the parties can elect to net payments that are due on the same date and in the same currency across transactions or groups of transactions. This diminishes counterparty credit risk in part by reducing “daylight risk” (the risk a counterparty faces between the time it makes a settlement payment and the time at which it received a corresponding payment, on the same day); and
- The second and more significant benefit is “close-out netting,” which provides a terminating party with the ability, upon its counterparty’s default or certain other termination events, to accelerate and terminate outstanding transactions and to net amounts owed to its counterparty from any termination payment owed by the terminating party. Although not all jurisdictions fully recognize the enforceability of close-out netting, ISDA has received opinions from dozens of jurisdictions opining on the enforceability of close-out netting.

To further increase efficiency, ISDA has developed and continues to develop standardized master confirmation agreements (MCAs) that have terms not covered by the Master Agreement and are specific to given trades, e.g., equity variance swaps, index options or total return swaps on bonds. Prior to the development of MCAs for specific derivative products, parties negotiated “long form confirmations” for each trade, with all of the specific terms for a product set out and negotiated in the confirmation. Under an MCA, a substantial portion of product specific terms are agreed to at the outset, and then the parties simply agree on the economic terms and certain elections every time they want to enter into a trade on that particular product, which are reflected in a short form “transaction supplement”.

The industry has taken standardization one step further with respect to credit default swaps (CDS) by establishing a matrix for CDS trades. The matrix facilitates the documentation of CDS transactions by establishing a standard set of non-economic definitions and elections for CDS trades referencing various

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types of reference entities. Unlike an MCA, the terms of a matrix for a particular CDS product are generally not negotiable. When parties reference a CDS matrix in their trade confirmation, they are agreeing to industry-wide elections and terms for a particular CDS product. Applying the matrix is now a widely accepted industry practice for plain vanilla CDS trades as it ensures fungibility and permits counterparties to easily novate (step out of the trade and have another market participant take their place) CDS trades.

The Confirmation Process – Electronic Confirmations

Typically OTC derivatives transactions are executed by telephone or other electronic means. Once the trade is executed, the confirming party sends its counterparty a paper confirmation for review and approval. This process unfortunately results in a number of confirmations not being returned to the confirming party, sometimes because the receiving party is under-staffed and cannot ensure review of the confirmations in a timely manner, or because the terms set out in the confirmation do not match the counterparty’s understanding of the transaction. Over the past several years, the derivative marketplace has seen significant improvement in the processing of OTC confirmations, some of which can be attributable to the development of electronic confirmation platforms. These improvements have been most evident in credit derivative trades, with a 92% reduction in aged confirmation backlogs despite volume increases of over 300% since 2005. There also has been a 74% confirmation backlog reduction in equity derivatives, and a 53% confirmation backlog reduction in interest rate derivatives, since 2006. While this progress is considerable, the industry acknowledges that more must be done to strengthen the operational infrastructure supporting the processing of OTC derivatives trades and further eliminate backlogs.

The Operations Management Group (OMG), a senior-level strategic group, comprised of a number of operational professionals from derivatives dealers, buy-side firms and trade associations, has committed to widespread implementation of

electronic platforms that assist market participants in processing OTC derivatives trades. Electronic confirmation processing is now available through the a variety of vendors including the following: IntercontinentalExchange, Inc.'s eConfirm platform for commodity trades; Markit's Markit Wire for interest rate, inflation, equity and credit derivatives; and DTCC's Deriv/Serv for CDS, equity and interest rate products. These are general examples, and other vendors are actively seeking to offer expanded product offerings.

While these platforms allow electronic confirmations for a number of products, not all trades are capable of being confirmed electronically. CDS trades have seen an increased rate of electronic confirmation capability (up to 95% in 2008); however, the rate of equity trade electronic confirmation has not been as high. Currently, only 40% of equity derivative transactions are eligible for electronic confirmation because there is a high proportion of products that are not electronically eligible due to their lack of standardization (or complex nature). However, several of these products are being prioritized by the OMG standardization.

Mitigation of Credit Risk – Clearing

In recent months there has been growing interest among regulators and certain market participants in the development of a central counterparty (CCP) or clearinghouse for CDS and perhaps other OTC derivatives. A CCP or clearinghouse generally assumes the credit risk of trades that are submitted to it by its members. The clearing process replaces the obligations of the counterparties with obligations of the CCP or clearinghouse. Submitting trades to a clearinghouse is expected to reduce systemic risk by ensuring that the failure of one market participant does not have a disproportionate effect on the overall OTC market. Other potential benefits of submitting trades to a CCP or clearinghouse include:

- the ability to offset and net all obligations that arise under trades that are cleared through the platform therefore reducing overall margining requirements and liquidity risk;
- cross-margining of on-exchange and OTC derivatives trades, which would reduce further a party's requirement for liquidity; and
- a reduction of operational risk as in most cases trades to be submitted to a CCP or clearinghouse would have to be electronically confirmed or at least electronically evidenced to be able to be submitted to the clearinghouse.

Currently certain commodity, single-currency interest rate and currency derivative trades are capable of being cleared. CME Group Inc. and ICE, The Clearing Corp., as well as other clearing service providers are working towards launching a clearing platform for CDS products in early 2009. More complex and structured OTC products are less likely to be subject to clearing as they are less liquid and not capable of standardization; in addition, their valuation is not always straightforward.

What the Future Holds

Our financial system is going through a period of almost unprecedented turmoil. Change appears inevitable for most markets, including OTC derivatives. History suggests that the OTC derivatives industry is capable of devising creative and sophisticated responses to these kinds of challenges. The growing standardization of the OTC derivatives markets has greatly promoted efficient processing of OTC derivatives transactions, and the industry has made phenomenal progress in overcoming the infrastructure challenges that were presented by the explosive growth of the CDS markets in recent years. The OTC derivatives industry can be expected to dynamically evolve as necessary so as to meet the needs of market participants and satisfy regulatory concerns.

Editor's Note: Through the work of its Derivatives Subcommittee, MFA and its members have consistently supported and participated in a number of industry efforts to promote the views of the larger buy-side trading community in the OTC derivatives markets. MFA has played an important role in improving industry-wide standards, engaging in dialogues with policy makers and industry regulators and providing various educational opportunities for MFA members. For over five years, MFA has been very active in working with the major OTC derivatives dealers, other industry groups and industry service providers to develop standardized template documentation for various OTC derivatives products and to help onboard our members onto electronic trading platforms. ©

Teigland-Hunt LLP is a New York law firm that focuses on derivative and commodity transactions and related trading and regulatory matters. The firm's lawyers have extensive experience representing financial institutions, hedge funds and commodity trading firms in various trading agreement negotiations as well as a wide range of fixed income, equity and commodity transactions. The firm acts as counsel to the derivatives committee of Managed Funds Association as well as several ISDA drafting committees. You can reach the authors at lteigland@teiglandhunt.com or gcharles@teiglandhunt.com.