Time for **action**

Back-office processing has long been the neglected stepchild of the derivatives business. But improved technology and growing systemic risk mean the time is ripe for supervisors to demand T+0 reconciliation, argues ***David Rowe***

The Counterparty

Risk Management Policy Group (CRMPG) recently called on the derivatives industry to implement T+0 reconciliation by the end of 2009, as noted in this column last month.[1] The CRMPG's proposal is for all major sell-side derivatives market-makers and buy-side end-users to co-operate in specifying and then implementing a fully electronic trade representation and matching system, to achieve daily transaction confirmation and full portfolio value reconciliation on a T+0 basis.

My own experience with voluntary industry efforts of this type goes back to 1990, when six US and five Canadian banks attempted to organise a North American Clearing House Organisation for multilateral netting and clearing of foreign exchange transactions. Conflicting interests of different participants – in particular, the different credit ratings across the group – presented insurmountable obstacles and the original project was abandoned. Eventually, however, a subset of the original 11 banks regrouped and succeeded in forming Multinet International Bank, which eventually merged into the CLS (Continuous Linked Settlement) Group. In the end, successful establishment of multilateral netting and settlement of forex transactions took more than a decade.

This was a significant achievement, especially in establishing an infrastructure that could handle the volume of interdealer transactions in the global forex markets. Nevertheless, it related to a comparatively narrow range of transaction types. Accurate electronic representation of the full range of derivatives is far more daunting. Achieving broadly consistent valuation across such a wide range of structures adds yet further complexity and represents an additional obstacle to achieving voluntary T+0 reconciliation.

None of this is to say T+0 reconciliation is impossible. Indeed, a number of technical advances in recent years offer important support for such an effort. Financial products Markup Language (FpML) has been under development since the late 1990s.[2] Unfortunately, the pace of development and implementation has been hampered by limited commitment and a resulting lack of resources. Like all such efforts with significant social network benefits and limited ability to capture these benefits privately, it has been plagued by a widespread wait-and-see attitude. Nevertheless, FpML is a valuable starting point for the development of a comprehensive industry-standard trade representation scheme.

Consistent and comprehensive valuation of the full range of derivatives products is the second big challenge. The technical problems have largely been addressed – tools that separate definition of transaction terms and conditions, stochastic diffusion processes for market variables and derivation of expected payouts have now come into their own. It is the first of these that introduces almost limitless variety into over-the-counter derivatives transactions. The second and third items are characterised by a limited number of alternatives. These tools already allow effective valuation of almost all types of transactions and, given industry commitment, could be expanded to virtually full coverage. One drawback is that they are quite computationally inefficient, but that can mostly be addressed by applying the emerging power of grid computing.

No-one should underestimate the effort involved in making T+0 reconciliation a reality. It is arguably far more daunting than bringing multilateral net settlement to the forex market, and for this reason I believe expecting it to occur as a result of voluntary efforts is unrealistic. Some have argued all derivatives should be confined to organised exchanges with a limited number of standardised contracts, claiming customisation has only served dealers at the expense of end-users. While I have criticised the tendency to introduce gratuitous complexity as a means of charging bigger spreads[3], arguing that customisation is useless to end-users is a serious overstatement. Nevertheless, the industry has persistently failed to correct its inadequate attention to back-office operations. Only when facing explicit regulatory pressure has it responded with a serious commitment of additional resources. Given the available technology, the biggest obstacle to T+0 reconciliation is insufficient industry commitment.

As we saw in the Bear Stearns situation, position uncertainty caused by the fluctuating backlog of unconfirmed trades presents potential systemic risk in a period of market uncertainty such as we have seen for the past year. In light of these considerations, it is time for regulators to go beyond moral suasion. The time for kid gloves has past. T+0 reconciliation should become a global regulatory requirement with a firm deadline. ■

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[1] Risk *September 2008, page 119 (www.risk.net/public/showPage.html?page=813202)*
[2] Risk *January 2000, page 89. The FpML development effort now functions as a project of the International Swaps and Derivatives Association*
[3] Risk *April 2005, page 73 (www.risk.net/public/showPage.html?page=216521)*