A natural role
for exchanges in OTC clearing

BY HEATHER MCKENZIE

Key industry associations say central counterparty clearing for OTC derivatives will improve market efficiency and transparency.

Momentum is gathering behind the establishment of central counterparty clearing for OTC derivatives, and exchanges are well positioned to step into the frame. In Europe, exchanges are lining up to offer clearing services, while in the US a debate is taking place about how much of the OTC derivatives trading life cycle should come under exchange-type controls.

In November, a proposal for a Derivatives Trading Integrity Act was introduced in the US which would bring the OTC derivatives market under federal regulation and would require OTC derivatives to be traded on an exchange. The bill was condemned by the International Swaps and Derivatives Association (ISDA), and the Securities Industry and Financial Markets Association (SIFMA). According to ISDA, if businesses and investors cannot use these products, their ability to manage risks and weather tough market conditions would be undermined.

KEVIN MCPARTLAND, a Senior Analyst at US-based financial research and advisory firm TABB Group, says it is logical for exchanges to be involved in OTC derivatives, but not all OTC derivatives should be traded on exchanges. "There are some instruments for which it makes sense, such as vanilla products and standard index CDS type products," he points out. "These are the more straightforward products and therefore the easiest place to start."

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Kevin Rideout, Global Head of Market Infrastructures, Citi Global Transaction Services

The London-based Wholesale Market Brokers' Association (WMBA) endorses the efforts of US and European regulators to encourage central counterparty clearing in OTC markets such as credit derivatives in order to mitigate counterparty risk. However, the WMBA stresses that several OTC markets are already fully compatible with central counterparty facility operations. For example, OTC products such as US treasuries, European interest rate swaps, OTC equities, spot foreign exchange and carbon emissions have been executed OTC and cleared centrally for some time.

THE WMBA FURTHER NOTES that the most recent, on-the-run US treasuries trade OTC and fully electronically, but they clear centrally through the DTCC. US energy derivatives trade OTC via voice brokers and electronically, but they are also centrally cleared through ICE or NYMEX/CME. Similarly, this applies to the operation of CLS in foreign exchange markets. These have proven to be effective mechanisms and such structures can be duplicated elsewhere in the OTC world.

McPartland says it is no accident that the four main parties vying for a place as a CDS central counterparty – ICE, CME, NYSE Euronext and Eurex – are all exchanges. "The exchanges already have central clearing for other products and it will be much easier, from an operational point of view, to tweak their existing environment and use their existing knowledge to create central clearing for OTC instruments."

Focusing on OTC interest rate swaps, NASDAQ OMX has also entered the OTC derivatives clearing space with an 80% stake in International Derivatives Clearing Group (IDCG), which cleared and settled its first US dollar interest rate swap futures contract in January 2009.

Kevin Rideout, Global Head of Market Infrastructures at Citi Global Transaction Services, says exchanges can play a vital role in bringing transparency to the OTC market. Straight through processing and risk management are the name of the game when it comes to clearing and settlement of OTC derivatives. "In any asset class where a bilateral trade takes place, there is a role for a central counterparty," he notes. "A safe house where trades are netted, recorded and novated and margin is collected as protection in conjunction with default funds is an absolute must."

BOB GREIFELD, CEO of NASDAQ OMX Group, agrees that centralized clearing is fundamental and also believes re-regulation is necessary. "The objective should not be more or less regulation. It should be smarter and more efficient re-regulation. We need new rules on the books, reflective of the world that exists today, not the world that existed in the 1930s. Regulated exchanges have a natural role to play in the new regulatory landscape."

Clear as mud

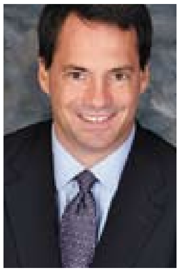
Preserving the benefits of OTC derivatives while improving transparency and reducing risk will be a challenge in 2009.

BY HEATHER MCKENZIE **ILLUSTRATION** ANNA SVANFELDT

Some observers maintain that widespread use of OTC derivatives led to the uncertainty that brought about the collapse of Lehman Brothers in September 2008 and accelerated the global financial crisis. The chaos in the world's financial markets during the latter part of last year has brought intense scrutiny to OTC derivatives markets and prompted calls for increased regulatory oversight. Inevitably, the OTC market will change in 2009 in such a way that could present central counterparty clearing opportunities for exchanges.

OTC derivatives are customized financial instruments bilaterally traded between firms, some of which are regulated. The terms of the contract – including maturity dates, notional amounts, specifications and trading and credit procedures – are privately negotiated by the trade counterparties. The deals may be transacted across jurisdictional boundaries, and typically they are governed by contracts based on International Swaps and Derivatives Association (ISDA) master agreements.

For various reasons OTC derivatives are perceived as being more risky and opaque than standardized, exchange-traded futures and options contracts. For starters, these contracts are transparent because they are regularly marked to market. OTC contracts may or may not be marked to market depending on the contract and counterparty's policy, and price quotes can vary significantly between dealers. In addition, these contracts are cleared by a central counterparty, which reduces default risk. Some OTC contracts are cleared centrally, but not all.



It is the lack of transparency rather than the OTC derivatives themselves that is the problem, says Andy Nybo, Senior Analyst at TABB Group.

A declaration issued at the meeting of the G20 group of countries in November 2008, and reinforced in April, called for greater transparency in the OTC derivatives markets. The group made a commitment to strengthening market transparency by enhancing required disclosure on complex financial products and ensuring complete and accurate disclosure

by firms of their financial conditions. It stated that there should be incentives to avoid excessive risk-taking.

Speaking at a Frankfurt conference, European Commissioner for Internal Market and Services Charlie McCreevy explained that the European Commission supports a comprehensive approach to international reform in order to avoid crises in the future. Such an approach entails strengthening of international regulatory standards; international cooperation between financial supervisors; multilateral macroeconomic surveillance and crisis prevention; and fortifying international crisis management and resolution capabilities. The Financial Stability Forum and the International Monetary Fund need to be strengthened, their effectiveness and legitimacy must be improved, and they must be encouraged to collaborate more closely.

"We need to take urgent steps to bring OTC derivative trading out from the shadows," said McCreevy. "We cannot let the OTC market continue without adequate counterparty clearing."

In an address hosted by the NASDAQ OMX Stockholm office in December 2008, Stefan Ingves, Governor of Sweden's central bank, Sveriges Riksbank, said a central counterparty provides safer and more efficient securities settlement. The transactions can be netted out, and the counterparty is known. The counterparty risks can be managed by the central counterparty obtaining collateral. Moreover, the central counterparty has its own financial resources.

DESPITE THESE ADVANTAGES, there is also a downside to central counterparty clearing. "The drawback with a central counterparty is that the market risks are concentrated to a single player – a high concentration of risk," Ingves warned. "Provided the operations are properly organized, however, this is not a problem."

Andy Nybo, a Senior Analyst at financial markets research and advisory firm TABB Group, argues that it is the lack of transparency rather than the OTC derivatives themselves that is the problem. "Derivatives are always like a stepchild when there is a market implosion or disturbance," he says. "While the finger is often pointed at OTC and equities derivatives as the problem, these instruments devolved for particular purposes."

OTC derivatives provide substantial benefit to the capital markets. By allowing risk to be transferred, firms can access markets and deploy capital to take positions or manage risks on their books. Further, OTC derivatives are not transparent for an important reason: investors want anonymity.

Sandy Frucher, Vice Chairman at NASDAQ OMX, agrees that investors have been attracted to OTC derivatives because of their lack of transparency, but tradeoffs have to be made. "What we have learned over the past year is that the risks of these instruments to the world's financial markets are too great," he says. "It is likely that reform of OTC derivatives will be high on the agenda for the new Obama administration."

BUT IT WILL NOT ONLY be regulators who sort out OTC derivatives. Kevin Rideout, Global Head of Market Infrastructures at Citi Global Transaction Services, says massive steps are being made by market participants to clear up the mess. "There are RFPs flying around all over the place for CCPs to step up and novate OTC derivatives," he says. "Like it or not, the regulators will have to put their foot down and make their mark on this space. It will be a much more regulated marketplace than before."

Market players would prefer principle-based governance to rules-based governance. A principles-based approach establishes a top line goal and allows individual firms to work out how to get there as long as they do not violate the larger principle. Ultimately, this model is more conducive to innovation, and it allows new products to be introduced quicker. In a rules-based approach, the regulator sets a standard and all firms have to comply with it.

Regardless of which approach is taken, it is likely that regulators will be more proactive in the coming year in forming policies that will push the OTC markets into a more transparent trading environment. In the meantime, the industry is working to develop solutions that can better manage the trading and pricing of OTC instruments as well as the creation and management of central clearing facilities that can handle the requirements of the OTC equity derivatives marketplace. ■