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Viewpoint

Implications of the Proposed OTC Derivatives Regulations

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In the wake of the global financial crisis, regulators on both sides of the Atlantic are proposing new rules to increase the transparency and operational efficiency of over-the-counter (OTC) derivatives contracts. Depending on the final details of the proposed regulations, we believe they could have significant implications for transacting in currency derivatives markets.

The European Commission's formal proposal was published in September and had much in common with the Dodd-Frank Wall Street Reform and Consumer Protection Act in the U.S. Both have similar objectives. In the words of the EU Commission, the new rules are meant to: "improve transparency and regulatory oversight of over-the-counter derivatives in an internationally consistent and non-discriminatory way."[1] In addition to improving transparency, the legislation is designed to reduce counterparty credit risk and, less well-defined, "operational risk." In Europe a new body called the European Securities Markets Authority (ESMA) will be set up. This body will be responsible for interpreting the new legislation and determining, among other things, which financial instruments and market participants will be covered.

Regulators are seeking to prevent disruption in the derivatives markets from triggering a systemic failure in the financial markets generally. Consequently, we believe the regulation is likely to apply to contracts undertaken between financial entities and all major categories of their customers: funds, collective investment vehicles, investment firms, investment managers, insurance companies and pension funds.

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1 http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_proposal_en.pdf

Derivatives range from instruments with fully standardized parameters (generally futures), to those that are tailored to the specific needs of a particular user (generally swaps). Fully standardized derivatives are commonly traded on exchanges, whereas the more customized contracts are traded bilaterally, or over-the-counter (OTC). As a result, OTC markets are opaque. As they comprise privately negotiated contracts, only the participants have information regarding their details. The near-collapse of Bear Stearns in March 2008 and the default of Lehman Bothers in September of that year raised concerns that the authorities had little idea of the scale of exposures within the OTC market. They were therefore unable to assess the systemic risk posed. Initially, attention was focused on credit default swaps (CDS), but now the entire market is under scrutiny. Since futures and swaps are integral to any foreign exchange strategy, currency managers are taking an interest in this process.

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Already a number of changes to the market are clear from the U.S. legislation and proposed European rules. Specifically:

- There will be a centralized repository containing comprehensive information on all OTC derivatives positions
- The use of Central Counterparty (CCP) clearing will be significantly increased
- Bilateral clearing practices will be improved
- OTC derivatives contracts will become more standardized

These changes could potentially affect the foreign exchange market more than any other because currently, at the wholesale end of the market at least, trading is executed bilaterally, with customized contracts and no clearing or margin arrangements. Trading is essentially based on credit, with counterparty banks allocating capital according to the size and length of contracts. This offers tremendous flexibility to participants as well as a simple administrative process. It is worth noting that despite the lack of formal regulation, in our opinion the foreign exchange markets withstood the credit crisis with fewer problems than many other markets. Liquidity was maintained throughout, although reduced, and there were no major counterparty defaults. We believe that even the collapse of Lehman Brothers was handled effectively by the existing process.

Of the proposed changes, we believe the expanded use of Central Counterparties to mitigate counterparty credit risk in OTC derivatives markets could have the most far-reaching effects. A Central Counterparty (CCP) Clearing House is a commercial firm that interposes itself between the two counterparties to a transaction with the purpose of managing the risk arising from a default by one of the participants. When a CCP is involved in the post-trade process, the original contract arising from an over-the counter (OTC) trade is replaced by new contracts between the CCP and the executing parties by way of "novation."[2] In order to access clearing, clients must retain at least one clearing broker if they wish to benefit from the default management facilities that enable positions to be automatically transferred. These brokers intermediate between their clients and the CCP for all trades that are submitted to clearing and collect the margin required.

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Where a client chooses to submit a trade for clearing, three intermediating trades as shown in Exhibit 1 replace the original contract with the executing broker. From a risk management perspective, it is important to understand that there is a time delay in the above process that results in the client having exposure to the clearing broker until such time as the trade is passed to the CCP.

Exhibit 1

FIGURE 1: Current OTC arrangement

Executing Broker + Client

FIGURE 2: Clearing arrangement

EB + CCP + Clearing Broker + Client

Source: Pareto.

We believe this structure has three clear benefits: firstly it improves the management of counterparty risk. Stringent rules are likely to be imposed on capital requirements for CCPs and regulators will likely impose both initial and variation margin requirements. Secondly, the CCP may perform multilateral netting of exposures and payments, which can minimize imbalances in the market. Finally, it improves market transparency by making activity and exposures available to regulators. A successful clearing model requires that the CCP is able to manage counterparty risks and mark-to-market positions. To facilitate this, policymakers have identified a number of important prerequisites such as the standardization of trade flows, transparent price discovery and fungibility to enable the netting and novation of contracts.

2 In *contract law* and *business law*, novation is the act of either replacing an obligation to perform with a new obligation, or replacing a party to an agreement with a new party. In contrast to an *assignment*, which generally is valid so long as the obligee (person receiving the benefit of the bargain) is given notice, a novation is valid only with the consent of all parties to the original agreement.

The complex and opaque nature of the OTC derivatives market has meant that regulators have not had a clear enough view of the risk exposures held, hence increasing the risk of contagion. The central clearing model would allow for the central collection of high-frequency market information on activity, prices and exposures.

Managing Counterparty Risk

We believe the introduction of clearing for certain instrument types should result in additional benefits beyond those associated with a reduction in counterparty risk. The use of central clearing may culminate in increased market liquidity, because clearing members should be able to free up capital for other purposes as collateral requirements diminish due to multilateral netting. Instead of the need to collateralize individually on a bilateral basis, the clearing member would ideally be required to post collateral only with the CCP. Operational risks should be improved as the central clearing model enforces both standardization of processes and operations.

Improving Transparency

The complex and opaque nature of the OTC derivatives market has meant that regulators have not had a clear enough view of the risk exposures held, hence increasing the risk of contagion. The central clearing model would allow for the central collection of high-frequency market information on activity, prices and exposures. We believe such a model should also result in an improved competitive environment, as all players could achieve identical access to a CCP. It is also possible that such a structure may enable certain markets to operate more efficiently during periods of higher stress due to the lower associated counterparty risks involved.

While we see many benefits of a centrally cleared market, there would be additional operational requirements for clients wishing to participate in markets where clearing has been mandated. The most obvious relates to the need to put in place a margining and collateral management process. Clients would be required to deliver collateral to their clearing member, made up of two components. Initial margin is required to cover potential losses relating to their positions, and variation margin to cover the change in value of these positions. It is anticipated that there will be mandatory segregation for clients participating in clearing, with trades registered between a Client Account and a House Account at the broker. We believe most clients will opt for "Gross Client Clearing," with margin held in a segregated designated client account rather than in an omnibus account with the associated cross-contamination risks.

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Fortunately, the resilience of the default management processes at clearing houses has not been routinely tested by large crises. We do, however, have a recent example with Lehman Brothers defaulting on their interest rate swap portfolio in 2008. The LCH.Clearnet's SwapClear service is responsible for clearing over 40% of all interest rate swap volumes and managed the Lehman Brothers' U.S. $9 trillion swap default by hedging and auctioning off to other clearing members over 60,000 trades within the margin held and with no recourse to the default fund.[3]

A central clearing system could therefore bring benefits to the foreign exchange market, and would meet the stated objectives of the proposed legislation. However, there are some concerns associated with the standardization of contracts and the requirement for margin to be posted with the counterparty. We believe these apply particularly to hedging activities for which the flexibility of customized contracts can be very useful, and for which the change in value of the hedging instrument is offset by (unrealized) gains or losses in an underlying asset or liability.

In summary, we believe there are many aspects of the proposed changes that could improve the efficiency and transparency of OTC derivatives markets. That in turn could reduce the counterparty and operational risk involved in these markets as well as the overall systemic risk to financial markets. But as we have outlined, we believe there could also be some unintended consequences that regulators should consider before implementing the rules. As with so many regulatory changes, the devil is often in the details. That is why we eagerly await the final version of these proposed changes.

3 Ivy Schmerken, "LCH.Clearnet's SwapClear IRS Volume Up 30% Year on Year," *Advanced Trading*, July 19, 2010.

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