OTC Derivatives Markets: Crises turn into Opportunities

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Crises provide impetus for change. The current financial turmoil will be no exception and while the precise way in which the structure of OTC derivatives markets will change is still evolving, the broad trends are emerging. What is clear is that the desire among regulators for safer, more transparent OTC derivatives markets and the recognition among industry participants of the need for change will push more business towards exchanges, electronic trading platforms and clearing house environments.

Driving forces

Without outside influence, the extent of change in OTC derivatives markets would probably not be as great. At the beginning of 2009, continued tightness in credit conditions and the fact that the majority of financial institutions had been significantly impacted by the crisis, gave market participants a strong financial reason for shifting business onto exchanges and into clearing houses. In a capital constrained market, conducting business on exchanges or in a clearing house environment frees up regulatory capital for, potentially more profitable, use elsewhere. Lower capital requirements remain a significant advantage of using CCPs, but credit concerns have waned with the gradual improvement in financial and economic conditions over the course of the year.

Regulators, however, continue to press for change. “Because of the help given to a number of financial institutions, regulators are trying to push as much business as possible, at least into the clearing space and potentially into the exchange space or onto electronic trading platforms,” says Ade Cordell, Director, OTC Services at NYSE Liffe. “Regulators want more visibility and transparency in the market place.”

But derivatives market participants are not waiting for the end results of this regulatory push. Ahead of any mandated solutions, market participants have already made commitments to strengthen the infrastructure of the OTC market to the key regulators – principally the New York Federal Reserve, but also the European Commission and the FSA. Market participants will look at, in future, putting more business into a clearing house environment across a range of asset classes and have defined the asset classes on which they will concentrate their efforts. A commitment has also been made to look at the possibility for greater automation in the OTC space. “It’s an acknowledgement to the regulators that some changes are needed,” says Cordell. Also, having recognized that reform is on the way, from an industry perspective it is preferable to be involved at an early stage in the design and implementation of change, to ensure that an optimal solution is achieved.

A firm timeline for action has been set. For example, the industry gave a commitment to the European Commission to start clearing CDS business in Europe by 31 July 2009 and most of the main dealers started to clear on that date. With clearing established in CDS, the dealer community will now look at clearing other asset classes. At the end of May LCH.Clearnet announced the planned extension of its OTC interest rate swap clearing service to the broader buy-side trading community and market participants have said they will be able to increase clearing of this asset class by the end of the year.

Beyond clearing

In addition to clearing services, market participants are extending other successful parts of OTC infrastructure to a wider range of asset classes. For example, at the height of the crisis in the wake of Lehman Brothers’ collapse, the investment bank’s exposure to the CDS market was rumoured to be as high as $400bn. The Depository Trust & Clearing Corporation (DTCC), through the information in its Trade Information Warehouse, was able to estimate the true exposure as closer to $6bn. “The DTCC has done an exceptional job with its trade information repository for the CDS market,” says Cordell. “That’s why regulators would like to see similar initiatives across other asset classes and why the industry is willing to provide them in a phased approach." A Trade Information Warehouse will be established for interest rate swaps by the end of the year, with a similar initiative to follow for equity derivatives, probably by 31 July 2010.

Market participants would prefer one global repository per asset class, to avoid the potentially higher costs of running two similar sets of infrastructure. Complications can arise, however, if different countries want large market infrastructure projects to reside within their jurisdiction. The DTCC, for example, has said that it is happy to be regulated by both the US and the European Union as a global platform with access open to all market participants. The European Commission, however, may have a preference for a repository that resides in Europe, rather than one that is US-owned and operated.

Is the customer king?

As well as meeting the needs of different regulators, new OTC market infrastructure must address the needs of different market participants, not just the dealer community. Which market participants are allowed access to the CCP is a significant issue. Under some existing market solutions only the members of the CCP, who are usually the main dealers, have access. This arrangement, however, can have adverse implications for buy-side customers.

Assume, for example, that prior to the collapse of Lehman Brothers a buyside customer had exposure to OTC derivatives and that most of that counterparty exposure was with Lehman – an exposure the customer was uncomfortable with. Moving the exposure onto a safer exchange environment by unwinding the position and taking Lehman out of the equation would have required going through one of the main dealers – one of whom was Lehman.

Now that OTC derivatives products are being cleared, it is often the dealers who still decide who is involved. The IntercontinentalExchange (ICE) service for clearing CDS, for example, handled only the main dealers' own business with each other when it launched earlier in 2009. Business between dealers and end customers remained in the OTC market and buy-side customers were therefore prevented from enjoying the benefits of the CCP model. NYSE Liffe's Bclear model, in contrast, is a service open to all market participants, which is likely to be the template for future access. Regulators are aware of the importance of the access issue for end customers and ICE will now allow buy-side participation from October 2009.

Concentration risk

The financial crisis has shown that even institutions previously considered unassailable can prove vulnerable. Some critics suggest that shifting business into a cleared environment would concentrate risk in the clearing houses, merely shifting the risk of failure away from the dealers and banks onto the CCPs.

But the collapse of a clearing house, while theoretically possible, is highly unlikely. One of the advantages of a CCP is that it neutralizes a significant amount of exposure between counterparties. A CCP's structure also includes various levels of protection: if one market participant fails its business is shared out amongst all the others, when a second fails, again its business is shared out amongst the rest. The initial margin that a clearing house collects is used to offset any potential losses. When Lehman Brothers collapsed, for example, the initial margin that LCH.Clearnet had collected was sufficient to unwind all of Lehman's business, with 60 per cent of the cash remaining available to be given back to the administrators.

"CCPs are cautious and prudent by nature," says Cordell. "Could one go under? In theory yes, but it would require the collapse of several major institutions at once. By that stage you would have a massive catastrophe on your hands and the central banks would have to be involved supporting the entire system."

Diversity of provision

Further diluting the already distant risk from concentration, the OTC derivatives markets look set to develop without one provider establishing a dominant position across a range of asset classes.

"There is potential for the OTC cleared market to grow and benefit the OTC market in general. There will be a core group of exchanges and CCPs that will do well and we believe we will be one of them," says Cordell. "Our Bclear model has been very successful in equity derivatives, LCH.Clearnet is establishing a strong position in interest rate swaps and ICE has been successful in CDS."

This diversity of provision is based on the different ways in which specific derivatives markets have evolved. In markets, such as equity derivatives, which are both an OTC product and are also traded on exchanges, the development of clearing services has not posed a significant challenge to the dealer community's franchise. In markets, such as CDS, which started and developed exclusively in the OTC market, dealers have been more sensitive about the arrival of exchanges offering cleared products in response to regulators' wishes. The result has been the emergence of consortia deals between dealers and platform providers based on a revenue sharing model – the dealers put their business into the cleared service in return for a share in the economics. The ICE CDS product, for example, follows this model.

As clearing extends into other asset classes, market participants are likely to be more comfortable with an infrastructure that does not threaten to turn OTC products into exchange traded ones. In interest rate swaps, for example, clearing resides with LCH.Clearnet, whose main business focus is the provision of clearing services rather than exchange traded products.

Future development

The pace of development of the OTC cleared derivatives market has been rapid, even before the advent of additional regulatory pressure to shift at least the clearing of OTC products onto exchanges and electronic trading platforms. The impetus from greater regulatory scrutiny and the industry's pre-emptive efforts to address concerns over safety and transparency will maintain, or even increase, the pace of market evolution.

"Primarily through regulators' desire for greater transparency I think you will see a shift, certainly in the US, of some OTC business onto exchanges and a move into a clearing house environment," says Cordell. "If products remain in the OTC market and are reported through Trade Information Warehouses there would be some increase in transparency, but perhaps not as much as the regulators would like."

The range of derivatives that can be cleared on exchange will continue to expand. CDS are cleared through ICE, LCH.Clearnet clears interest rate swaps and equity derivatives are cleared on Bclear. In commodities; Bclear, CME and ICE all have a cleared service. To capture the benefits of netting exposures that clearing offers, products need to be standardized, which remains a subject of debate between the industry and regulators. But there are a wide number of other assets that could be considered for clearing – metals, precious metals, additional agricultural commodities, even, potentially, emissions. "There is an opportunity for market participants to get more of their business cleared," says Cordell. "But also an opportunity for operators, such as NYSE Liffe, to innovate and invest in their systems to be in a position to offer the industry the infrastructure it needs."

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