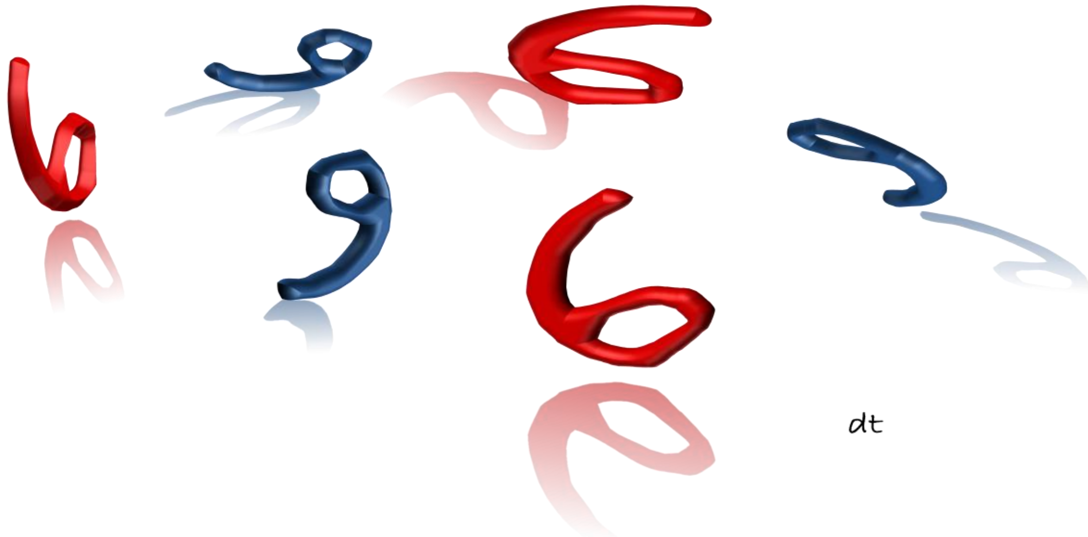
If 6 was 9....



...the trouble with OTC trades is...

A whitepaper by Dave Tolladay - Director, Alerts4 Financial Markets Ltd.

If 6 was 9 discusses the current focus on OTC trading and the direction and the implications of potential new regulation.

If 6 was 9…

If you wound the clock back two or three decades and walked around the areas that equate to the trading floor, middle and back offices of a Bank today, the differences you would notice would be staggering. Back then, trading was largely voice based or open outcry, carried out on exchange floor itself. The squawk box, telex and fax were prime means of communication. The back office contained armies of staff driving largely paper-based systems. Checking, re-checking, re-keying and reconciliation were common parts of the process. Some of the most experienced staff had developed the knack of being able to rapidly review long columns of numbers and identify the ones that were wrong in a matter of seconds – an invaluable capability. This seeming magic was often simply the trick of knowing that one of the most common forms of data input error was reversal of figures and the common symptom of it was simply differences of 9 or multiples thereof (the difference between 69 and 96 being 27 or 3x9).

Today we take for granted the inexorable move towards largely electronic trading and straight-through automated processing. And when was the last time you sent a fax? So the need for such arcane manual skills seems to have vanished. Well, that's only true up to a point. Actually, there is still a large world of voice-broked, off-exchange and over-the-counter (OTC) trading in existence, most particularly for derivatives. It is a non-standard world, which still has reliance on some manual back-office functions and some old-fashioned skills to keep it all moving. But now, even that may be about to change.

The size and geographic spread of OTC derivative trading

OTC Type	**Notional outstanding**	**Gross market values**
	(US$bn)	*(US$bn)*
Foreign Exchange	48,775	2,470
Interest Rate	437,198	15,478
Equity	6,619	879
Commodity	3,729	689
CDS	36,046	2,987
Totals	**532,367**	**22,503**
Notes:		
Notional outstanding amounts are the total values of all contracts added together.		
Gross market values are total outstanding cash between counterparties,if all contracts are 'netted out'		
Based on Bank of International Settlements data collected from G10 central banks in 2009.		

Geographically, London is the most important centre for the OTC derivatives market. It accounts for 39% of the interest rate derivatives market and 44% of the foreign exchange derivatives market. In total, the EU accounts for 66% and 60% of the same markets respectively. The US has a 24% share of the total global OTC derivatives market but, while Asia currently constitutes a relative small part, trading volumes are rising fast. In Japan, the largest market in the region, the interest rate swap market grew by 47% in the two years up to June 2009.

Why all the fuss?

While it is not true to say that derivatives alone caused the financial crisis of 2008/9, the conclusion that they played a significant part is inescapable. Most OTC derivatives – like credit defaults swaps and interest rate swaps – are traded bilaterally between banks or sold by banks to other corporate businesses as hedging tools. However, the characteristics of OTC derivative markets (the private nature of contracting, limited public information, the complex web of mutual dependencies, difficulties in understanding and quantifying the nature and level of risks) increased uncertainty at a time of market volatility. Regulators, not unnaturally, have concluded that this market poses significant risks to the overall stability of the financial system and the major players within it.

During the crisis, the difficulties experienced by Bear Stearns, Lehman Brothers and AIG had their origins outside the derivatives market. However, the involvement of all three in the OTC derivatives market, and in particular CDS contracts, spread those difficulties around the world. Lehman's involvement is perhaps the best known. They were counter-party to many OTC derivative transactions. After their sudden collapse, the unwinding of positions and successful clearing of transactions was considered to be a success, since the margins provided by different counterparties were sufficient to close out the position. However, because collateral payments provided by Lehman clients were not segregated from those of Lehman's other assets, there were some unexpected and damaging consequences.

Some financial institutions, such as hedge funds, used Lehman as a prime broker and provided it with margin and collateral payments. To reduce funding costs, these clients did not insist on the segregation of these payments. This allowed Lehman to use the collateral to fund further business activity through re-hypothecation. But as a consequence, after their collapse, some funds were unable to reclaim assets they had posted against derivatives and other trades because the collateral had been reused in the bank's other businesses, including in the UK, and was blocked in bankruptcy proceedings.

Several hedge funds suffered a liquidity crisis due to their inability to close positions entered with or through Lehman. This liquidity crisis coincided with redemptions by hedge fund investors and, as a result, hedge funds were forced to pull capital from other still healthy investment banks to meet investor redemptions. Since many of these still healthy investment banks were heavily reliant on wholesale funding, these in turn suffered a liquidity squeeze.

Politicians and regulators consider these to be unacceptable systemic risks. These linkages and interconnections in the market, created by the large number of derivatives contracts, mean that the default of one party can have far-reaching implications for the creditworthiness of its counterparties - the "domino effect". Clearly, size mattered too - the larger the counterparty, the greater effect its default causes on the market as a whole. And lack of understanding and transparency only served to further obscure the risks that were being taken.

Of course, once an area falls under the spotlight for detailed examination, further concerns often come to light. There is a growing suspicion that opaque markets such as these, are subject to various forms of market manipulation and abuse. Commodity derivatives have been especially under the spotlight of late. In the sub-text and small print of new regulation and supervision, these areas are also likely to be subject to greater scrutiny and demands for control.

Nature of the changes

While many market participants themselves think that politicians and regulators are in danger of over-regulating, it is clear that the option to do nothing has gone. Whatever the rights and wrongs, the question is now what should be done, not if something should be done at all.

During the last few months, regulators of both sides of the Atlantic have unveiled initiatives to address regulation and supervision of banks and financial markets generally and systemic risk and the OTC derivatives market in particular. Key concerns include the lack of transparency, uncertainty over firms' positions and potential over-exposure to certain asset classes, particularly credit default swaps.

The G20 leaders agreed at a summit in Pittsburgh last September that, by the end of 2012, standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms and processed through clearing houses, or central counterparties (CCPs). A clearing house stands between two parties to a trade, intervening in case of default to ensure the transaction process. Contracts would also be recorded in trade repositories.

The US response – the Dodd-Frank Act

Created at speed and passed into law on 21st July 2010 the Act runs to over 2,300 pages and affects almost every aspect of the U.S. financial services industry. The political objective is to restore public confidence in the financial system, prevent another financial crisis, and allow any future asset bubble to be detected and deflated without causing another crisis.

The Dodd-Frank Act represents a step change in regulation of Financial Services. The Act gives U.S. authorities more funding, more information and more power. It allows US regulators significant discretionary authority to write and interpret new rules – many commentators are expecting in excess of 200 new rules to make an appearance over the coming months.

Specifically, the Act imposes a new regulatory regime on OTC derivatives, which include clearing, exchange trading and other requirements intended to increase transparency, liquidity and efficiency, and to decrease systemic risk. Currently, the CFTC are also beginning to wrestle with the definition and controls that will be required for the so-called SEFs – Swaps Execution Facilities.

The impact and effectiveness of all of this, and the success in meeting, will only be judged over the coming years, but there are many fears and questions to be answered. Will it meet the political objectives and promote stability? Will new products simply circumvent the regulations and make them irrelevant? Will the Act have unintended consequences Will the availability of credit and the ability to hedge be impaired? Will U.S. firms lose business to foreign competitors? Will the regulations stifle innovation? Downside risks include potential market dislocations, increase the cost of certain swap transactions, and adversely affect certain types of investment funds and structured finance transactions.

The EU response

The European response is running several steps behind the US, which may not be such a bad thing. The aim is to introduce more transparency to the huge OTC derivatives market, in the same way as the Dodd-Frank act.

The Commission's proposed legislation sets down rules for a system to decide which contracts need to go through clearing houses, laying down tougher governance standards for CCPs and mandating reporting of deals to trade repositories. Unlike the Dodd-Frank act, the Brussels proposals will not deal with how OTC derivatives should be traded. That will be tackled separately under a review of MiFID, which is also under way. Consultation and debate continues.

One issue is the extent to which non-financial firms, which use OTC derivatives for business hedging purposes – such as managing exposure to interest rate and foreign exchange price fluctuations – should be caught by the new rules. A draft of the proposal largely exempts them from the clearing obligation, unless their business has "systemic" implications – mirroring a similar exemption in the US legislation.

Another issue is whether clearing houses, which are set to become more systemically important as they handle a new wave of OTC derivatives, should be given access to central bank liquidity in times of crisis. A draft circulating last week stipulated that clearing houses "must have access" to central banks.

Key EU recommendations include:

- Standardisation
  The EU regards increased standardisation as a "core building block" in its proposals as it is a prerequisite for other actions. It is hoped that it will increase operational efficiency, transparency and the number of products eligible for central clearing.

- Centralised clearing
  CCP clearing is intended to be the main tool to manage counterparty risk, with the CCPs ensuring high standards of risk management. The Commission intends to make it mandatory

to clear standardised derivatives through CCPs. The Communication does recognise that central clearing is not suitable for all derivatives products however.

- Supervision and Authorisation
  Decisions are still to be made about the supervision and authorisation of EU CCPs and the recognition of third country CCPs. ESMA will be responsible for the authorisation, and possibly supervision, of CCPs. New European Securities and Markets Authority (ESMA) should be responsible for the supervision and authorisation of repositories.

- Reporting
  It will become mandatory to report all OTC transactions to trade repositories. . Through reporting of trades either through CCPs (for centrally cleared products) or trade repositories, Commission legislation will ensure supervisors will have a complete picture of the derivatives market as all derivatives contracts will be reported.

- Collateralisation
  Firms to provide initial margin and variation margin on bilateral contracts and to increase collateralisation of products that are not centrally cleared. These requirements would provide an incentive to engage in central clearing.

- Capital charges
  Proposed adjustments to the Capital Requirements Directive will widen the difference between capital charges on centrally cleared and bilaterally cleared products again providing an incentive for the development of central clearing.

The participants response

There has been reaction across the spectrum. Exchanges and Clearing Houses naturally seek to capitalise on a new business opportunity.

> *"Exchange trading and central counterparty clearing have an important role to play in enhancing transparency, managing risk, protecting market integrity and defending against market abuse, and in mitigating systemic risk. We believe that as exchange and clearing-house operators, we can make a significant contribution to these efforts."*
>
> TMX Group – Toronto

OTC Derivatives market participants themselves have deeper concerns.

> *"In view of current industry initiatives to reduce the risk of bilaterally executed OTC transactions, a regulatory mandate does not seem either advisable or necessary, certainly at this stage," "The risks of unintended market consequences are all too obvious. The advantages of trading on-exchange are well known, but product diversity is critically important if the risk-management capabilities of end-users are not just to be sustained, but actually enhanced. After all, the need to enhance risk management capability was one of the key lessons of the crisis."*
>
> Anthony Belchambers - Chief Executive, FOA.

While standardisation may have some benefits, they believe that it is also important to acknowledge the inherently bespoke nature of derivatives contracts. The end-users of the derivatives contracts can often be non-financial companies that are seeking to mitigate specific risks. This cannot be achieved if all contracts become so standardised that they no longer fully achieve the risk management objective. Customised OTC products are important for a corporate's ability to hedge, which, in turn, reduces overall systemic risk. The overwhelming response to consultation with the market participants is that OTC products should be standardised only when driven by market needs

Losing product flexibility, while incurring additional costs from adopting new standards and processes, is thought likely to create further barriers to entry for customers and participants think that there may be better ways than simply rush to standardising all products and mandating exchange trading to reduce systemic risk.

Many investors also continue to favour OTC and voice trading over electronic or organised trading venues. In a recent survey 29% cited, as the main reason, the ability to trade in large volume; 18% noted access to liquidity as the dominant reason; and 11% said that they would choose to trade OTC and voice in time of increased volatility.

How far these concerns will be listened to and how severe the extent of restrictions and the speed of implementation remain to be seen but the general regulatory direction is clear. The implications for OTC derivatives operations are significant and will inevitably involve considerable change and cost.

Practical problems and solutions

Without trying to second guess the details of new regulations, there are some things that can be predicted. Even where OTC trading continues, clearer processes and more stringent, accurate reporting will be required in shorter time-scales. In addition, regulators are increasingly concerned about overall 'positions' becoming more transparent and potentially limited, not only to help in management of risk, but also to counter concerns about market manipulation, particularly in commodity and derivatives markets.

Several practical issues face many firms:

- Classification of the trades – new coding standards are being implemented to facilitate the new and better reporting of OTC derivatives, but many organisations will have quite a way to go to achieve consistent classifications across all internal systems for type of trade and client.
- Because trades are not executed electronically, the accuracy of time-stamping, of when a trade is done, when it's recorded, when it's reported or published are rarely completely accurate and can be a stumbling block to improved reporting and controls.
- Errors – errors on data input are a consistent problem and an error rate of up to 30% is not uncommon.
- Comparative data – the bespoke nature of some transactions makes it extremely hard to find the type of comparative data that is needed to check pricing.

To these practical issues can be added the more general challenges:

- The existence of a predictable workflow and demonstrable controls
- Flexibility to be able to adapt processes, systems and controls – the cost of change could end up pricing some participants out of some areas and product types all together.

And finally, the ability to get an up-to-date near real-time view of what is happening will become ever more important. Closer monitoring, not forced by Market Abuse compliance, will be needed, for risk management. Regulators are increasingly expecting market participants to be responsible 'gatekeepers' and ensure they have senior management overview of all of their trading. This implies senior management operational monitoring capabilities above and beyond some of the existing risks metrics and historical management information currently produced.

Clearly, there are a number of serious challenges to come which will not be addressed over-night, however, the time to start work is surely now. Until these problems are solved and the new processes and solutions in place, it just might be that there is still a need for some of those old fashioned skills that to help spot when a 6 was really supposed to be 9.

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About us

Alerts4 Financial Markets are experienced consultants and particular specialists in market surveillance and compliance. We are an SME partner with Progress Software Corporation in the delivery of real-time surveillance and monitoring solutions. If you are considering monitoring challenges at this moment and you are interested in having a discussion about where we could help, please contact us.

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