TRANSACTION SERVICES

FINANCIAL TIMES **SPECIAL REPORT** | Tuesday September 20 2011

www.ft.com/transaction-services-2011 | twitter.com/ftreports

China is emerging as a force

As the industry gets to grips with a fresh set of reforms, **Jeremy Grant** and **Sharlene Goff** look at the implications

As delegates from the world's payments, custodial, asset servicing and post-trade industries attend this year's Sibos conference in Toronto, the memory of the turmoil of 2008 is fading.

But that has been replaced by fresh uncertainties, as a blizzard of regulatory reform bears down on the sector.

For banks, opportunities to expand in areas such as trade finance – and their increased appetite for less risky types of business – have been somewhat dimmed by the prospect of much larger capital requirements.

Bankers and industry groups have spent much of this year attempting to convince the Basel Committee on Banking Supervision that new capital rules could undermine cross-border trade by making finance much more expensive.

There is a growing consensus that their lobbying has paid off, and that the package of Basel III reforms announced a year ago will be watered down for some crucial transaction banking activities.

But providers remain concerned that uncertainties are making it harder to develop their businesses.

And as banks increasingly move away from riskier investment banking activities, which have come under pressure from extreme volatility in markets as well as much larger capital requirements, they are keen to beef up their transaction services divisions.

In Britain, where the government is relying on exports to reinvigorate the economy, the two state-backed banks – Royal Bank

Continued on Page 3

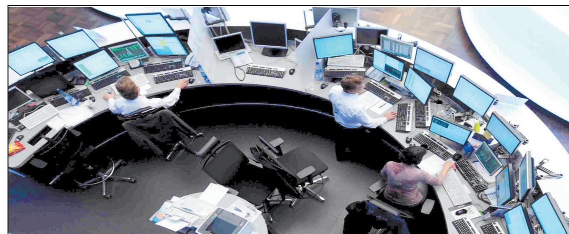
Financial Markets series

IN THIS ISSUE

International banks look east
CHINA Rapidly growing demand from Chinese companies to trade and invest overseas could give global institutions opportunities to forge lucrative partnerships with Chinese ones **Page 4**

The renminbi rides abroad
CURRENCY CONTROLS Increased liquidity from China, as restrictions are lifted, is expected to relieve inflationary pressures in other economies **Page 4**

Depositories unsettled by change
TRADE SETTLEMENT The T2S project to create a Europe-wide platform for all securities is causing unease in some quarters **Page 6**



Not stellar but steady
TRADE FINANCE Fears of a repressive regulatory regime abate **Page 7**

Policymakers get down to detail
Clearing: there are worries about changes to the rules for central counterparties
Page 8

Chris Dodd (left) and Barney Frank headlined an overhaul of US regulation

Front page illustration: MEESON

Contributors

Jeremy Grant
Editor, FT Trading Room

Sharlene Goff
Retail Banking Correspondent

Brooke Masters
Chief Regulation Correspondent

Ursula Milton
Commissioning Editor

Steven Bird
Designer

Andy Mears
Picture Editor

For advertising details, contact **Ceri Williams** on +44 (0)20 7873 6321, fax + 44 (0)20 7873 4296, e-mail: ceri.williams@ft.com, or your usual Financial Times representative

All FT Reports are available on FT.com. **www.ft.com/reports**
Follow us on twitter at **www.twitter.com/ ft. reports**
All editorial content in this supplement is produced by the FT

Bernard Madoff enters court. New rules for fund custodians are designed to prevent a repeat of his fraudulent scheme Reuters

Industry worries about the impact of new rules

Regulation

Legal obligations, liquidity and capital requirements will become more stringent, writes **Brooke Masters**

Global regulatory efforts to make banks safer and more responsible could drive up the price of some basic transaction services, bankers and consultants have warned. These include payments processing and securities custody.

Some institutions may quit those businesses entirely.

The Basel III reform package agreed by international regulators last year requires banks to hold more and better quality capital in case of losses.

It also includes the first international liquidity rules that will oblige groups to hold enough cash and easy-to-sell assets to survive a 30-day market crisis.

US and European regulators are also enacting local regulations that will raise costs and could hit profits.

The reforms weigh hardest on the riskiest endeavours of the banking industry: proprietary trading (on a bank's own account, rather than for customers) and securitisation (packaging and reselling debt). However, even plain vanilla fee-for-service business lines may feel the pinch.

David Sayer, global head of retail banking at KPMG, says that higher costs will change the commercial reality of transaction banking, in part because of additional regulatory requirements. "The challenge in a competitive market will be to pass those costs on to customers."

Payment services is a particular area of concern, because it is relatively low-margin and requires a lot of intraday liquidity.

This has become far more important and expensive because of the Basel III requirements. Banks will either have to charge more for payments processing and see their profits shrink, or turn to outside providers and save their liquid assets for other businesses.

Paul Styles of ACI Worldwide, a payments software provider, says: "You could see a number of banks pulling out of the payments business because it is just too expensive. It's still early days. This is a general concern for banks.

"Whether that concern will escalate sufficiently for banks to pull out of payment services entirely is not clear. The potential is there."

But Mark Garvin, chairman of JPMorgan's international treasury and securities services business, is optimistic that regulators will make changes where needed.

Global regulators are collecting information on liquidity stocks as part of an observational period before the rules take effect in 2015.

"The observation period is long enough to allow policymakers to assess the impact and adjust as necessary," he says.

Also, the profitability of custodial services could be threatened by rules designed to prevent a repeat of the Bernard Madoff fraud scheme.

> 'Whether concern will escalate sufficiently for banks to pull out of payment services entirely is not clear'

In that scandal, banks such as UBS and HSBC were hired to serve as custodians for funds that sent money to Mr Madoff, but they delegated their responsibility to safeguard assets back to Mr Madoff.

When he turned out to be a fraud, the fund clients filed suit both in the US and in Europe. The EU's new directive for alternative investment managers increases the legal onus on custodians by holding them more responsible for their subcontractors.

Trade finance businesses could also be at risk, under the current version of the Basel III capital rules.

These effectively increase capital requirements fivefold by assigning trade lending the same risk weight as other corporate lending.

Banks have been arguing that the higher risk-weight makes no sense, given the short-term nature of the loans and the history of low loss rates.

Many of them are now optimistic the capital rules will be eased, but regulators have not publicly said this will happen.

Even if the rules for wider transaction services are eased, banks may find their ability to make profits in this area constrained.

That is because they tend to be businesses that require frequent upgrades to systems and security.

Many banks will have less to invest, because they will need to retain profits to build up capital to meet the Basel III requirements for their other businesses.

"The transaction business is not a balance-sheet heavy business, but it needs technology and constant investment.

"Some banks that have to raise capital [because of Basel III] will be tempted to reduce the pace of investment and some may choose to make a strategic decision to focus elsewhere," says Mr Garvin.

China emerges as a force in the trade servicing business

Continued from Page 1

of Scotland and Lloyds Banking Group – have both revealed plans to expand in trade finance and other areas of transaction services.

RBS, which derives about 12 per cent of group revenue from its global transaction services arm, hopes to double this in five years.

Other European banks, including Deutsche Bank, are planning to step up their efforts in these areas, attracted by the stable income streams and the recovery in international trade and investment.

Strong growth is evident in Asia, as banks there move to strengthen their presence in areas such as cash management, trade finance and securities.

Big market participants, such as JPMorgan and State Street in the US and HSBC and Standard Chartered in the UK, are benefiting from rising trade volumes in Asia. But they are increasingly having to offer lower prices to compete with Asian rivals.

While they believe the opening of the Chinese currency markets will exacerbate this trend, they also see opportunities to partner with new competitors, particularly Chinese lenders.

International banks say that China's domestic lenders are increasingly seeking to offer clients a foothold overseas, but are unable to give them access to a worldwide network, which can cost billions of dollars to build and maintain.

None the less, China is emerging as a force in the payments and securities servicing business, with its biggest banks muscling in on western rivals.

The renminbi's gradual move towards convertibility could have significant implications for banks; already, 7 per cent of the value of China's international trade is being settled in the renminbi, rather than in US dollars, according to Swift, the payments services group that has organised Sibos.

At the same time, technology is helping reduce complexity by automating processes, reducing settlement and reputation risks. "E-invoicing" is taking off.

In parallel, other parts of the financial "plumbing" – trade compression, matching and confirmation, clearing and settlement – are gearing up for the implementation of G20 regulatory reforms enshrined in the Dodd-Frank Act in the US and the European Market Infrastructure Regulation (Emir) and revised Markets in Financial Instruments Directive (Mifid), in the European Union.

Aite, a consultancy, says one area – trade reconciliation – is returning to growth after a downturn in spending because of the credit crisis. Vendors are trying to adapt to an evolving marketplace.

Aite also estimates that spending on reconciliation will reach $520m a year by 2014.

As Swift notes: "Much of the responsibility for ensuring market safety and better risk controls post the financial crisis is being placed on the shoulders of the market infrastructures – the central securities depositories, the trade repositories and the clearing houses that are being relied upon to inject greater robustness and risk management into post-trade processing across all asset classes."

At the same time, reforms that require the shifting of over-the-counter (OTC) derivative trading on to formal platforms – such as "swap execution facilities" – and the move into clearing, will produce a surge in the amount of data being handled and a need for improved risk management.

Last month, a company called AcadiaSoft launched a web portal that allows market participants to receive, send and confirm margin calls, as an alternative to the current widely-used practice of using e-mail, fax and phone.

Tabb Group, a consultancy, estimates that implementation of OTC reform will cause data levels to surge by 400 per cent above current levels because of electronic trading, clearing, reporting, risk management and other processes.

Kevin McPartland, head of fixed income research at Tabb, says: "He or she who holds the data, and knows what to do with it, will hold the power. Just like equities, futures and options before them, OTC derivative market winners and losers will be determined by the strength and intelligence of their technology infrastructure."

> 'Much responsibility for market safety and risk after the crisis is being placed on market infrastructures'

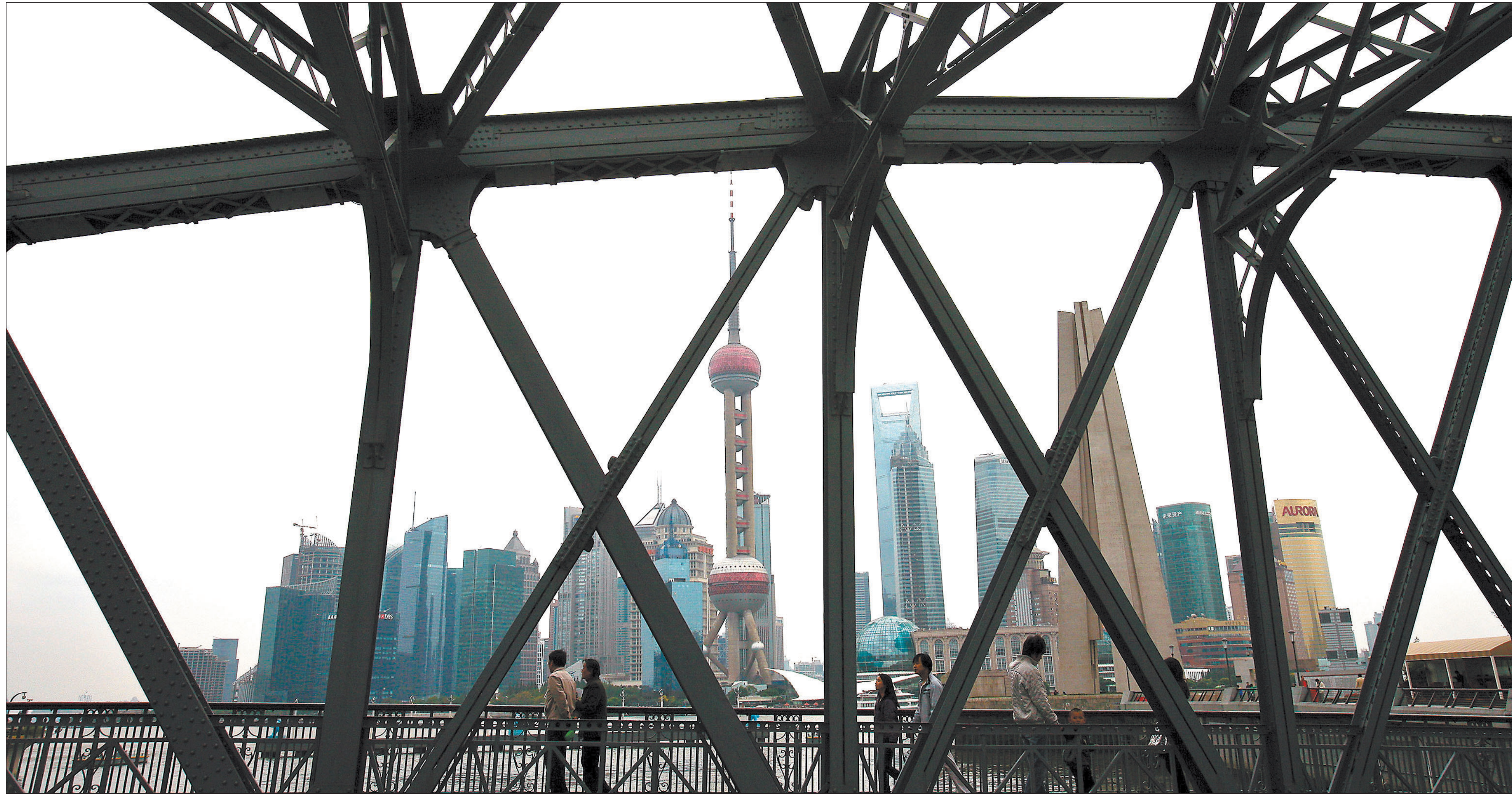
To what extent are market participants making the necessary investments to comply?

The move to central clearing of OTC derivatives – a key requirement of Dodd-Frank and Emir – has led to questions over the robustness of clearing houses, or central counterparties (CCPs), as well as a new burden in the form of widespread data reporting to "trade repositories".

Neil Vernon, development director at Gresham Computing, a banking software company, says: "For the instruments that are well understood, where best practice exists and standards are emerging or defined, the market infrastructures are ready to take on the task of providing confirmation and central counterparty clearing.

"Where the instruments are more innovative, less well understood, traded by fewer market participants, there appears to be some reluctance on behalf of the participants to determine best practice and appropriate standards."

Transaction Services



Rapidly growing demand from Chinese companies to trade and invest overseas could give global banks opportunities to forge lucrative partnerships with Chinese ones AP

Increased trade lifts banks' profile

China

High entry barriers may limit their global role at first, says **Sharlene Goff**

The increased presence of Chinese lenders at high-profile transaction banking events indicates their ambition to burst into a business that has long been dominated by a handful of big international groups.

Driven by the loosening of restrictions on China's currency – the renminbi – and a growing recognition of the resilience of areas such as cash management, custody and settlement, big Chinese banks are keen to build up their businesses.

But while the additional competition is squeezing pricing for banks such as JPMorgan, Citigroup and State Street in the US and HSBC and Standard Chartered in Britain, it is also bringing opportunities for big operators.

International banks say rapidly growing demand from Chinese companies to trade and invest overseas provides them with an opportunity to forge lucrative partnerships.

Karen Fawcett, group head of transaction banking at Standard Chartered, says domestic Chinese banks have been "strategic and aggressive" in their support of national enterprises that are venturing abroad.

"Banks in China compete well in their ability to facilitate international trade and investment for Chinese enterprises," she says.

However she believes their activities compliment rather than threaten Standard Chartered's business.

"Although Chinese multinational companies often rely on a domestic bank to establish an initial foothold overseas, this is frequently followed with subsequent engagements with an international bank for more comprehensive cross-border services," she says.

This reflects one of the significant constraints to Chinese and other Asian banks as they look to expand their transaction services divisions.

While they have built powerful cash management, custody and trade businesses at home – and which overseas banks cannot rival – they do not have the global networks to fully support businesses in their quest to expand overseas.

"Chinese and other Asian banks have been growing in various areas but are not yet global custodians," says John Coverdale head of global transaction banking at HSBC.

"They tend to play more of a regional game."

While Chinese banks have huge scale in their home markets, international rivals say it is essential to have an established global network and sophisticated systems in order to offer cross-border transaction services.

They are also quick to point out that businesses such as cash management, custody and securities require high capital expenditure.

Put simply, the barriers to entry can be prohibitively high for local Chinese banks to move overseas.

"Scale is important when the technology investment is so high," says Mr Coverdale. "And with the regulatory environment, if anything the barriers are going to go up higher."

Citi's global transaction services unit, for example, spent $1bn on technology last year.

"It is hard for single country providers to invest like that," says David Russell, Asia head of Citi's securities and fund services.

He says that while Chinese banks can offer basic offshore services for local asset managers, they need to be able to tap into a bigger and broader network. But he does not underestimate their potential to bulk up their offshore business, particularly as currency markets open up.

Mr Russell, too, believes there are opportunities to link up.

"They are capable of moving aggressively into the offshore space as competitors – but also as partners and clients," he says.

> '[Chinese banks] could move aggressively into offshore business as competitors but also as partners and clients'

Bankers also expect the landscape to change, as China's currency becomes more widely used (*see article above*).

They say this will unlock the potential of domestic companies to trade and invest offshore and Chinese banks will want to be there to support them.

They also note that while increased competition has brought pricing pressures to some parts of their business, the expansion of the renminbi also brings benefits for global banks.

"The rapid and significant expansion of business opportunities, such as the internationalisation of the [renminbi], offer potential revenue growth," says Ms Fawcett.

The renminbi rides abroad A crucial step as Chinese companies seek to expand

China's efforts to internationalise its currency have accelerated in the past year and restrictions are now being lifted much faster than forecast.

The country is keen to encourage an offshore renminbi market both in Hong Kong and in London, while central banks in other emerging markets – such as Nigeria – plan to diversify their foreign reserves into the currency.

Arvind Subramanian, a senior fellow at the Peterson Institute for International Economics, recently wrote in the Financial Times that the renminbi could even displace the dollar as the premier reserve currency in the next decade.

This expansion is crucial for international trade, as Chinese companies are keen to expand into overseas markets.

Experts say the volumes of trades settled in the renminbi outside China are still small but are growing rapidly.

Some banks have seen their volumes of renminbi-denominated trades more than triple in the past year.

China is seen as an important trading partner by emerging markets in Africa and Latin America as well as Europe and the US.

Being able to trade in the domestic currency reduces costs and helps mitigate risks for exporters. Liquidity from China is also expected to relieve inflationary pressures in other economies.

Sharlene Goff

Let us show you why one fifth of the world's assets are trusted to us.

Who's helping you?

At BNY Mellon, asset servicing is our primary business. As the global leader, we attract the best people in the industry — experts with a passion for superior service and the experience to address the challenges you're facing now. Armed with industry-leading technology and insights on today's issues, our team works with you to address the impact of global regulatory changes, margin pressures, and the need for better transparency and risk management, all with an eye on your continued growth.

BNY MELLON
ASSET SERVICING

bnymellon.com/assetservicing

BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation. Products and services are provided in various countries by subsidiaries, affiliates, and joint ventures of The Bank of New York Mellon Corporation, including The Bank of New York Mellon, and in some instances by third party providers. Each is authorised and regulated as required within each jurisdiction. Products and services may be provided under various brand names, including BNY Mellon. This document and information contained herein is for general information and reference purposes only and does not constitute legal, tax, accounting or other professional advice nor is it an offer or solicitation of securities or services or an endorsement thereof in any jurisdiction or in any circumstance that is otherwise unlawful or not authorised. Statistics pertaining to assets under custody worldwide are as of February 2011 by globalcustody.net.
©2011 The Bank of New York Mellon Corporation. All rights reserved.

Depositories unsettled by big changes

T2S settlement

The project to create a Europe-wide platform for all securities is causing some unease, reports **Jeremy Grant**

With so much attention on the sweeping changes to equity and derivatives trading and to clearing houses, it is easy to overlook the least glamorous aspect of the market structure: securities settlement.

Yet the European Union is in the midst of an overhaul of settlement – the exchange of cash for securities – which is essential to underpin trading, especially at stock exchanges.

The European Commission is working on legislation, expected next year, that would for the first time define the role of central securities depositories (CSDs). CSDs handle registration, safekeeping and settlement.

The legislation would also set out the first region-wide supervision of CSDs.

At the same time, the European Central Bank is at work on a project to harmonise settlement across the region, known as Target2Securities (T2S).

Currently, each European country carries out its own settlement, which can be expensive where cross-border transactions are involved.

By contrast, settlement in the US is handled in one place at The Depository Trust & Clearing Corporation.

The T2S project was begun in 2006 and is designed to create a single settlement platform for both domestic and cross-border securities settlement, removing the role of so-called "agent banks" that currently handle many of the complex aspects of cross-border settlement – and charge for it.

Not to be looked down upon: settlement – the exchange of cash for securities – is essential to underpin trading, especially at stock exchanges Epa

T2S will affect 30 CSDs in the 27 EU countries, which in 2009 signed a memorandum of understanding to be part of the system.

The ECB believes it will cut cross-border settlement costs in Europe by 90 per cent when it comes into operation by 2014.

This single platform for cross-border and domestic securities will settle trades in central bank money, as opposed to commercial bank money, making the region more competitive with the US.

Yet T2S has run into controversy. The plan to create a platform for Europe-wide settlement, T2S has caused unease among CSDs because it will take over the settlement function they handle for their own markets and they will lose that revenue.

Negotiations have been going on for more than a year between the ECB, which is running the T2S project, and CSDs, over a "framework agreement" to govern the relationship between the two sides.

While the "programme board" that is running the ECB side of the T2S project recently struck an optimistic note on when that agreement might be signed – suggesting that this month would be possible – it has become clear that the CSDs see it differently and that the two sides are still in disagreement on key points.

The head of one CSD says: "There are outstanding issues. We are getting closer, but we are not there yet. It's clear that we cannot sign a contract within a month."

Big unanswered questions include where the liability lies if something goes wrong with the project; its governance; who would need to compensate whom in case of termination of T2S; and technical issues, such as how long a "testing window" should be for CSDs to be connected to the system.

Reto Faber, head for financial intermediaries client sales management at Citi, says: "The combined impact of the issues is that the [target of 2014] appears increasingly ambitious."

The project – hailed by the ECB when work started in 2008 as "a major step forward in the delivery of a single integrated securities market for financial services" – has already been delayed once. Any further delay would be embarrassing for the ECB, as the project has become increasingly political.

One industry expert says: "It's got political momentum as an ECB project and there's a date written in blood [for completion] that the ECB cannot miss."

An added complication is the project's estimated €1bn ($1.37bn) cost, how that will be recovered, and at what cost to users.

Jean-Michel Godeffroy, chairman of the T2S programme board, brushes aside such concerns, saying the "migration" of CSDs to T2S would likely be done by the end of 2016.

"We have based the system on a full cost recovery and our expectation is to recover the costs by about 2022. I don't think we have a specific problem with the costs, to be honest," he says.

> Where the liability lies if something goes wrong with the project is one of the unanswered questions

Marianne Brown, chief executive of Omgeo, a post-trade services provider, said the industry would nonetheless have to prepare itself, harmonising and shortening settlement cycles from three days to two.

She suggests this must be "a pre-requisite for the successful implementation of T2S".

Meanwhile, CSDs are grappling with what the loss of settlement revenues will mean.

There is some acceptance that their role will change and that they may have to move into new services such as collateral management, asset servicing and issuer services, even though this would pit them against custodian banks already in that business.

Adriana Tanasoiu, chief executive of Depozitarul Central, the Romanian CSD, says T2S will change the business model not only for CSDs. "There is room for everybody," she says.

Fears of repressive regulatory regime abate

Trade finance

Returns are not stellar but at least they are steady, says **Sharlene Goff**

Banks around the world are rushing to expand their international trade services, as they become increasingly confident that regulators will protect these less risky activities from onerous new rules.

"We believe regulators and policymakers are listening to our concerns", says Donna Alexander, chief executive of Baft-Ifsa, the US financial services trade body. "They recognise the importance of trade finance to the global recovery and understand that it is lower risk and so deserves different treatment."

While policymakers have not given any firm signals that they will exclude the financing of international trade from tougher capital rules, there is a growing consensus that they understand how damaging this could be – particularly as western economies are relying on international trade to claw themselves out of recession.

> 'Policymakers recognise the importance of trade finance to the global recovery'

Early proposals to raise capital requirements were met with staunch resistance from the industry last year, amid fears they would severely hamper international trade.

Now, after months of lobbying, bankers are optimistic that their concerns have been acknowledged.

Trade finance is essential for companies around the world – it enables them to buy and sell goods and services to each other.

Banks provide financing and insurance for the transactions and help mitigate risk by guaranteeing payments from importers.

As the attractions of riskier activities in some areas of investment banking have dwindled since the financial crisis, many banks have looked to build up their presence in trade finance.

While it may not deliver the returns achieved by some higher risk activities, it is widely viewed as a steady revenue generator that has proved resilient during the financial crisis.

Moreover, demand has increased because companies no longer have such free access to financing from capital markets.

"As less structured types of lending become more difficult to get hold of, trade finance is more in favour," says John Ahearn, global head of trade finance at Citigroup. "A lot of European banks are moving in."

Royal Bank of Scotland, for example, has a target to double revenues from its global transaction services business, which includes trade finance, cash management and custody services, over the next five years.

"Trade is one of the core pillars of that growth," says Adnan Ghani, head of global trade finance at the state-backed bank.

Lloyds Banking Group and Deutsche Bank have also earmarked the activity for growth, while Asian lenders are beefing up their presence to take advantage of rapidly rising trade flows in and out of the fast-growing region.

With such strong growth prospects, the fear that swept through the market in response to the initial draft of the Basel III capital rules was unsurprising.

In their initial form, the proposals would have imposed rules such as requiring banks to hold a year's worth of capital against a transaction that may have taken only one or two months to go through.

Standard Chartered, one of the big international providers of trade finance, estimates that prices would increase by 20-40 per cent if the Basel III rules were implemented in their current form.

However, despite recognition from policymakers that such onerous capital rules are not appropriate for this particular banking activity, uncertainties persist.

One problem, says Ms Alexander, is that countries may adopt new rules at different times, distorting the international market.

"There needs to be harmonisation," she says. "We don't want to have different standards in different jurisdictions."

Also, while the initial fears of a sudden and large increase in prices may have been overblown, some pressure looks unavoidable.

"With all the regulatory changes, banks are now required to hold more capital, thus lowering returns on capital: as a result there is no doubt that pricing will have to go up," says Mr Ahearn. "The question is whether clients will pay more or whether banking will turn into a lower yielding business."

Already, analysts warn that return on equity from trade finance could drop from about 18-19 per cent to closer to 10-12 per cent, even if capital requirements are watered down.

The regulatory uncertainties also mean more pressing day-to-day business matters are being delayed.

"It is harder for banks to figure out returns – and whether a certain transaction will be a good deal," says Mr Ahearn.

Cargo cash: demand for trade finance has grown Bloomberg

BUILDING TOMORROW™

Make geography history

Our global network can help achieve your clients' ambitions on a world stage

As a leading provider of global transaction services, RBS offers you access to local expertise in over 35 countries. Through this and our partner bank arrangements in a further 17 countries, we're bringing your business and others around the globe closer together by energising trade and working your capital better. Our services cover Global Cash & Liquidity Management, Global Trade Finance & Supply Chain Management and Commercial Cards. Across the network and the globe, through each of the millions of transactions that we manage daily, we're helping to build tomorrow.

Visit us at Sibos on stand C114

rbs.com/sibos2011

RBS™

The Royal Bank of Scotland plc. Registered in Scotland No. 90312. Registered Office: 36 St Andrew Square, Edinburgh EH2 2YB. The Royal Bank of Scotland plc is authorised and regulated in the United Kingdom by the Financial Services Authority. The Royal Bank of Scotland N.V. is authorised by De Nederlandsche Bank and regulated by the Autoriteit Financiele Markten (AFM) for the conduct of business in the Netherlands. The Royal Bank of Scotland plc is in certain jurisdictions an authorised agent of The Royal Bank of Scotland N.V. and The Royal Bank of Scotland N.V. is in certain jurisdictions an authorised agent of The Royal Bank of Scotland plc.

Policymakers get down to the detail

Clearing

Jeremy Grant reports on worries about changes to the rules for central counterparties

Two years on from the start of a huge overhaul of financial market infrastructure, it has become a central tenet for policymakers that one way to make the financial system safer is through greater use of clearing, especially in over-the-counter (OTC) derivatives markets.

That change is enshrined in the Dodd-Frank Act on financial regulation in the US.

It is also the thrust of the European Market Infrastructure Regulation (Emir) rules being finalised in the European Union.

Dodd-Frank, for example, mandates that all clearing-eligible derivatives be processed through clearers, or central counterparties (CCPs) to help reduce risk.

The seller of a security sells to the CCP. The CCP sells to the buyer at the same time – if one party defaults the CCP can absorb the loss. It uses margin or collateral provided by the defaulting member to enable it to do this and can call on pooled resources.

This sounds relatively simple, but complications have started to arise as regulators come up with the fine print on how it should work and market participants grapple with how to adjust.

There are concerns that, if CCPs are to take on new risks – which is what clearing much more of the $600,000bn in notional outstanding value of OTC derivatives would entail – the risks they are taking on should be adequately managed.

As Craig Pirrong, professor of finance at the University of Houston, says, this is because CCPs are "important interconnectors in the financial system and thus likely to be systemically important financial institutions".

That, experts argue, means there should be adequate oversight and on a worldwide basis, since the derivatives markets they will handle are global.

No cross-border system for CCP oversight exists, although this is being worked on.

At the same time, the drive for more central clearing is already pitting the world's biggest CCPs – those operated by CME Group and IntercontinentalExchange of the US, Deutsche Börse's Eurex Clearing and LCH.Clearnet, the UK clearer – against each other.

The concern is that increased competition could lead to laxer financial thresholds and standards in the name of attracting customers to CCPs. And that this could lead to increased risk.

For these reasons, debate is raging over the ownership model and governance structure for CCPs.

The Bank of England notes that, from a risk perspective, "not-for-profit, user-owned CCPs provide strong incentives for effective risk management". Whereas for-profit companies are less able to do that, it says.

Yet Mr Pirrong points out that most CCPs were originally created by exchanges to serve their members' interests, and were not "designed as macro-prudential institutions".

Others are worried about the level of new risks moving into CCPs.

Manmohan Singh, a senior economist at the International Monetary Fund, says the OTC derivatives markets are under-collateralised by $2,000bn, meaning that banks using them may have to post more collateral than they had thought.

There are also questions about who should be allowed to be members of a CCP.

The Commodity Futures Trading Commission, the US futures regulator that is writing rules to implement Dodd-Frank, is grappling with whether to open CCP membership to a relatively wide group of financial institutions – to help spread risk – or to restrict it to the largest that would be strong enough financially to handle big defaults.

Banks that will act as intermediaries between users of derivatives – such as asset managers and companies – and the CCPs themselves are also worried about the relationships emerging between CCPs, banks and their customers.

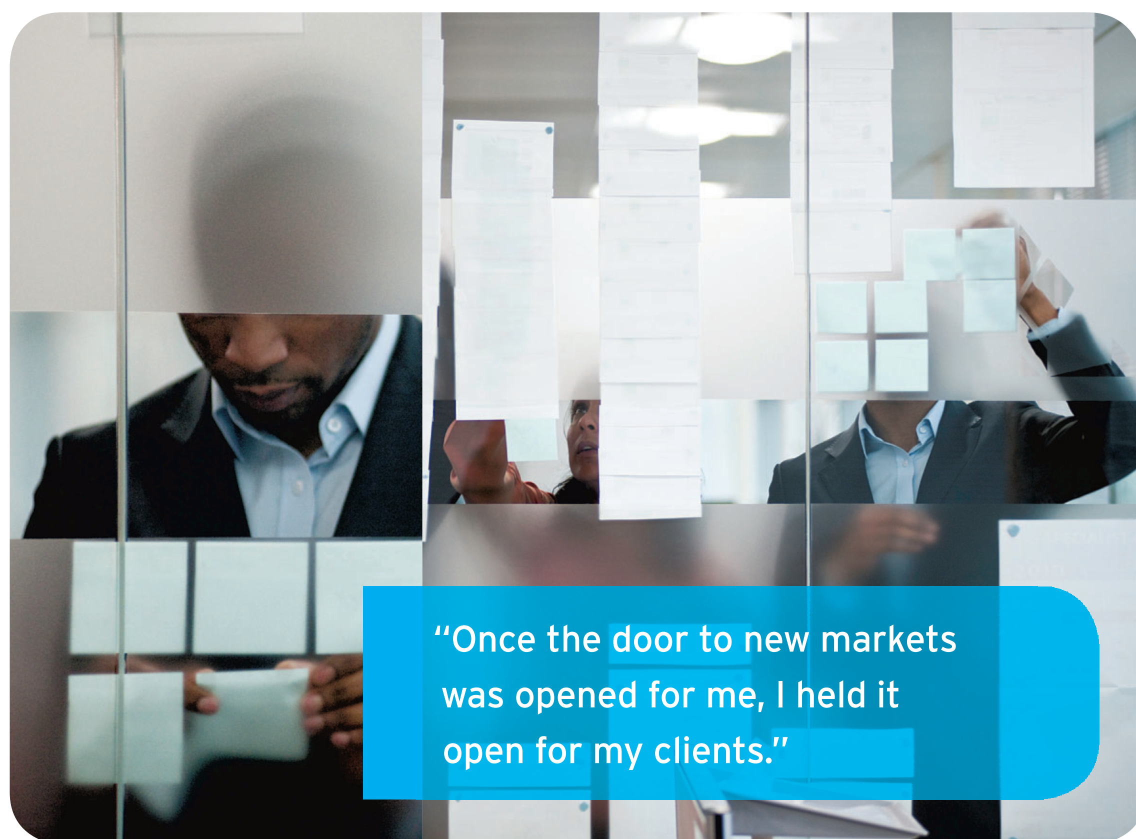
A key aspect is "guaranteed portability", an agreement between clearing members – banks, for example – to take on client portfolios cleared via another member, should one default.

While not required in law, this facility is increasingly being asked of some banks by their clients. Yet banks are uneasy, as this could expose them to what they claim would be unmeasurable risk.

JPMorgan says clearing members that sign these agreements "commit to unknown additional risk, unknown funding requirements to the clearing house, and an unknown impact on their capital measures, right at the point of extreme market stress" – such as a default.

Dale Braithwait, global head of credit clearing at the bank, says: "We believe that guaranteed portability is pro-cyclical and potentially dangerous if widely adopted . . . The problem is where to draw the line, since this is the ultimate 'wrong-way risk'."

Chris Dodd (left) and Barney Frank headlined an overhaul of US financial rules enacted in 2010



Citi's Global Transaction Services helps you and your clients realize global business ambitions.

Success in new markets requires local insight and expertise. That's why Citi's global network provides 60 proprietary Direct Custody and Clearing branches, international payments in 135 currencies and trade services across 126 cities in 73 countries. These capabilities are delivered on a consistent global platform and backed by on-the-ground advisors with years of market experience. Our long-standing commitment to the needs of financial institutions can help you and your clients increase your customer base and global presence. Find out more about how our global network, award-winning solutions and trusted advisors can give you a competitive edge at **transactionservices.citi.com**.

Please visit us at Sibos, Booth #F114 or sibos.citi.com.

Citi never sleeps®

© 2011 Citibank, N.A. All rights reserved. Citi and Arc Design and Citi Never Sleeps are registered service marks of Citigroup Inc.