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Battle lines emerge as new rules are created

Aline van Duyn reports on the heated debate about how much of the market will be regulated and where the rules will apply

Sweeping changes to the world's derivatives markets have been promised by lawmakers and regulators since the financial crisis.

Indeed, ministers representing the Group of 20 leading industrialised countries set a deadline: full implementation of reforms by the end of 2012.

There are frantic efforts afoot across the world to try and meet this deadline.

In the US, which is farthest ahead after the passing of financial reforms in July last year, regulators have already proposed hundreds of pages of new rules.

Their aim is to flesh out the parts of the Dodd-Frank Act that aim to "improve the regulation of swap and security-based swap activities".

The US itself has a deadline by which the new rules have to be written: July.

After that, it could still take two years or more to implement those regulations fully, meaning that, even in the US, it is likely that the G20 plan will slip.

Reams of new rules for privately traded swaps – the biggest part of the $600,000bn global over-the-counter derivatives markets – have been proposed by the new US derivatives cops – the Commodity Futures Trading Commission – and the Securities and Exchange Commission.

So far, however, few rules have

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Contributors

Aline van Duyn
US Markets Editor

Michael Mackenzie
US Deputy Markets Editor

David Oakley
Capital Markets Correspondent

Jeremy Grant
Editor, FT Trading Room

Telis Demos
US Markets Reporter

Ursula Milton
Commissioning Editor

Steven Bird
Designer

Andy Mears
Picture Editor

For advertising, contact:
Ceri Williams on:
++44 020 7873 6321;
fax: +44 020 7873 4296;
e-mail:
ceri.williams@ft.com
or your usual representative

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Regulatory rap: Gary Gensler (left), head of the Commodity Futures Trading Commission, with Mary Schapiro, head of the SEC
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Battle lines emerge as new rules are created

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been finalised and there are growing calls for more time to revamp the enormous and complex swaps markets, which include interest rate swaps, credit default swaps, currency, equity and commodity swaps.

There is already a push to introduce legislation to formally extend the US's July deadline for the derivatives rules to be written.

"Dodd-Frank created a whole new regulatory structure for derivatives markets and it is vitally important to our economy that regulators get this new structure and underlying rules right," says Ken Bentsen, executive vice-president for public policy and advocacy at the Securities Industry and Financial Markets Association, an industry lobby group.

He adds: "While we remain committed to fully implementing the derivatives provisions in the act, we believe the July deadline does not provide time for regulators to consider the critical issues related to this new regulatory system for over-the-counter derivatives markets."

The root causes of trillions of dollars of losses in the financial crisis for investors and financial institutions around the world were unrealistic assumptions about rises in US house prices and excessive lending to people with little or no income to repay debts such as mortgages.

Yet derivatives also played a role in augmenting the scale of the crisis by increasing leverage in the financial system and enhancing the extent to which the world's biggest financial institutions are intertwined.

In particular, the collapse of Lehman Brothers and the need for a bail-out of insurance group AIG in 2008 highlighted the "counterparty" risks that buyers and sellers of private derivatives expose themselves to.

"During the financial crisis, the credit default swap market, a part of the OTC derivatives market, took centre stage as difficulties in financial markets began to intensify and the counterparty risk involved in a largely bilaterally cleared market became apparent," said an International Monetary Fund report on making OTC derivatives safer.

"Authorities had to make expensive decisions regarding Lehman Brothers and AIG based on only partially informed views of potential knock-on effects of the firms' failures."

The planned solutions to this lack of insight in the US encompass four main areas, with a similar approach expected in Europe. (*See Europe reforms article, page 6.*)

First, large parts of the markets will be pushed into clearing houses, instead of trades being settled directly between the contracting parties.

Borrowing from widely used and successful practices in equity, currency and other markets, more widespread use of such central counterparties should reduce the systemic risks from having so many bilateral contracts outstanding.

Then, if one dealer or "counterparty" defaults, the knock-on effects can theoretically be measured, handled and absorbed by clearing house members.

These clearing methods have already been adopted by many in the industry and large parts of standardised interest rate swaps, for example, are now centrally cleared.

"Central counterparties are being put forth as the way to make OTC derivatives markets safer and sounder, and to help mitigate systemic risk," said the IMF report. (*See clearing article, page 8*)

Second, there will be requirements for all trades to be reported to regulators, with data repositories being set up to track the amount of exposure accumulated in both cleared and uncleared swaps.

Third, and more controversially, there will be much more extensive requirements for public information about trading and prices, especially for cleared swaps.

Now, many swaps trades are private, with a handful of dealers and brokers dominating the business.

Many are agreed on the telephone or by e-mail, leaving few traces of prices.

In future, swaps subject to US law will have to be traded on newly-invented trading venues called "swap execution facilities", or SEFs, which will have exchange-like features (*see SEFs article, page 4*).

Large clouds of uncertainty hang over these entities, so decisions by regulators about new rules will be crucial.

"The biggest remaining issue for derivatives markets is what will constitute a SEF," says Darrell Duffie, professor at Stanford University.

"The more competition comes into the trading of derivatives, the smaller the profits for the current big traders will be. The entire food chain of the derivatives markets could get rearranged."

A last prong in the attempts to improve safety is centred on the amount of money that will have to be put up to back trades. So, supporters say, when trades go sour, there will be more protection from this collateral built into the system.

Although this may seem sensible from a systemic risk perspective, the cost of putting up more money is a concern for many derivatives users, from investors such as Pimco and BlackRock to industrial companies. Tabb Group, a research company, estimates that the additional collateral required could amount to about $2,000bn.

Andrew Feldstein, chief executive of BlueMountain Capital Management, a hedge fund, says new collateral rules will not prevent another AIG.

"But they will have an adverse impact on capital allocation, economic growth and the competitiveness of the US financial sector," he has written in the FT.

"That sounds like a bad trade. Would it not be more sensible to upgrade accounting rules and improve public disclosure of derivatives, so the market can actually spot the next AIG and price risk and allocate capital accordingly?"

Battle lines are emerging in several areas as the rules are created.

First of all, there are arguments over just how much of the derivatives world will be overseen by US regulators. Some of the debate is about the types of swaps. Already, the US Treasury has indicated it plans to exempt foreign exchange swaps. This is seen by some as a dangerous loophole.

Exemptions are also likely for some buyers of derivatives, such as companies using them to hedge fuel costs or currency fluctuations.

Lastly, there is a heated debate about the extent to which US regulations will apply to non-US financial institutions or even the foreign subsidiaries of US institutions. This issue of "extraterritoriality" is particularly important, because poor regulations in this area open the door for regulatory arbitrage.

There are still many more questions than answers. One thing is clear, however: the G20 timeline for reform looks ambitious.

The Financial Stability Board, the international body that co-ordinates global financial policy, recently said: "Many jurisdictions may not meet the G20's end-2012 deadline."

'It is vital to our economy that regulators get this new structure and underlying rules right'

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Dodd-Frank act drives tie-ups and innovation

Exchanges

Markets combine to profit from moves to regulate over-the-counter products, writes **Telis Demos**

The world's exchanges must be exhausted. It was scarcely a decade ago that many of the largest groups – including the New York Stock Exchange, the London Stock Exchange, the Chicago Mercantile Exchange – became public companies.

A few years later, a wave of consolidation began within and across national borders, as they sought scale to cut costs and fend off electronic upstarts.

Now, another wave has overtaken them, and it may be the most significant yet.

Exchanges are engaged in another round of mergers partly to take advantage of the most recent big change: in the wake of the financial crisis, there is a global effort to regulate over-the-counter (OTC) derivatives, a $600,000bn market in notional value traded annually.

"For the future of exchanges, the capacity to create new derivative possibilities is huge," says Georges Ugeux, a former exchange executive and chairman of Galileo Global Advisors, a consultancy.

"Without that, it becomes extraordinarily difficult to figure out exactly how to make money in the long run," he adds.

The most notable example is the proposed NYSE Euronext-Deutsche Börse tie-up. The two have made derivatives the core logic of their combination, with a key target the OTC market, that makes up 89 per cent of notional values, globally.

"The most volume in [the] derivatives business is OTC," said Reto Francioni, chief executive of Deutsche Börse at the initial conference laying out the deal. "And I think together we are much stronger to tackle the whole OTC market in the trading area but also in the clearing area."

In addition to creating an enormous European futures exchange on the scale of the US's own giant, the CME Group, which combined the "Merc" with the Chicago Board of Trade, it would also bring Deutsche Börse's Eurex, and its clearing and settlement businesses, closer to the US market.

Those groups could become important cogs in a new market structure that will see more derivative trades – such as credit default swaps, interest rate swaps and other products – taking place in centralised market places.

The driving force is the US Dodd-Frank reform laws, which require that standardised derivative products be centrally cleared. The Tabb Group, a research company, estimates that 90 per cent of OTC derivatives could need to be cleared in the wake of the reforms.

To be cleared safely, and in volume, many contracts will need to be simplified. The increasing cost of OTC trading will also make exchange-based products that hedge against credit, interest rate and currency risks more competitive.

Andy Nybo, a senior analyst at Tabb Group, says that notional value in the most liquid markets, such as interest-rate swaps, could easily see more trading on exchanges.

But less-liquid markets, such as credit-default swaps, or markets that trade via dealers, such as currencies, will be more challenging.

"The hard parts are figuring out clearing margins and building liquidity. Replicating the size of the market on an exchange will be a huge undertaking, especially considering that the biggest players in the world, the banks, trade in such large size they just aren't liquid," he says.

Some of the exchanges' efforts are already quite mature.

The clearing houses owned by the futures exchanges (CME and the IntercontinentalExchange) will be central to market structure. ICE launched ICE Trust, a clearing house for credit default swaps, in 2008, and leads the market in volumes.

CME Group's Clearport already serves as the clearing backbone for several credit and rate swap products, including those of CME and competitors, for example the Eris Exchange – launched by several marketmaker hedge funds.

NYSE Euronext has launched NYSE Liffe US, a futures exchange, that uses its own clearing function, New York Portfolio Clearing, to clear Treasury futures and eurodollar swaps in the same account, reducing costs for traders.

"The pot of gold at the end of the rainbow for these exchange mergers is being able to cross-margin positions across asset types," says Mr Nybo.

For now, many efforts are still modest. Nasdaq OMX has co-ownership of the International Derivatives Clearing Group, which will clear interest-rate swaps, though it has so far attracted only a small sliver of the market.

Since its launch this year, NYSE Liffe US has taken a 5 per cent market share in eurodollar futures.

The exchanges are not alone in moving to trade OTC contracts.

US regulators have also created a new category of trading venue, called a swap execution facility, or SEF (*see article below*), that will handle markets with modest volume or that are not traded electronically.

That market is expected to be dominated by interdealer brokers such as Icap, Tullett Prebon, BGC and GFI.

But innovation may be a powerful tool.

Start-up exchanges, such as Eris or Plus-DX, launched by the UK market data provider Plus Markets, have created new products. Eris's contracts are designed to replicate the cash flow of an OTC swap. Plus-DX will trade index-based swaps.

It is the opportunity – and the peril – for exchanges that no one knows yet which products will be successful.

> 'The hard part is figuring out clearing margins and building liquidity'

NYSE Euronext and Deutsche Börse say opportunities in derivatives markets are a core reason for their merger Bloomberg

Habits change in anticipation of arrival of electronic trading

Swaps trading

Michael Mackenzie predicts further wrangling over rules for swap execution facilities

Interest rate swaps in the US are about to enter the 21st century. Proposed rules should bring a surge of electronic trading and open the door for new participants, such as high frequency traders.

Currently, fewer than 5 per cent of US interest rate swaps traded between banks and their clients are executed on electronic platforms, say dealers.

Instead, a vast army of sales staff, traders and brokers rely on telephone calls and e-mails pinged across Bloomberg terminals.

Such "voice trading" will be transformed with the arrival of swap execution facilities (SEFs). While there is uncertainty as to when these rules will be finalised, the industry is already preparing for the new era.

"The main [participants], banks, interdealer brokers and 'big end' users are ready to go," says Paul Zubulake, senior analyst at Aite Group, a consultancy.

Already, habits are changing in anticipation of SEFs, with investors and dealers shifting more business to electronic trading.

While voice trading will be allowed for large so-called "block" trades and bespoke swaps, the vast majority of interest rate swaps – upwards of 80 per cent – could be executed in a purely electronic form, say some dealers.

Regulators, such as the Commodity Futures Trading Commission in the US, see electronic trading as a means to boost transparency, cut costs and aid the monitoring of exposure to risk.

The question for the over-the-counter swaps market – where trades are conducted directly between parties rather than via an exchange – is how jarring this transformation might be and what opportunities await for participants?

The migration of the most liquid and traded sectors of the OTC swaps market – those in the five- to 10-year sector – towards a market with the characteristics of the less flexible model of listed futures contracts, alarms big derivative dealers and investors.

It will eat into dealers' margins and, they say, will make it more difficult for large funds to transact big trades that do not qualify as block trades.

Many big customers and dealers contend that a futures type model is the wrong approach for OTC swaps, which trade less frequently and in much larger sizes than futures.

Isda and Sifma, the main industry lobby groups, estimate that the average size of US swaps in the five-, to 10-year sector is $75m, with a significant number of trades in excess of $200m.

By contrast, they say, 95 per cent of five-year Treasury notes futures trades are for less than $5m.

This is why many banks and large investors have criticised the request for quote (RFQ) trading protocol as currently proposed by the CFTC.

They argue that the proposed rule of sending an RFQ to at least five market participants could reduce liquidity – because trades will be harder to hedge – widening bid-offer spreads and thereby increasing transaction costs.

Analysts at Morgan Stanley say the higher costs of trading swaps under the Dodd-Frank act will push marginal transactions towards the Treasury and futures markets.

"Transaction and other frictional costs associated with margin, capital requirements and processing make cash and exchange-traded products more economically efficient," says Morgan Stanley. "This will represent a major shift in the behaviour of investors who have up until now enjoyed the fluidity of the swaps market."

While dealers and big investors are lobbying the CFTC against the futures model, others see an opportunity. "It will no longer be a market just for the big dealers," says James Cawley, chief executive of Javelin Capital Markets, a trading platform.

The use of computer algorithms or "algos" to break up large swap trades into smaller slices is seen as a likely outcome.

The idea is that once liquid swap benchmarks move to a futures style central limit order book – where orders are electronically collected and centralised by marketmakers – there is no question that high frequency trading will result.

Algo trading in swaps will probably focus on maturities of less than five years and "small" amounts of $10m or less, following the pattern seen in the electronic transformation of equities, foreign exchange and bond trading.

But, some dealers warn that opening up the swaps market so that liquidity becomes more dependent on high frequency trading and algos – as is the case with equities – increases the risk of it evaporating during periods of turmoil.

This is not stopping some dealers from preparing for an algo-driven world.

Tabb Group, a research company, says some dealers led by Credit Suisse, Deutsche Bank, Goldman Sachs and Barclays Capital are pushing ahead with greater use of algo trading.

The move is seen as dovetailing with the rise of SEFs, as more investors gravitate towards trading in and out of Treasury bonds, futures and swaps across electronic platforms.

"Dealers that do a better job of aggregating sovereign debt, rates futures and swaps will have a significant edge," says Adam Sussman, analyst at Tabb.

> 'Dealers that do a better job of aggregating debt, rates futures and swaps will have a significant edge'
> **Adam Sussman, analyst at Tabb Group**

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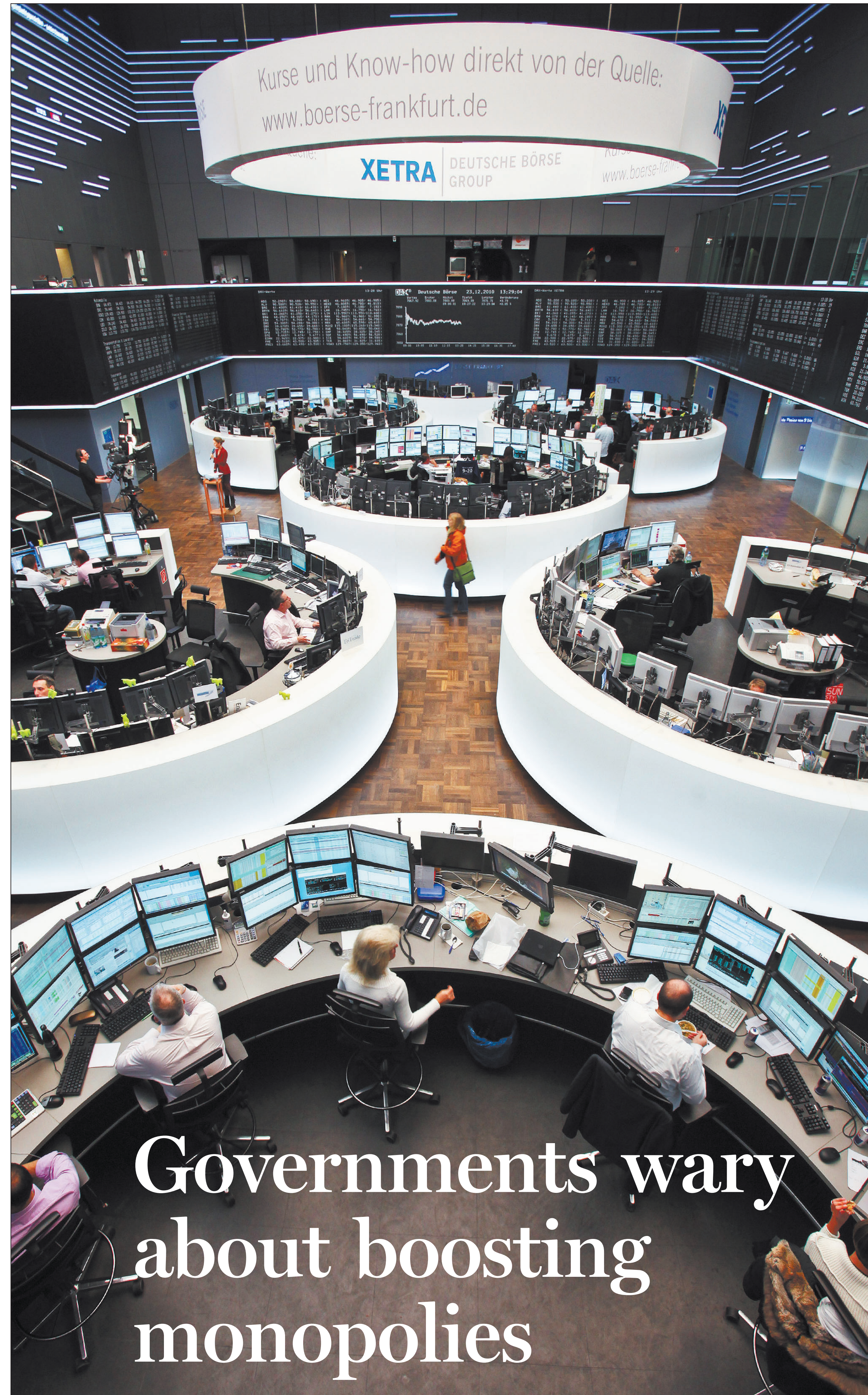


The Deutsche Börse: some worry that exchange mergers will create trading and clearing silos Hannelore Foerster

Governments wary about boosting monopolies

Reform in Europe

Regulators are taking a different route from the US, says **Jeremy Grant**

The efforts of US regulators to hammer out how to implement the Dodd-Frank act and assess the way it will change derivatives markets may have hogged the limelight, but the European Union has meanwhile been busy on reforms of its own.

Those are centred on two initiatives working their way through Brussels: the European Market Infrastructure Regulation (Emir) and the Markets in Financial Instruments Directive (Mifid).

In the US, the Dodd-Frank act mandates that standardised over-the-counter (OTC) derivatives be traded on exchanges and "swap execution facilities" (SEFs) – an as-yet undefined new type of trading platform – while OTC derivatives are also to be processed through clearing houses.

Confusingly to many outside Europe – and also to many inside – Brussels has decided to tackle these two related aspects in separate initiatives.

Emir, which emerged from the European Commission in December, mirrors Dodd-Frank with broadly similar requirements that OTC derivatives be processed through clearing houses, while their trading is being handled separately in Mifid.

Both Emir and Mifid are being worked on to slightly different timetables, involving difference processes.

But the idea is that, when completed, Europe will end up with about the same sweeping reforms to OTC derivatives markets as are being finalised in the US.

However, differences between the US and European approaches are threatening to undermine the ability of US and European regulators to ensure they end up with harmonised rules.

That is seen as important, because OTC, or bilaterally-traded, derivatives markets are far more global than their cash equities equivalents.

As in the US, Europe's approach to how to shift OTC derivatives trading on to more formal platforms is designed to increase price transparency in such markets.

Previously, contracts such as interest rate swaps and credit default swaps – the two largest OTC derivatives products by value – were negotiated privately between banks, or between banks and their customers, such as companies that use them for routine business hedging.

In the US, the Commodity Futures Trading Commission, the futures regulator, has proposed a structure for SEFs that would allow prices to be viewed by market participants in a model that is quite far removed from the current one, where dealers negotiate privately with little information reaching the public domain.

In the wake of the financial crisis, regulators have said that they want to make markets more transparent – hence the CFTC focus on a more "exchange-like" model, with prices posted widely.

Yet the Mifid draft suggests a model for Europe's version of SEFs – "organised trading facilities" (OTFs) – that is far more flexible than the US one, even suggesting that inter-dealer brokers' voice-broking models could fall into such a category.

> US and EU regulators are mindful that risk must be mitigated, not just shifted around the globe

Dealers have taken heart from this, as a sign that their model – whereby a few dealers call around to see which buyers and sellers are interested – might yet survive more or less intact.

Another area of controversy in Europe centres on clearing of derivatives – dealt with in Emir.

The CFTC in the US has proposed that clearing houses cannot set capital requirements on new members above $50m.

In Europe, where new capital levels have yet to be set, LCH.Clearnet, the continent's largest derivatives clearing house, imposes a minimum threshold 100 times higher at $5bn.

Brokers object to this imbalance. It remains to be seen what Emir will stipulate.

Jeremy Jennings-Mares, capital markets partner at law firm Morrison & Foerster, says it is not yet clear whether these and other differences "will be substantial enough to create a window of competitive advantage for EU parties".

"Both US and EU regulators are mindful that risk must be mitigated, not just shifted around the globe. But absolute convergence between the two jurisdictions looks unlikely," he says.

In addition, dealers in Europe are anxiously watching how Emir evolves around the issue of facilitating competition

While the latest draft says that any clearing house authorised to clear derivatives must accept trades from any trading venue, concerns have been raised by some – including the UK government – that OTC derivatives reform should not reinforce monopolies in the clearing business.

Such structures – known as "vertical silos" – have significant power in markets, because control over clearing, on top of trading of financial instruments, such as derivatives, makes it hard for rivals to compete.

Concern over silos is growing because the current wave of exchange mergers, including the planned merger of Deutsche Börse and NYSE Euronext, could strengthen some of the biggest silos.

Mark Hoban, financial secretary to the UK Treasury, says: "We must not allow new standards [for clearing houses], combined with a legal obligation to clear derivative products, to embed monopolies in clearing that will result in costs passing back to the wider economy."

Euro worries: Jean-Claude Trichet, European Central Bank president (left), and Fernando Teixeira dos Santos, Portugal's finance minister, at a finance meeting in May Reuters

It is not all the fault of credit default swaps

Eurozone debt crisis

Scrutiny has led to a better general understanding of the importance of CDS to hedge against risk, reports **David Oakley**

The eurozone debt crisis has turned many assumptions about the safety of government debt on its head.

It has also sparked a debate over the use of derivatives as a way of hedging risk.

Nowhere has this debate been more intense than in the world of credit derivatives – financial products that can be used to protect investors against bond defaults.

In the sovereign debt market, these derivatives have been blamed by politicians for almost bringing down whole economies. This has lead to demands for restrictions in the way they are traded.

One senior banker says: "Credit default swaps have been seen as the instruments of evil speculators, but the whole debate has got completely out of hand. They are there to protect against risk, not create it."

Now, after more than a year of arguments, investigations and soul searching by politicians and investors, an uneasy truce between policymakers and financial markets seems to have been agreed.

The European Commission and EU heads of state are expected to overrule the European Parliament, which wants to ban so-called "naked trading" of CDS – the trading of these products without owning the underlying bond.

Countries such as the UK, the Netherlands and Italy have been fiercely opposed to restrictions, fearing they would reduce liquidity in the CDS market.

This, it is argued, would lead to higher CDS prices and thus to higher bond yields, pushing up borrowing costs for the very countries, such as Greece, where politicians have been the biggest critics of the market.

One of the big turning points for CDS was an investigation by the European Commission, which found no evidence they had caused bond yields of peripheral economics such as Greece to rise.

Indeed, even the politicians most sceptical of CDS have been won round as banks and investment fund managers have made clear that one of the most important functions of the market is not to create opportunities for speculation but to hedge risk.

Banks are the main users of CDS and they have insisted that price rises have generally been in tandem with bond yields, rather than the cause of rising borrowing costs.

> 'Credit default swaps have been seen as the instruments of evil speculators but they are there to protect against risk, not create it'

In fact at the height of the eurozone crisis last year, just before the international community came to the rescue of Greece in May, bond yields at times moved ahead of CDS as worries over the country's debt levels triggered a bond sell-off.

The situation looked very different before the financial crisis of August 2007.

At the time, bankers and investors barely gave a thought to the possibility of a developed eurozone nation defaulting on its bonds. Indeed, this has not happened for more than six decades.

It has only been in the past year and a half, as the Greek crisis escalated, sparking contagion in other countries on the Europe's periphery, that the threat of default became a serious concern.

As the eurozone crisis deepened at the start of last year, politicians saw the CDS market as an easy target as they tried to shift the blame for economic problems to appease voters.

However, the increasing attacks on CDS gave rise to more scrutiny of the market and this helped turn the tide in their favour, as more politicians came to understand the way they worked.

Behind the scenes, regulators such as the UK's Financial Services Authority were important in convincing others how important CDS are for banks and the stability of the financial system.

So-called credit valuation adjustment (CVA) desks at the banks, which are responsible for hedging risk, rely heavily on CDS.

For example, a CVA desk would buy a Greek or Portuguese CDS as a way of hedging the risk of lending to Greek or Portuguese banks or companies.

Other derivatives are also used, such as recovery swaps, which allow banks to assess the amount of money they are likely to recover in a sovereign bond default.

In the case of Greece, expectations of recovery are 45 per cent of the amount invested in the assets.

Without CDS, these CVA desks might decide it was simply too risky to lend to a Greek or Portuguese bank or company, which would hit the wider economy of that country, as the financial sector would be more restricted over how much it could lend to individuals and businesses.

One senior CVA banker says: "In the end, common sense has prevailed and CDS have not been wrecked by reforms that would see liquidity and the market dry up. This is to the advantage of the whole of the eurozone, not just the banks."

The eurozone debt crisis has in a sense seen the debate on derivatives turn one full circle – they are now seen by many as essential tools for hedging risk and the stability of the financial system, rather than instruments of "evil" speculators.

Proposals could widen competition

Clearing houses

Changes aim to open up business to many more banks and financial institutions, reports Aline van Duyn

Mention the sum of $50m to anyone in the derivatives clearing business, and a strong reaction is almost inevitable.

This seemingly innocuous figure was proposed by the Commodity Futures Trading Commission (CFTC), the new overseer of large parts of previously unregulated swaps markets, as the amount of capital that members of proposed swaps clearing houses would be required to hold.

With some clearing houses now requiring a minimum capital threshold of $5bn, such a change in the rules would open the clearing business to many more banks and financial institutions.

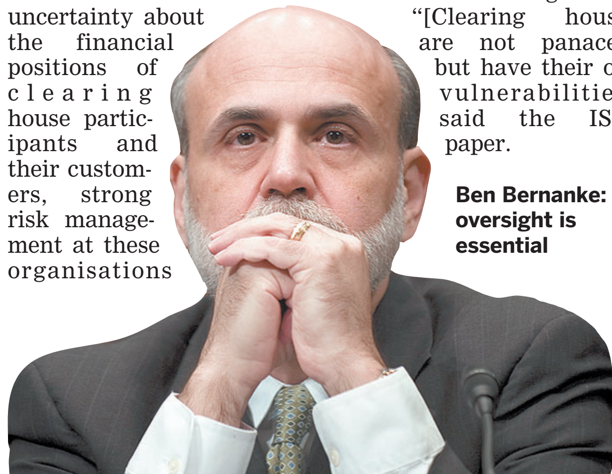
Supporters of such a move say this is exactly the point: that the privately traded $600,000bn over-the-counter derivatives markets need to be prised open to allow competition to flourish.

There are plenty of opponents to this vision, including regulators in Europe.

In a highly unusual move, the UK Financial Services Authority said in a letter to the CFTC that those requirements may increase access, but "to impose them on clearing arrangements for products that have complex or unique characteristics could lead to increased risk to the system in the short to medium term".

Ben Bernanke, chairman of the Federal Reserve, has also warned that these institutions needed to be carefully watched.

"Because the failure of – or loss of confidence in – a major clearing house would create enormous uncertainty about the financial positions of clearing house participants and their customers, strong risk management at these organisations as well as effective prudential oversight are essential," he said.



Ben Bernanke: oversight is essential

The debate over the $50m capital rule encapsulates the broader concerns that have emerged, as plans are finalised to make central clearing of many types of swaps mandatory.

Clearing has a history of reducing the risks to the broader markets of a default of one of its participants, by sharing the burden across many market participants and by requiring upfront payments or collateral against positions.

The default of Lehman Brothers and the near-default of AIG, the insurance group, brought home the fact that both of these institutions were counterparties on billions of dollars worth of derivatives contracts.

The US government bailed out AIG, in part to avoid knock-on defaults among banks that owned derivatives written by AIG.

"The financial crisis that culminated in 2008 has led to the search for new market institutions that can reduce the likelihood and severity of future crises," said a recent paper from the International Swaps and Derivatives Association, an industry trade group.

"Policymakers identified counterparty risk in OTC derivatives contracts as a major source of risk to the system, and proposed the widespread adoption of central clearing of OTC derivatives as a means of reducing that risk."

Even though clearing houses have a good record of withstanding defaults of members, there are cases when they have been brought down, most recently in 1984 in Kuala Lumpur and in 1987 in Hong Kong.

The potential for a clearing house to buckle has led to concerns that quickly pushing too many swaps into clearing houses, and also reducing risk management standards, might create situations where governments have to bail out derivatives clearing houses.

"[Clearing houses] are not panaceas, but have their own vulnerabilities," said the ISDA paper.

> The crisis has led to the search for market institutions that can reduce the likelihood of future crises

"Identifying these sources of fragility is essential to devising policies that can mitigate their adverse effects."

Charles Rauch, an analyst at Standard & Poor's, says the new regulations for swaps clearing houses will be important in determining the riskiness of these institutions.

He says several factors make it difficult to assess the risks of swaps clearing houses.

First, the performance of prices and the liquidity of markets such as credit default swaps have not been tested in the real world.

Second, encouraging too much competition might also encourage clearing houses to reduce their risk management standards to attract business.

"These factors will be crucial to the creditworthiness of swaps clearing houses," he says.

Meanwhile, debate about the rules continues. Clearing is widely accepted as the path down which derivatives markets must go, yet it is unclear what the final destination will look like.

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