FTfm OTC derivatives

New rules are struggle for industry and regulators

Overview

Post-crisis reforms have provoked a backlash and caused confusion, writes **Jeremy Grant**

More than two years into the process of dealing with a wave of regulations aimed at reshaping the over-the-counter (OTC) derivatives markets, Craig Donohue, chief executive of CME Group, recently described how he felt.

"I feel I am being waterboarded by regulation," he said, in a reference to the tough interrogation practice used by the US military in the Iraq war that sparked such controversy.

His remark will have resonance among many in the industry, which continues to face a wave of rules that are supposed to lay out how asset managers, banks, clearing houses and others are to comply with post-2008 crisis reforms such as the US Dodd-Frank act and its equivalent regulations in Europe.

Indeed this month seven associations representing exchanges, clearing houses and derivatives dealers wrote to European Union commissioner Michel Barnier, the finance minister of Denmark – current holder of the rotating presidency of the EU – and to Sharon Bowles, chair of the European Parliament's economic and monetary affairs committee, complaining of "acute challenges" associated with the phase regulators now face in drafting detailed technical rules.

In effect, more than two years into the process of implementing the G20 reforms that created Dodd-Frank, the derivatives industry is struggling to keep up with the detail. At the same time regulators – and in particular the Commodity Futures Trading Commission, the US watchdog charged with implementing vast chunks of Dodd-Frank – is also struggling with a huge workload and a budget under threat.

According to Davis Polk, a US law firm, the CFTC has passed 21 rules but has missed the deadline for approving the same number of rules that have reached proposal stage. The agency has also missed the deadline for three rules that it has yet to propose.

However, it notes that the CFTC has still done more than any other federal regulator on implementing Dodd-Frank.

In Europe, there are concerns that new supervisory authorities, such as the European Securities and Markets Authority, do not have enough time to come up with detailed technical rules on clearing, short-selling and credit default swaps without jeopardising "high quality and credible regulation".

Some of the criticism can be attributed to a general backlash against the new regulations as dealers attempt to defend their existing business models. In the US they have been emboldened by a Republican-controlled House of Representatives and hopes that the US presidential election will distract from the implementation process.

In spite of this, a clear trend is emerging: key players in the derivatives industry are moving to embrace the new market structures mandated by Dodd-Frank and, in Europe, the yet-to-be-finalised European Market Infrastructure Regulation (Emir) and Markets in Financial Instruments Directive (Mifid).

Key among them are that OTC derivatives that are "standardised" be traded on exchanges or new platforms to be established for OTC derivatives called "swap execution facilities" (SEFs), and that derivatives eligible for clearing should be processed through clearing houses or central counterparties (CCPs).

Large asset managers are starting to use clearing for their OTC derivatives transactions, and banks that are to act as brokers between derivatives users – such as the buyside – and CCPs say they are signing up customers in anticipation of clearing.

Dale Braithwait, global head of credit clearing at JPMorgan, says the adoption of clearing by large asset managers "has created a bit of a tipping point in the way other people are thinking about this".

Christopher Perkins, global head of derivatives clearing at Citi, agrees. "It's got very real for us, it's no longer ceremonial," he says, adding that Citi expects the second quarter will be "key" in terms of customers awarding the banks clearing mandates.

In the latest sign Robeco, a Dutch asset manager, this month said it had started clearing its derivatives through LCH.Clearnet, the Anglo-French clearer, saying it was "convinced that doing so will improve the mitigation of counterparty and systematic risk from bilateral collateral agreements".

One factor driving the trend is the realisation that capital requirements – both applied to banks and on the collateral that must be applied to non-clearable derivatives – are forcing asset managers and pension funds to think about clearing. The amount of capital that must be held against uncleared derivatives trades is set to go up under proposed new Basel rules on bank capital, enshrined in a legislative package known as CRD4.

That said, considerable uncertainties remain. A big concern is how the myriad rules will be applied globally. Specifically there are worries over certain extraterritoriality provisions in Dodd-Frank and "third country provisions" in Emir.

Banks, so-called buyside institutions, exchanges and clearing houses are concerned over requirements that financial services businesses in non-EU countries be recognised on the basis of their home country's "equivalence" with EU regulations – as laid out in Emir and Mifid.

Equally, it is unclear whether a non-EU bank would have to set up a branch in the EU if it wanted to become a member of a clearing house based in the region.

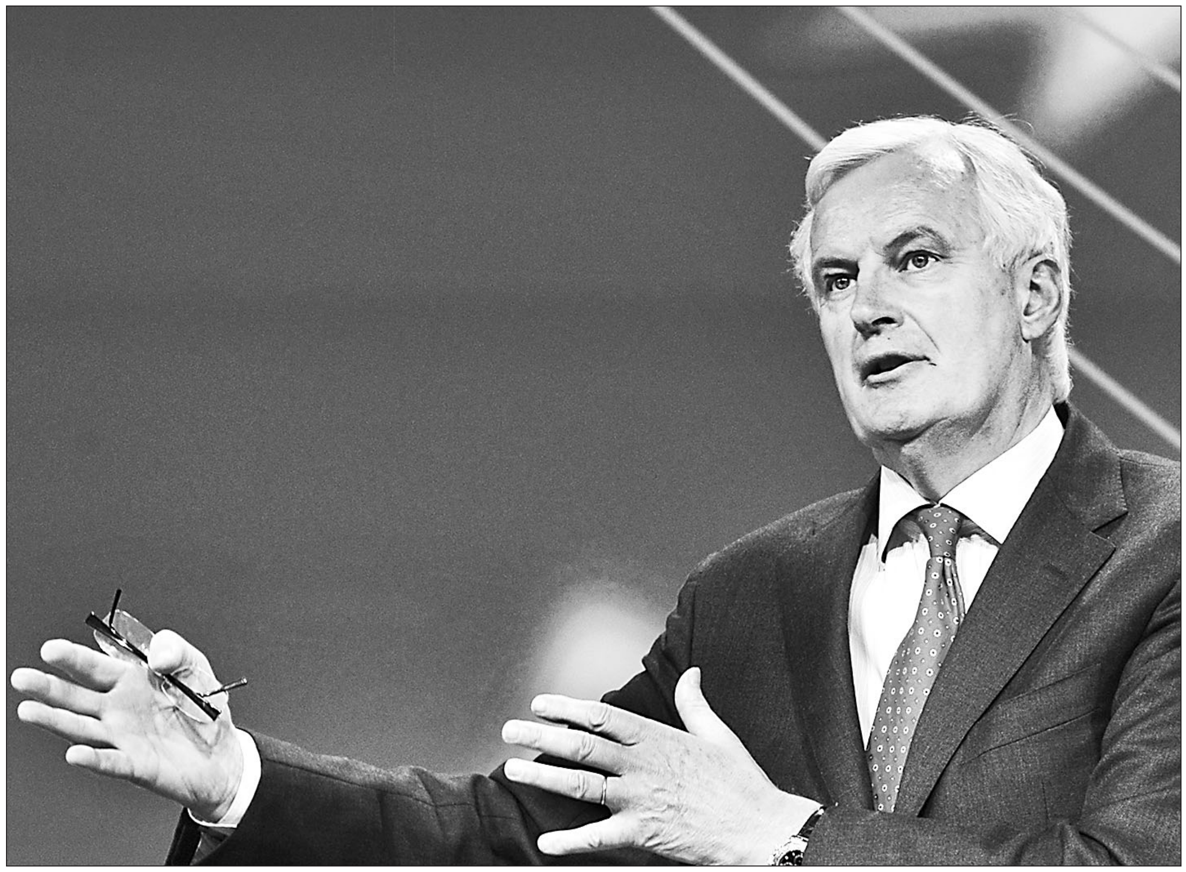
There is also confusion over how financial institutions operating globally would comply with Dodd-Frank, Emir, Mifid and legislation in Asia.

Davis Polk notes that although the CFTC's proposed swap dealer registration rule had requested comment on the extraterritorial application of the swap entity registration requirements, the CFTC did not address this "critical issue" in its final rule recently. "This leaves many internationally active swap entities in a state of uncertainty regarding the implications of swap entity registration for their global operations," Davis Polk says.

In addition the CFTC has yet to finalise how SEFs will operate. Lee Olesky, chief executive of Tradeweb Markets, operator of electronic trading platforms for fixed income and derivatives, says: "End users need to be clear on which trading platforms they are able to trade swaps on, using which protocols, following the various implementation dates. At this stage, that is not the case."

Meanwhile efforts are underway to ensure that global regulators are co-ordinating their approaches. However, the industry remains sceptical.

Rick McVey, chief executive of MarketAxess, a corporate and government bond trading platform that is, like Tradeweb, expected to register as an SEF, says: "We are still very interested in seeing consistency of rules between the US and Europe. But I don't know if it's feasible."



Under pressure: EU commissioner Michel Barnier has been told regulation is posing 'acute challenges' Getty

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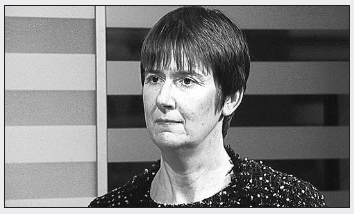

Video on FT.com

Jeremy Grant, editor of FT Trading Room, talks to Jane Lowe (above), director of markets at the Investment Management Association, about progress made on regulation in Europe. **http://video.ft.com/ft-trading-room**

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Collapse of MF Global raises question over futures model

Regulation

Michael Mackenzie on the debate over new rules to better protect client funds

Since Washington crafted landmark laws designed to regulate the vast over-the-counter derivatives market, the big worry within the industry has been any move to push it towards a futures type model.

In the wake of the global financial crisis, key players in the much smaller futures world wasted no opportunity to highlight the safety and transparency of their market versus the much larger, opaque and unregulated OTC arena.

But the demise of MF Global in late October has resulted in customers trading futures facing up to $1.2bn in losses, through no fault of their own. The collapse of MF Global and its futures commission merchant or FCM has duly focused attention on its main regulators, the US Commodity Futures Trading Commission and the CME Group, the vast Chicago futures exchange.

While inquiries into MF Global continue, the OTC industry is watching whether rules finalised under the Dodd-Frank Act over the coming months offer more protection for client funds and veer from a futures type model to one where the unique characteristics of OTC trading are recognised.

Late last month, there was some evidence that the CFTC is backing away from a prescriptive approach as it voted on real time reporting rules that seek to preserve the liquidity of the swaps market.

"No doubt the CFTC is listening to the industry and the comment letters," says an inter-dealer broker. "They are trying not to hurt liquidity."

He adds: "The centralised clearing and FCM model is not without its pitfalls and prior to MF Global it was held up as a panacea for OTC derivatives. But it didn't function the way it was supposed to do."

One clear message in the wake of MF Global is that a proposed rule that offers stronger protection for client funds via FCMs than that of the futures model in the new world of cleared OTC derivatives is likely to pass.

In futures trading, margin payments from clients are pooled into one gross omnibus account at an FCM and can be used to help offset a default by one or more clients at the clearing house. The CFTC has proposed a system for OTC derivatives called "legally segregated, operationally commingled" or LSOC.

> The industry is wary of strict rules from the CFTC that could hurt liquidity in swaps

Under this approach, margin from non-defaulting clients is protected. This has angered the CME, smaller FCMs and clearing houses as it will raise costs.

However, Richard Prager, head of global trading at BlackRock, says: "LSOC strikes the right balance." And Ray Kahn, head of OTC clearing at Barclays Capital, says: "A proposal – LSOC – that provides a higher level of protection for client funds in OTC derivatives clearing is positive."

It means FCMs will require stronger capital and better safeguards at a time when the failure of MF Global has shocked investors and eroded their trust in the futures market.

"FCMs will still play a meaningful role, however given recent risk management rules for clearing organisations, the winners will be defined by those that are best capitalised and that have the best risk processes in place," says Mr Prager.

Beyond FCMs and client funds, important rules have yet to be finalised and the industry remains wary of strict rules from the CFTC that could hurt liquidity in swaps. "Some of the most contentious rule proposals are those that will impact liquidity fragmentation the most," says Kevin McPartland, senior analyst at Tabb Group.

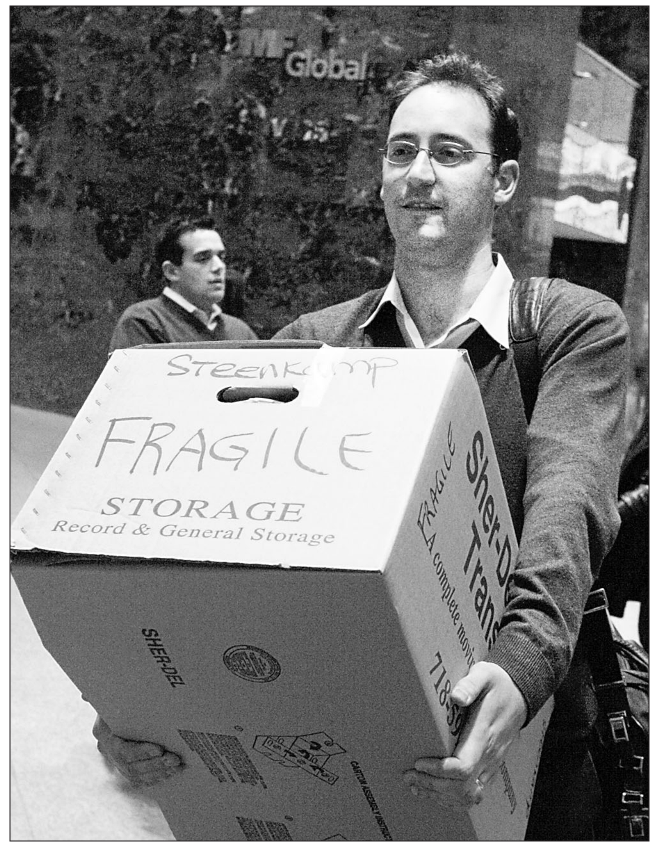
The big risk to OTC trading is the likely escalation in the costs of margin, compliance and even trading, factors that are unknown at this stage.

Mr Kahn says: "The added cost of new regulatory requirements could make trading OTC derivatives expensive, which could have an impact on liquidity in the market."

The head of trading at a major dealer says regulators should: "Let the market decide, don't prescribe. Giving people a choice in how they trade is the best approach."

He says swap traders look at how the US Treasury market trades – via a combination of electronic systems and the telephone for large orders – and wonder why OTC reform does not replicate that approach.

"Either the Treasury market is broken or regulators are trying to reinvent the wheel."



Carry trade: aftermath of the MF Global collapse Reuters

Changes bring global flurry of innovation

Technology

Central clearing will have a big impact, writes **Philip Stafford**

Gone in 1.932 seconds. That's how long it took for a group of swap market participants and CME Group, the world's largest futures exchange, to execute and clear 21 off-exchange trades totalling a notional $4.1bn last month.

It was a piece of one-upmanship typical of an industry obsessed by speed but it also encapsulated a dramatic change the industry is still feeling its way around – the impact of moving swathes of the vast $6tn over-the-counter derivatives (OTC) market on to electronic venues and through central clearing.

"Due in part to the sheer size of the market, the migration of OTC derivatives to exchange trading and central clearing will change financial relationships to the greatest extent since the electronification of equity trading in the 1980s and 1990s," says Rob Hegarty, global head of market structure at Thomson Reuters, the financial information provider.

The catalyst for the change is a mandate from the G20 group of economies in 2009, keen to strengthen the global financial system in the wake of the collapse of Lehman Brothers. Policymakers cited the opaque OTC market as a key factor exacerbating market instability. Sweeping legislation such as the Dodd-Frank act in the US and the European Markets Infrastructure Regulation, passing through European lawmakers, are designed to strengthen critical market infrastructure.

Among the changes, the Commodity Futures Trading Commission, the US regulator, has proposed that participants execute and clear OTC trades "as soon as technologically practicable".

The new rules have sparked a flurry of technology projects around the world as exchanges, banks and institutional investors build technology infrastructure capable of handling the changes. A tie-up between BM&F Bovespa and software makers Cinnober and Calypso Technologies in November was only the latest in a string of projects being undertaken by many of the world's largest exchanges.

But some argue that in one crucial respect, policymakers were pushing at an open door.

At the same time banks and institutional investors have grown to realise that understanding their risk exposure during the trading day at any moment has become an imperative rather than a luxury.

"As volatility alone can cause rapid intra-day deterioration of major counterparty credit quality, a move towards near-time or real-time clearing is inevitable anyway," said Kevin McPartland, fixed income analyst at Tabb Group, in a report last year.

It marks a radical departure for an industry that negotiated trades bilaterally between counterparties, usually investment banks. The effects could be profound.

For a start, the technology will have to manage huge amounts of complex data to calculate both initial margin and variation margin as fast as possible. Valuing an OTC credit default swap is far more complex than valuing a standard interest rate swap. Unlike exchange-traded instruments, OTC derivatives were frequently never intended for clearing and processing.

> Larger institutions have begun IT upgrades, but many smaller ones are holding back

Furthermore market participants may have to hold more funds in reserve to meet any intra-day margin calls, while clearing houses may require more capital to protect themselves. Traders of OTC derivatives, such as brokers and buyside firms, have not historically had to put up margin for clearing. Tabb estimates, as a worst case scenario, that the industry may need to come up with $2tn in capital.

"Due to the onerous membership and operational requirements tied to becoming a direct clearing member of a central counterparty, the vast majority of fund management firms will elect to clear their derivatives through general clearing members," says Marianne Brown, chief executive of Omgeo, the post-trade services group.

"The fees associated with using a clearing broker, along with the increased margin requirements from the central counterparties, will likely increase the overall cost of doing business for fund management firms."

The threat of increased costs in straitened times leads many to predict that market participants will look for ways to streamline operations that tie-up large amounts of collateral. Clearing cycles may be completed intra-day. Currently the system can take several days.

If central counterparties lower margin and collateral requirements to gain market share, Mr Hegarty warns it could raise systemic risk. It will "reduce the ability for that central counterparty to absorb a counterparty failure," he says.

But while exchanges, banks and clearing houses try to get a better view of potential risks in the financial system, there has been a mixed response from end users – institutional investors. Larger firms have begun IT upgrades, but many smaller ones are waiting for further clarification over the final rules.

"In the new clearing environment, it will become essential for fund management firms to have a near real-time consolidated view of their counterparty exposures across both their bilateral and centrally cleared portfolios," says Ms Brown.

Vision of buyside clearing fails to become reality

US

Telis Demos explains the complexities in an evolving landscape

Even in the world of complex derivatives, it is worth remembering a hoary old business tenet: the customer comes first.

Many arcane debates have raged around the core Dodd-Frank financial reform act principle that more derivatives trades should be centrally cleared, including whether smaller dealers should be allowed to participate in clearing.

Yet it is easy to forget that dealers have already been centrally clearing trades among themselves for a few years.

The same cannot be said for trades between banks and their clients, even as the final clearing rules near, with the beginning of the implementation phase expected later this year.

Though in recent months CME Group and LCH.Clearnet have cleared a number of such trades, market participants say the landscape is still evolving, and many clients of the banks are still not ready for the "big bang".

Despite the law's requirement of "fair and open access" to clearing, the initial vision of having asset managers, hedge funds and other institutions that trade risks related to commodity prices or interest rates with banks become direct clearing members has not come to fruition.

Instead, buyside firms have chosen to operate through futures clearing merchants, or FCMs, as the law also allows. BlackRock's recent trades cleared on LCH.Clearnet's SwapClear platform, for example, were via Goldman Sachs as FCM.

The primary barrier, aside from the costs of new systems and the expense of contributing to clearing houses' central funds, is that clearing houses typically ask that members step in to trades in the event of a default – a prospect now much more real after MF Global's collapse. That requires the member to have a trading desk and agree to take that principal risk, which many institutions do not want to do.

"If we were to take the current clearing house and regulatory requirements that exist today, for large asset managers that act as a fiduciary, direct membership doesn't work," says Supurna VedBrat, co-head of BlackRock's market structure and electronic trading team.

Clearing houses acknowledge this challenge. "We are talking to some on the buyside about whether they want to be members themselves," says Michael Davie, chief executive of LCH's SwapClear. "But I think that most will avail themselves of clearing services rather than provide them."

But that does not mean the buyside is leaving these choices up to dealers. As more standardised swaps begin to trade in electronic, transparent markets, with trades reported to a central marketplace, known as a swap execution facility, they are likely to rely far less on dealers.

"Discussions among the buyside have been around how can we respond to regulation, and how can we derive business benefit," says Ebbe Kjaersbo, chief business consultant at SimCorp, which provides back office services for fund managers.

On cue, new firms are popping up to serve more agile fund managers. The custodian banks BNY Mellon and State Street, for example, have launched FCMs.

"The traditional buyside/sellside dichotomy is breaking down," says Charley Cooper, senior managing director at State Street Global Markets. "In the old days, you would clear with whom you were doing the trade with. Those things are now unbundling."

Clearing houses are also competing to have buyside clients direct their FCMs to send trades to one house or another with more streamlined processes for posting margin or expanded ranges of acceptable collateral.

'I cannot emphasise how important it is that clients are comfortable that collateral is protected'

"It may be that when buyside clients clear through CME, it is a lot more capital efficient than another clearing house," says Laurent Paulhac, managing director of OTC services at CME Group.

Sanjay Kannambadi, chief executive at BNY Mellon Clearing, also cites concern about margin and collateral as an advantage that custodian banks may have over the incumbent dealers.

"The main demand to start this business came from the client side," he says. "These clients have assets with us already, and clearing is a natural extension, with efficiencies therein to help mobilise their collateral."

But there may be limits to how creative the buyside wants to be in chasing opportunities to take out costs and trade agressively.

"I cannot emphasise how important it is that clients are comfortable that collateral is protected," says Ms VedBrat of BlackRock. Or as Mr Paulhac puts it: "The buyside is not seeking to compete. Their aim is to reduce risk."

Time of their lives: as old people enjoy a special play area in Manchester, funds are getting a breather on central clearing PA

Pension funds win time to tackle Emir problems

Europe

The central clearing directive is a headache for institutions, writes **Sophia Grene**

Deferring a problem in the hope that it will go away is not usually recommended as a good way to deal with challenges, but sometimes it really does work.

The European asset management industry hopes it has found such an instance with the European markets infrastructure regulation (Emir) requirement that all over the counter derivatives be centrally cleared.

Pension funds have been given a three-year exemption, during which they hope to be able to work with European regulators to establish how to come under the regulatory framework without undue penalisation for their particular characteristics.

"The bottom line is that the process has been creeping forward at a slow pace but at each stage it's going in the right direction," says Andrew Giles, chief investment officer, solutions, at Insight Investment. Mr Giles, who spearheaded the campaign to get pension funds and their asset managers treated differently from other derivatives users, is confident the extra time will be enough to work out most of the problems the original plan would have created.

Central clearing of derivatives is intended to remove systemic risk from the network of financial institutions that rely on each other as counterparties to a huge and complex tangle of derivative trades (such as interest rate swaps, inflation hedges and other more arcane instruments). The fear is that if one large player were to go bust, it could trigger problems for all its counterparties, starting a cascade effect that might bring the global financial system to its knees.

Requiring these transactions to go through a central clearing house would mean if a financial institution defaulted, the clearing house would step in to ensure transactions with its counterparties were completed. Thus counterparties would be vulnerable only to a collapse of the clearing house itself.

Draft legislation did not make any distinction between buyside and sellside, but the asset management industry immediately began a vociferous campaign to point out that not only was it not a contributor to systemic risk, it would probably end up paying a disproportionate price for dubiously improved safety of its transactions.

"European pension funds are already pretty well protected against key risks in the market," says Phil Page, client manager at Cardano, which specialises in using derivatives to build liability driven solutions for pension funds. "UK and Dutch pension funds will have daily collateralisation with pretty high quality collateral, so it's not as if there's a massive risk if a counterparty goes bust."

'The process has been creeping forward at a slow pace but at each stage it's going in the right direction'

In fact, movement towards central clearing has meant an improvement in the quality of collateral held against derivatives, Mr Page says, as new contracts are negotiated with an eye on other market participants. The problem with the Emir plan is the level and quality of initial and variable margin that would be required.

Central clearing would require users of OTC derivatives to post initial margin when they agreed a transaction and variable margin every time the value of the derivative changed. These requirements would mean pension funds would have to hold a significant proportion of their assets in eligible instruments such as cash or low-yielding government bonds to be able to stump up the variable margin as necessary.

"We would expect it to be a drag on the long term performance of pension funds," says Mr Page.

"The initial margin is not the real problem," says Michel Lansink, senior structurer at Cardano. "The problem is the variable margin, which is supposed to be cash only."

"There's nothing in the regulation that specifically precludes what we really want, which is to allow pension funds to post government bonds as collateral," says Mr Giles. "It's just a question of the clearing houses accommodating that."

According to Mr Giles, however, there is a problem with the initial margin, namely that its level is set irrespective of the true risk brought to the system by the derivative. This means, he says, that low risk players such as pension funds would in fact subsidise higher risk entities such as hedge funds. "That's been put in the 'too-difficult-to-solve' bucket for now," he says.

Nevertheless, he is sanguine about the future. The three-year exemption, which may even be deferred further because the directive itself is already behind schedule in coming to the European Parliament, should give the industry sufficient time to sort things out.

"Permanent exemption won't work," said Mr Giles, "because liquidity [in the relevant derivatives markets] is very unlikely to be split between exchange and OTC." In other words, if the derivatives are going to be mostly traded on exchange with central clearing, pension funds cannot afford to cut themselves off from the most efficient market. They just have to make sure the terms of participation are acceptable.