All clear on the derivatives front?

How far can clearing of OTC derivatives be mandated without standardisation of the instruments themselves?

On 2 September, the Basel Committee on Banking Supervision (BCBS) and the International Organisation of Securities Commissions (Iosco) released the final framework for margin requirements for non-centrally cleared derivatives. Their statement confirmed that contrary to received wisdom, not all OTC derivatives instruments will be forced into clearing.

Four years ago, in September 2009, G20 leaders agreed in a meeting at Pittsburgh that all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, *where appropriate.* Further such contracts should be cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Those derivatives contracts for which central clearing or standardisation is not appropriate would be subject to higher capital requirements.

The overriding trend since the financial crisis, however, is that if a derivatives product can be standardised, it should be and also should be centrally cleared. A raft of regulations is pushing the market in this direction, including the US Dodd-Frank Wall →

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Street Reform and Consumer Protection Act (Dodd-Frank), CPSS-Iosco Principles for financial market infrastructures, Basel III capital reforms and the European Market Infrastructure Regulation (EMIR).

"Since the G20 meeting in Pittsburgh, many people have assumed that all derivatives will be managed into central clearing, but that was never the expectation of the G20, which realised that not everything can be cleared," says David Clark, chairman of the London-based inter-dealer broker industry body, the Wholesale Market Brokers' Association. "However, during the past four years, regulators have aimed for derivatives to be standardised and that is the direction of travel in the industry. But this won't happen overnight. It is a global work in progress."

European lag

The financial industry has been running behind on the G20's original deadline of end-2012. In the US (under section VII of the Dodd-Frank Act) the final phase-in of central clearing for interest rate swaps, forwards, options and other types of 'regular' swaps took place on 9 September this year. It is anticipated that central clearing will not be introduced into Europe, via EMIR, until at least May 2014.

In July, the European Securities and Markets Authority (ESMA) issued a discussion paper on the regulatory technical standards for central clearing of OTC derivatives in EMIR. The paper on the clearing obligation outlines ESMA's approach in determining the characteristics of OTC derivative classes that should be subject to the clearing obligation; the date(s) from which the clearing obligation takes effect, including any phase-in and the categories of counterparties to which the obligation applies; and the minimum remaining maturity of the OTC derivative contracts referred to under EMIR.

The paper also provides a high level analysis of the current readiness of derivative asset classes regarding the clearing obligation on the basis of some of the criteria that ESMA will take into account when defining the classes for central clearing. The paper sets out the standardisation, volume and liquidity of relevant classes of OTC derivatives; the availability of data related to OTC derivative markets; and the experience in clearing and the international regulatory framework.

In the meantime, standardisation efforts are continuing. In April, the International Swaps and Derivatives Association (ISDA) published confirmation features for a Market Agreed Coupon (MAC) contract. The MAC will act as an additional choice for market participants who wish to use OTC interest rate swaps that have common, pre-agreed terms. The MAC confirmation features a range of pre-set terms in such areas as start and end dates, payment dates, fixed coupons, currencies and maturities.

ISDA said the coupons in the contract are likely to be based on the three- or six-month forward curve and rounded to the nearest 25 basis point increments. Effective dates will be the third Wednesday of March, June, September and December. The initial currencies covered include the USD, EUR, GBP, JPY, CAD and AUD. Maturities will be 1, 2, 3, 5, 7, 10, 15, 20 and 30 years.

ISDA says the MAC contract will help to further improve transparency and promote liquidity in the interest rate swap market. It is also expected to improve the ability of buy-side market participants to engage in portfolio compression, which reduces notional amounts outstanding. "The Market Agreed Coupon confirmation is part of ISDA's continuing efforts to increase efficiency in the OTC derivatives markets by offering market participants the option to trade using pre-agreed contract terms," Robert Pickel, ISDA chief executive said when the contract was launched. "It follows from other efforts we have made in this area, ranging from the development of the ISDA Master in 1987 to the CDS 'Big Bang' in 2009, which brought greater standardisation to credit default swaps contracts."

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What do regulators want?

John Wilson, global head of OTC clearing at agency broker Newedge, says there is a strong desire on the part of financial regulators to stop the use of highly customised derivatives that are difficult to price or understand. "Regulators want the industry to use more standardised products, and will use financial incentives to get people to conform to the use of standardised derivatives," he says.

But is standardisation of derivatives instruments necessarily a bad thing? The answer, like the derivatives industry itself, is far from clear-cut. Clark says the lifecycle of an OTC derivative product typically begins with a highly customised instrument that is not →

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standardised. But the more widely traded and more liquid it becomes, the more standardised it is likely to be. However, there will always be those who "think outside the box" and develop instruments that are not suitable for standardisation. "Standardisation is a function of the client base and the products themselves. There will always be an underlying flow towards getting instruments into clearing, which is what everyone wants, but a new product that will not be standardised is always likely to come down the line," he says. The OTC derivatives markets will therefore continue to have cleared and non-cleared instruments, he adds.

Jeremy Taylor, specialist, operational processing and derivatives at UK-based consultancy company Rule Financial, says standardisation has in fact been the norm for high volume users of OTC derivatives for quite some time. "This standardisation is becoming more formalised through instruments such as the MAC swaps," he says. "These increasingly standardised products are half-way to a futures contract."

According to Wilson, however, clearing houses will take in only products they feel they can dispose of quickly if a member fails. "Customised, crafted OTC derivatives that are illiquid or difficult to manage will be avoided by the clearing houses," he says.

Cost/benefit

There are positives and negatives attached to clearing, says Wilson. "On a positive note, clearing simplifies administration of derivatives trading in terms of statements of variation margin, which have to be done only with the clearing firm. Additionally, at the clearing level, it means you face only the clearing house rather than myriad counterparties of different credit standing." This means a large financial firm can trade with other firms that are poorly rated because they are not taking the credit risk. "Firms are happy to trade on this basis because they know the trade will be going into clearing," he explains. "They are also not consuming any internally placed limits with particular counterparties."

However, a move towards clearing will impose additional burdens on market participants. "Firms will be faced with the requirement to post variation margin each day in cash in the underlying currency of the swaps and will have to post an initial margin to cover the replacement risk in case of a default," says Wilson. "There is a funding cost associated with using cleared products; it is all part of the regulatory push to make firms pay for derivatives trading."

Joe Halberstadt, head of FX and derivatives markets, at Brussels-based financial messaging cooperative, SWIFT, says the object of the OTC markets is to provide customised trades (amounts, tenors, etc.) to allow clients to manage risk. "A move to standardisation reduces the ability to provide a perfect hedge for a position," he suggests, "but a close hedge may be an acceptable alternative *if* (and it's still a big *if*) standardisation and central clearing reduce the cost of trading."

Wilson agrees. "There is an evolution towards building liquidity around products. The industry is looking at how they can create more standardised items in terms of date with the same characteristics," Wilson adds. But while building liquidity around more standardised products delivers advantages for the trading side of the transaction, such standardisation may result in instruments that do not fit the exact needs of the user.

The regulatory push towards clearing will certainly have an impact on the structure of derivatives instruments, moots Clark. "Recently, market participants have been much keener to look at certain products and consider what they need to do to make them standardised," he says. "Previously, products were introduced to the market and whether they became standardised or not wasn't an issue." This change in thinking will not make a significant difference to the types of products in the market, he suggests – there always will be a set of derivatives products that cannot be standardised. "However, it does help to think about standardisation

Joe Halberstadt | SWIFT

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conventions, product maturity etc. So for example, anyone trading a five-year credit default swap would find it has a particular maturity date in that year," he says. There are also moves to standardise the coupon rates on interest rate swaps. "This means everyone can trade, say, a ten-year swap particularly with regards to the price, structure and documentation that supports these products." The question will be whether the by-products of standardisation are sufficiently attractive for producers to change their methods of production and revisit the nature of the products themselves. •