



OTC Derivatives: Catching the Train to Centralisation

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The midst of the financial storm is behind us and regulators on both sides of the Atlantic are drafting new rules for over-the counter derivatives markets. On November 20th, the European Capital Markets Institute (ECMI) held a seminar on OTC derivatives at De Warande Club, Brussels. The event - chaired by **Ruben Lee**, Oxford Finance Group - brought at the same table regulators and market players representing the whole chain value of the OTC derivative transaction. **Patrick Pearson**, Head of Unit, Financial Infrastructure at the European Commission and **Anne Wetherilt**, Senior Manager of the Bank of England discussed the legislative proposals and the main implications for financial stability of a run to centralisation for trading and clearing. The second section included **Jeff Gooch**, CEO, MarkitSERV, **Simon Grensted**, Managing Director, LCH.Clearnet, **Godfried De Vidts**, Head of European Affairs, ICAP and **Richard Metcalfe**, Head of Global Policy, ISDA. The debate finally focussed upon benefits and costs of current proposals and potential risks for current business models

Regulatory reforms and financial stability issues for OTC derivatives

After the welcome message of the Chair, Patrick Pearson took the floor describing the regulatory measures discussed by the G-20 and the commitment to centralise clearing on CCPs by 2012. The European Commission has a tight schedule for next year, including measures on capital requirements (at latest by September 2010) that should abandon the 0% risk weight for derivatives, renew stress tests, draft regulation for clearing and settlement (and specifically on CCPs), mandate standardised products on CCPs and design regulation for trade repositories (e.g. accessibility). Mr Pearson confirmed that the Commission will make sure drafting sound and clear definitions on what, for instance, should be considered as “standardised” or “eligible” and who should be considered as “CCP”. He also discussed the possibility of a European passport for

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CCPs, regional authorisation for trade repositories and stricter corporate governance requirements (as independent directors). Finally, he concluded that a wave of substantial legislation is coming, but risk of overregulation will be seriously taken into account.

Anne Wetherilt, instead, gave an overview of the systemic implications of this huge market and common objectives and aspects of current US and EU legislative proposals. Although derivatives are mainly used for funding and hedging, there are still important issues to be addressed: standardisation, credit risk management, infrastructure and liquidity resilience, and transparency. Mrs Wetherilt, then, discussed benefits and risks of central clearing, pointing out that bilateral trading and clearing will be still a relevant part of derivatives markets in the coming years.

Shaping new business models: issues and prospects for standardisation and centralised trading and clearing

After the break, the second section dealt with the evolution of business models to cope with these potentially radical changes. Jeff Gooch described the role of complementary services as performed by MarkitSERV. Electronic systems for capture and confirmation of trades play a crucial role to insure the resilience and efficiency of the infrastructure. Electronic systems are still not much diffused, except in the market for CDS where 96% of trades are electronically captured and confirmed. Verification and confirmation systems should achieve significant scale in electronic processes and automation, in order to increase the efficiency of the whole process.

With a long experience in clearing services with LCH.Clearnet, Simon Grensted stated that clearing is not the panacea and not all standardised products can be centrally cleared, even though CCPs currently can process panoply of products. However, CCPs' clearing should be widely used when liquidity is high. Standardisation, instead, impacts on all the elements of the structure from users to clearing structures, therefore, the level of standardisation is not only defined by clearing operators. Clearing services, then, support several steps in the transaction (from trading to settlement). They transform credit risk in market risk, while the CCP has the role to manage this market risk with straight-through processing of transaction (default management, price transparency and liquidity). In this process clearing members are essential, but – in case of default – they should be called to cover losses only after defaulters have paid with all available resources, in order to reduce the opportunistic incentives to get in a derivative transaction.

Godfried De Vidts, representing ICAP, confirmed the necessity of a more resilient infrastructure and predicted a consolidation process for CCPs at global level. On the operational side, more should be done for a straight-through processing. In this regard, even if electronic systems and automation should be widely adopted, voice services are still used and important for customised positions. Other services, as trade compression and reconciliation, help to reduce the exposure to OTC instruments (50% for CDSs) and reduce the risks of litigations.

In conclusion, Richard Metcalfe firstly described the role of ISDA for OTC derivatives markets, then, he showed his scepticism around centralisation, which brings relative advantages and many commercial reasons. On one hand, there are problems on capital requirements but, on the other in current proposals we are making strong assumptions around liquidity. In this market, bilateral close-out netting is crucial. It covers around 85% of OTC derivatives. On standardisation, he remarked the role of master agreements to ensure legal certainty and standardised processes. In addition, he mentioned the importance of complementary services (as reconciliation and compression) and the segregation of collateral. Lastly, transparency should not be pre-trade, as it is useless for the characteristics of derivatives transactions.

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