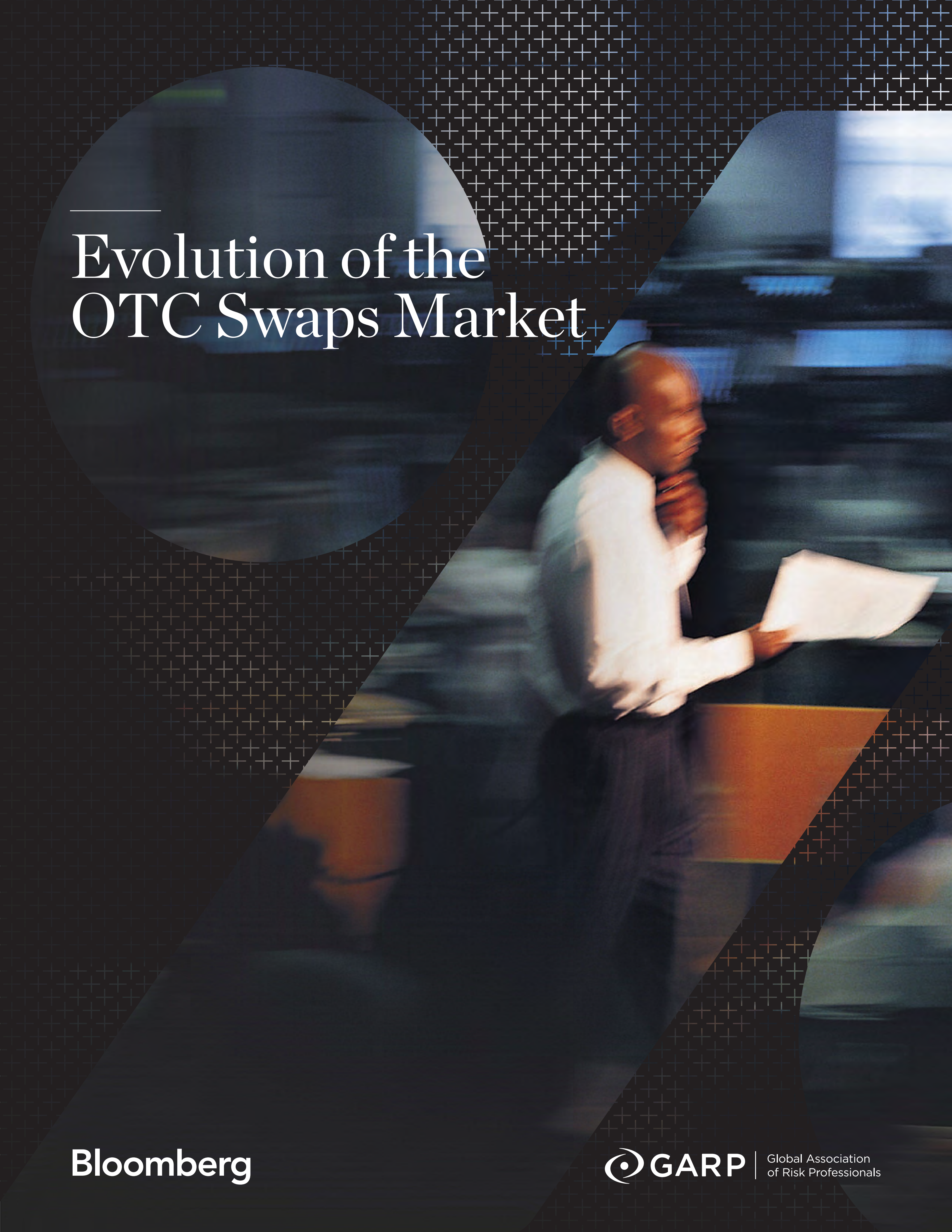

Evolution of the OTC Swaps Market

Bloomberg

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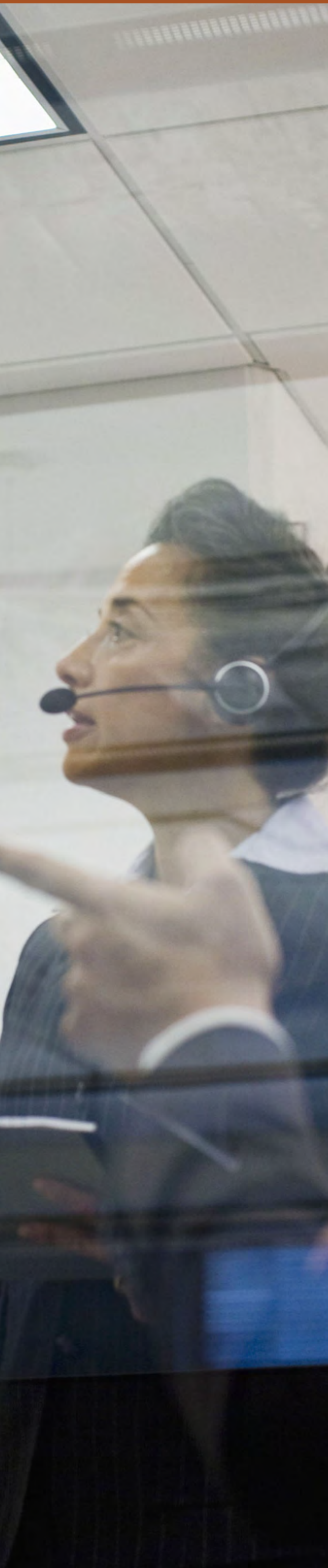

Evolution of the OTC Swaps Market

There was much pointing of fingers in the aftermath of the global crash of 2008, as politicians, economists, the media, and the financial industry itself scrambled to assign blame for what many consider the worst financial crisis since the Great Depression. One of the primary targets for criticism was the over-the-counter derivatives market, which was largely seen as the catalyst for the crash. In the U.S., the regulatory response was significant, as derivatives reform took a central role in the Dodd-Frank Act. Now, as those mandates come into play, the OTC swaps market is transforming in ways that may be hard to predict.

Increasing Transparency

When AIG collapsed in September 2008, it wasn't immediately apparent to market participants who all of the firm's counterparties were, nor was the pricing of those derivatives seen as transparent. "You had a situation where pricing was murky and risk was systemically interlinked," says Nathan Jenner, COO of Fixed Income E-Trading at Bloomberg. As a result, uncertainty spread through the market.

Through Dodd-Frank legislators and regulators are seeking to prevent such occurrences from happening again. The regulatory regime is designed to increase transparency through swap data reporting, electronic execution and business conduct rules, while addressing systemic risk by mandating centralized clearing.

"In the past, OTC derivative trades were bilateral and typically executed over some means of communications like voice or phone between the buyer and the seller," says Biswarup Chatterjee, Citigroup's Global Head of Electronic Trading, Credit Markets.

Under Dodd-Frank, the vast majority of trades will need to be executed on electronic venues, also known as swap execution facilities (SEFs). As the year-end deadline has approached, the movement to electronic trading has been gathering momentum.

"The impending SEFs have made many market participants examine the options that exist out there today," says Jenner. "Many of them have found that they get great liquidity, they get great pricing and they want to be ahead of the regulatory curve."

Phased-In Clearing

Where electronic execution is expected to promote price transparency, regulators want to remove some of the risk from the financial system by requiring market participants to clear through central counterparties (CCPs) such as LCH.Clearnet and CME. In an OTC swap transaction, "if one of the parties were to go south, then the central counterparty absorbs that risk and the market as a whole doesn't have to," notes Jenner. "At the same time, it's open and transparent as to exactly who has what positions."

Regulators chose to phase in the clearing mandate, with swap dealers, major swap participants and active funds—participants that trade at least 200 swaps a month—beginning to clear on March 15, 2013. The deadline for commodity pools, private funds and participants who are predominantly engaged in banking or financial activities was June 10, with all non-commercial end users, including pension funds and third-party subaccounts, joining them by Sept. 9.

"Phase II was a significant learning experience for the industry, both in terms of the manner in which clearing was to be done and in terms of the processes that people had to get ready, both operationally and from a risk perspective," says Chatterjee.

For market participants, the most basic challenge was determining which category they belonged to in the staggered rollout. The Commodity Futures Trading Commission established a self-identification process, offering detailed guidelines for buy-side and sell-side firms to follow. Once that determination was made, however, participants needed to communicate their category to the rest of the market. The lack of a coordinated central database to store this information made the task particularly challenging.

As firms have been phased in, there has been an accompanying need for additional documentation. Because the instruments are executed over the counter before being submitted for clearing, an execution agreement needs to be in place between the two parties to the trade. And for many parties, a clearing agreement is also required. If a market participant doesn't have a direct membership in a clearinghouse, they need someone to clear those trades.

"That's where the futures commission merchant, or FCM, comes in," explains Chatterjee. "The FCM is your access point to the clearinghouse, so you need to get an agreement in place between you and the FCM to get your trades into clearing."

A Post-CCP World

What kind of impact will central counterparties have on the OTC derivatives market? What effects has the industry already seen?

One of the more obvious changes, according to Jenner, is that without a CCP, a market participant who wanted to enter into an OTC derivatives transaction had to face a counterparty who had the necessary balance sheet and credit to be able to stand behind a trade, which is where major swap dealers came into play.

That has led many to suggest that centralized clearing is essentially equalizing credit. "The credit facing a big bank like Goldman Sachs, JP Morgan or Bank of America arguably will no longer be different than the credit facing a much smaller bank, or potentially even a hedge fund, and that's because all parties of the transaction will be giving up their trade to face a central clearing venue," says Bloomberg's Jenner.

That could mean that the OTC derivatives market will see new entrants and an influx of liquidity. On the other hand, the cost of trading will rise for many participants. "Many firms today are lucky enough to be able to enter into certain types of OTC derivatives and not necessarily have to pay large initial margins or variation margins," adds Jenner. "That's going to change once those firms are clearing." And that may apply downward pressure on OTC transaction volumes.

Another much-discussed potential outcome of the Dodd-Frank regulatory reforms is the "futurization" of the swaps market. Trading venues and clearing providers are increasingly offering versions of OTC instruments that have economically similar profiles but are executed on an exchange – a deliverable swap future from CME, for example, or a futures contract from Eris Exchange that mimics a swap, or a credit index future from ICE. The main difference, however, is in the unequal margin treatment. A swap future traded on CME is subject to a two-day margin, while the over-the-counter version incurs a five-day minimum margin.

"That's something that regulators are looking to address, perhaps to try and level the playing field," says Jenner. "But that's currently a factor that may drive the market to a slightly more futurized version."

Rates swaps and other OTC markets have also seen a general movement toward standardization. But, adds Jenner, "a large swath of the market is still going to need to customize and tailor their OTC derivative instruments."

Tough Decisions

Market participants have had their work cut out for them in deciding what approach to take in the new environment, and many hours have been spent evaluating trading platforms, clearinghouses, FCMs and middleware providers. The decisions can be daunting. "There are multiple execution venues where the same product can be executed, you have multiple middleware providers and you have multiple possibilities of clearing the trade at different clearinghouses," says Jenner.

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A small bank, for instance, may have the option of joining a clearinghouse directly, but it will have to evaluate the relative advantages and disadvantages, from a legal, operational and cost perspective, to direct and indirect clearing.

Chatterjee advises market participants who opt to connect to a clearinghouse via an FCM to look carefully at the services that are provided, beyond the cost of clearing trades. "Each of them, even though they may be providing generic access to a clearinghouse, may differentiate the services they give to you," he says.

Whether you clear directly or indirectly, it is important from a credit and market risk perspective to examine prospective clearinghouses and their risk models. How much initial margin is the CCP charging? Are they offering portfolio margining benefits? What do the portfolio margin models look like? The models used by clearinghouses are not identical; the same portfolio cleared through different CCPs will produce different levels of initial margin and portfolio margining.

Equally important are a CCP's collateral rules, says Chatterjee, adding that there are very important frameworks around segregating collateral and making sure that it is protected. "One of the biggest experiences from the Lehman example is that people found their collateral trapped," he notes.

The operational challenges have also been significant. With multiple platforms, middleware providers and CCPs, ensuring that a trade between two parties ends up in the right place isn't simple. "All the existing infrastructure in the OTC industry was mainly designed and meant to cater to bilateral trading," says Chatterjee. "And we are moving from bilateral trading into a world that looks very much like futures clearing."

Some industry participants are much further along than others in transitioning their OTC bilateral systems into futures processing systems, Chatterjee suggests.

Gradual Evolution

The market is coming to terms with the massive amount of pipes and infrastructure that technology providers are putting in place and asking market participants connect to, says Jenner. "That's really a huge undertaking for the industry and it's worth keeping in mind that it's something that doesn't happen overnight."

The challenges facing the OTC industry certainly go beyond infrastructure and technology, and there are many open questions that will affect how the market develops. How will different international regimes coordinate their regulatory response? How will trades that pre-date mandatory clearing be treated? Ultimately, what will be the characteristics that distinguish the swaps market from the futures market as the instruments evolve?

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