Congress versus the OTC market – rout or orderly retreat?

The time for dire predictions is over. Over the counter derivative specialists are now soberly getting to grips with a new US regulatory regime. The rules are still not fully formed, but their shape is becoming clear. As **Elise Coroneos** reports, some market experts still think the law likely to be passed by Congress is too intrusive, while others relish the opportunities it will bring. All, however, are privately working out how to live with it.

The synthetic collateralised debt obligations that nearly brought down the US financial system in 2008 were almost as foreign to most derivatives professionals as they were to the average mortgage borrower.

These were highly structured credit products, which grew out of the asset-backed securities discipline at Wall Street and City banks.

But derivatives they were, nonetheless, and the discovery of billions of dollars of these instruments, stuffed in the bottom drawers of nearly all the world's big investment banks, meant the derivatives market was going to have to face a reckoning.

However much futures exchanges and swap dealers protested that derivatives of their kinds had not caused the credit crisis, it was clear that the over-the-counter market harboured too many hiding places for volatile, opaque contracts with the potential to torpedo an institution's balance sheet.

The freewheeling days of derivatives markets were numbered. Now, the countdown is almost over.

The Senate passed the Restoring American Financial Stability Bill on May 20, taking the OTC derivatives markets one step closer to reform and stricter oversight.

Known as the Dodd Lincoln Bill, this law will be married with the Frank Bill, which the House of Representatives passed in December. Negotiations about merging them are expected to take place over the next few weeks, with the aim of passing the completed text through a final vote in both houses of Congress before the July 4 long weekend.

Honey, I shrunk the market

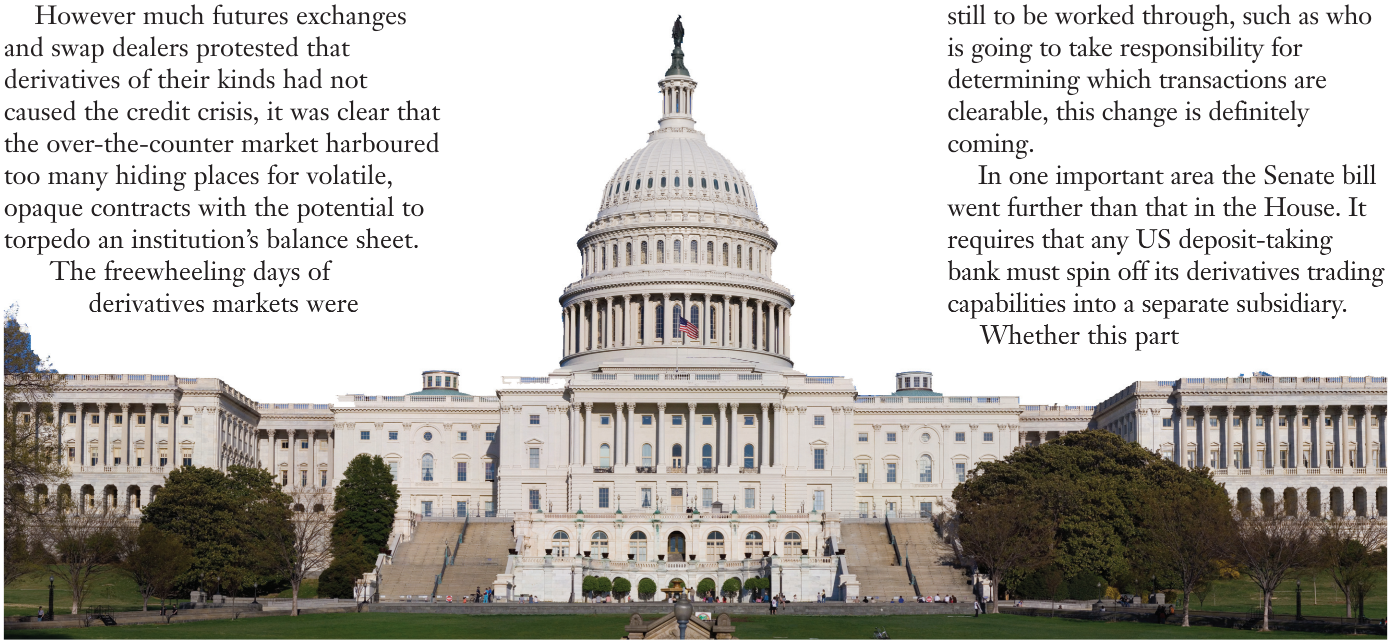
While it is still uncertain exactly what the Congress will agree this time round, some elements of the legislation have already passed both Houses, making it highly likely that those particular changes will become law.

One of these is that the US OTC derivative market is about to shrink substantially, following the mandate that standardised derivatives, including those that will be forced to become standardised under the reform, must be cleared by central counterparty clearing houses and traded in transparent public venues.

While some of the finer details are still to be worked through, such as who is going to take responsibility for determining which transactions are clearable, this change is definitely coming.

In one important area the Senate bill went further than that in the House. It requires that any US deposit-taking bank must spin off its derivatives trading capabilities into a separate subsidiary.

Whether this part



of the legislation is ratified by the Congress will be closely watched. Many consider it the most radical element, with the potential to alter the US banking business substantially.

Electoral pressure

Complicating the matter is the fact that all this is occurring as the mid-term electoral season begins to hot up. Senator Blanche Lincoln, the chairman of the Senate Agriculture Committee and prime mover of splitting off derivatives desks, is fighting for her own political future.

Only a few days before the Senate voted on the bill, Lincoln failed to win a majority of votes in the Arkansas Democratic primary. She will now face a runoff election to retain the right to contest her Senate seat in November.

One reason may be that even Lincoln's tough stance on the banks was not harsh enough for bailout-weary taxpayers. Other incumbents will be taking note.

Many believe both Democrats and Republicans are trying to serve two masters: the electorate, angry against the banks, but also the banks and their lobbyists, vital because they control the election purse-strings.

The shifting balance of political power between the voters and Wall Street is still in flux. Several market participants who were interviewed for this article before the Senate vote did not expect the clause cordoning off banks' derivatives businesses to pass. It did.

There is widespread doubt that the provision will become law – after all, even the Obama administration and the Treasury are against it, for fear it could harm the still fragile economic recovery.

Yet voters may have the final say – it might come down to how many Congress members are willing to risk the electoral damage that may come from dismissing Lincoln's amendment.

To clear or not to clear?

While a lot may change before the financial reform bill is signed into law by President Obama, it seems clear that the House and Senate have sufficient resolve to carry through a big shift of OTC derivatives into centralised trading and clearing.

At the most basic level this is probably good news for the exchanges and clearing houses, but the influx of new business will also bring them significant challenges.

A central issue yet to be determined is just how much of the OTC derivatives market will be considered clearable, and therefore tradable at a public venue.

So far, the legislation has left room for the OTC market to remain, with phone trading having been codified into the Senate bill. But in future, market participants will no longer be the ones who choose whether or not their transactions are cleared.

That decision will be made for them – the question is, by whom?

Under the House bill, the clearing houses will determine what is clearable. The law could be interpreted as meaning that if no clearing house accepts your swap contract, you do not have to have it cleared and therefore do not have to trade at a public trading venue. The Senate bill, however, calls on regulators to decide what is clearable and therefore must be traded publicly.

Consensus likely

Many believe that ultimately a combination of the clearing houses and regulators will decide.

"I don't think the regulators or the clearing houses can make the determination about what should be clearable in isolation," says Warren Davis, a Washington DC-based partner at the law firm Sutherland. "If the clearing organisations don't feel they can prudently or safely do it, I don't think you can make them do it."

If the decision is left to the clearing houses, the outcome may remain close to the status quo – at least for a time. While clearing houses will presumably want the extra business from mandated clearing, they will also be reluctant to take on the pricing of risky, esoteric contracts.

"Any clearing house is going to want control over what is clearable and what is not. It is the clearing house that is in charge of risk management. You have to be able to understand what your risks are so you are collecting the proper margin," says Jim Binder, spokesperson for the Chicago-based Options Clearing Corporation, the world's largest equity derivatives clearing house.

"That being said, as far as OTC equity derivatives move from opaque to transparent markets, we are ready to provide clearing services to the market," adds Binder.

As time went by, there would presumably be an incentive for new clearing houses to establish themselves, in order to soak up business shunned by the incumbent clearers.

If, on the other hand, the job of deciphering which contracts can be cleared is left to regulators, the question is whether a government agency can rightfully mandate that a clearing house take on a risk that could endanger its very business.

Even if it was decided that the government should establish its own clearing house of last resort, the risk for the riskiest part of the market would then be borne by the taxpayer, which is exactly the problem the legislation is supposed to sort out.

Although the mechanism is still to be determined, many are assuming that clearing houses and regulators will form a sort of committee alliance – clearing houses to make sure their business interests are not compromised by being required to clear contracts for whose risks they do not want to be responsible, and regulators to make sure that what OTC derivatives can neatly move to a clearing and public trading model, indeed do so.

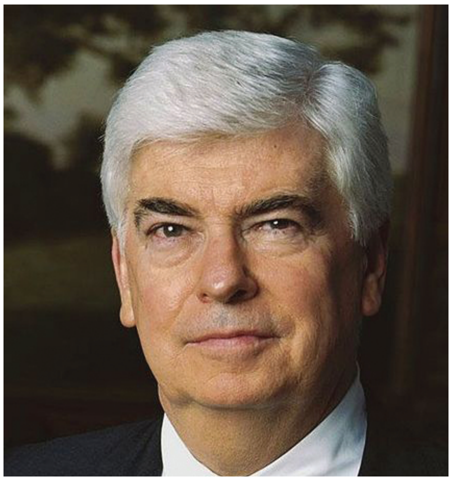
"We believe that groups that have not yet looked at derivatives, like traditional investment managers, will now be compelled to take a look"

The frontier of standardisation

Whoever ends up making these decisions, many of today's customised swaps are comparable with standardised products that are already cleared. It should therefore be easy to convert to the new model, according to Willa Gibson of the University of Akron School of Law.

In March, Gibson released a paper entitled 'OTC Derivatives Trading under the Financial Reform Bill: Is it Tough Enough?'

Her main concern was that the definitions of clearable and therefore publicly tradable swaps should not be



drawn so narrowly as to undermine efforts to bring the markets out of the shadows.

Gibson is not reassured by Congress having left the hard work of defining what is clearable to another day. "I am not comfortable with giving that type of law making authorities to agencies," she says.

A wide spectrum of products, Gibson contends, are not currently standardised, but could be, enabling them to be "brought into the market using comparable products to create a more competitive environment".

Binder says the OCC is trying to identify what can most easily be standardised from the current crop of OTC equity derivatives: "There are a lot of lookalike products to index options products that are traded on exchange, so there is discussion as to whether these can be tweaked in terms of their contract size or the durations."

But, of course, not everyone believes this is the best course.

"To reinvent the whole marketplace to avoid another crisis is a step in the right direction but [achieving] it is not as easy as saying 'let's put everything through a clearing house'," argues Paul Zubulake, a senior analyst with Boston-based financial services consultancy Aite Group. "The specifics of many customised swaps simply cannot be priced out and if the market is forced to do so, people are going to be facing significant margin increases, which may lead some companies to simply shelve their attempts to hedge risk the way they have in the past."

Front runners for conversion

Although there is still no clear view about how much of the current OTC market can be standardised, opinions are

Senators Christopher Dodd (L) and Blanche Lincoln: their bill will now be merged with that of Congressman Barney Frank (below)

emerging as to which areas are most likely to convert soonest.

Kevin McPartland, a senior analyst at Westborough, Massachusetts-based research firm Tabb Group, points to interest rate swaps. "The interdealer interest rate market is almost all being cleared by LCH.Clearnet, which suggests that a large part of that market will likely become eligible and subject to mandatory trading in the not too distant future," he says.

Richard McVey is chairman and CEO of MarketAxess, an electronic trading platform for corporate bonds and credit default swaps. "A significant portion of the daily CDS volume could be standardised," he believes, "and major market participants would have to trade those instruments electronically. So it could be a fairly significant shift."

Today, only a small percentage of CDS contracts in the US are traded electronically. Client to dealer trading is particularly slow on the uptake.

And yet these contracts are highly standardised, even homogeneous. McVey reckons over half of daily CDS volume is trades on the main credit indices, while another 25% is sub-components of the indices. "We have had CDS trading capabilities available for four years, however the market has not yet really embraced e-trading," McVey admits. "But the technology is already here and ready."

If the OTC market shrinks, the cost of doing business that way is likely to rise. Many fear this will reduce the range of affordable hedging products, especially customised ones. Business could be sent overseas, into the arms of UBS or Deutsche Bank.

Who wants to be a SEF?

Besides clearing houses, the group that most obviously stands to gain from reform is derivatives trading venues – exchanges and what the bill calls Swaps Execution Facilities (SEFs).

Both CME Group and Intercontinental Exchange declined to comment in detail on the legislation for this article. The CME's spokesperson would only say "we are reviewing the legislation and continue to monitor the progression of financial reform".

According to Richard Repetto, an analyst at investment bank Sandler O'Neill & Partners in New York, "the only thing to debate is how much they [the exchanges] are going to make. It will all be incremental business that is mandated."

McVey at MarketAxess believes that instead of hurting the US derivatives markets, the legislation provides a framework from which unprecedented growth may spring as new participants are attracted to the market.

"We believe that groups that have not yet looked at derivatives, like traditional investment managers, will now be compelled to take a look," says McVey. "Centralised clearing, more trading transparency, more standardisation of swap contracts will make it so much easier for them to utilise these markets for their plans and funds."

McVey believes MarketAxess may fall into the category of an SEF. It provides a client/multi-dealer environment where the dealer provides client liquidity on the back of a client order.

Christopher Giancarlo, head of corporate development at interdealer broker GFI Group in New York, goes further. He believes wholesale brokers are the natural SEFs.

"Everything we have seen so far would suggest that the SEF language does include interdealer brokerage firms like GFI," says Giancarlo, who is also chairman of the Wholesale Markets Brokers Association Americas (WMBAA). "With their established swaps market liquidity, hybrid electronic trading technology and institutional independence, the wholesale brokers are the most naturally qualified intermediaries to serve as Swap Execution Facilities under the pending law."

Other interdealer brokers and execution firms such as Icap and Creditex would presumably be delighted by Giancarlo's words, but both declined to comment for this article due to the sensitive nature of the subject matter.

Keeping OTC alive

While electronic trading venues are still working out whether they are eligible to be considered SEFs, Giancarlo has recently spent a great deal of time in Washington, trying to ensure that when legislators were defining SEFs and their regulatory framework, they did it in a way that made sense for the industry.

One of the WMBAA's main concerns was to ensure that both the House and the Senate Bills preserved for them the ability to use all means of commerce, including phone trading, to serve market participants.

So while potential SEFs expect significant new business as a result of obligatory public trading for all clearable derivatives, they also wanted the ability to make markets in the OTC products that will remain – giving them a foot in both camps.

"Many customised or bespoke swaps do not trade frequently enough for there to be a liquid, electronic marketplace or to establish enough price points necessary to set clearing margin for effective central counterparty clearing," Giancarlo says. "But allowing wholesale brokers to execute transactions using a number of means – from fully electronic platforms to hybrid platforms featuring professional brokers using sophisticated communication and pricing technology – will enable us to foster more liquidity in these markets, bringing more transactions through the new regulatory framework."

Brokers wary of exchanges

Another top issue for the WMBAA was to ensure that exchanges like the CME and ICE, which also have their own clearing houses, would not use one business to promote the other. For example, they might offer favourable clearing terms for trades done on their own exchanges.

"We needed to know that if an SEF executes a trade and sends it to a clearing house tied to an exchange, the SEF would get the same price treatment and technology interface as do customers who transact on the tied exchange," Giancarlo explains.

The WMBAA's goal is to have multiple execution venues with equal access to clearing that compete for customer transactions on the basis of best price and service.

"This has been achieved in both the House and Senate bills, which restrict clearers of swaps transactions from discriminating against SEFs in favour of transactions executed on their own exchanges," says Giancarlo.

Polarising light

As the rough outlines of the new market begin to emerge, derivatives specialists are starting to ask what effect the changes will have on actual trading. In particular, how previously opaque markets will behave in a public trading environment.

Some are worred that the transition period may be destabilising. "Existing contracts and master agreements that did not require the posting of margin were priced to reflect that fact," says one source.

Davis at Sutherland believes the law goes too far. Reporting all trades to a central depository would have been enough to create transparency, he argues: "The push for transparent trading by the CFTC mystifies me. I think the whole market could end up the loser."

Zubulake from Aite Group agrees. "Ultimately, reform does not have to be about creating transparency between you and I, it only needs to be about transparency to the regulators," he says. "Sending all information to a central depository and making sure it is in a readable form so regulators have an understanding of overall positions in the marketplace would be enough."

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Indeed, under the legislation, all transactions, including those that remain OTC, must be reported to a depository facilitated by the Depository Trust & Clearing Corporation, a resource which would be available to regulators and the public alike.

However, Gibson at the University of Akron believes this kind of "wholesale transparency" – only allowing people to see the aggregate volume of swap trades and not specific deals – is inconsistent with the free market values of real time pricing and equal access to information.

She sites the recent case brought by the government against Goldman Sachs for failing to disclose that a short investor had taken a hand in structuring a CDO sold to long investors.

"If derivatives were traded outside opaque markets and out in the open," Gibson claims, "Goldman clients would not have had to solely rely on the firm itself for information about its proprietary positions. End users have too often been on the wrong side of a swap transaction."

Setting the pace

Many companies in the US derivatives market operate internationally, including in some markets with tighter regulation.

This legislative move, while likely to upset the balance even in ways yet to be determined, may bring the US more into alignment with some parts of the offshore derivatives industry. Equally, the US legislation is likely to set the pace and direction for regulatory reforms in Europe, Asia and elsewhere.

It is already clear that the OTC derivative market is going to change substantially – though it is also certain that little if any business is going to be stifled by the new law.

Just how far reform goes, and whether US banks will have to separate their balance sheets between their derivatives and general banking businesses, is set to be determined in Washington over the next month. Stay tuned. ■