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CENTRAL COUNTERPARTY CLEARING: OVERVIEW OF CURRENT POSITION AND LIKELY FUTURE CHANGES

The contents of this article are descriptive only. The clearing of OTC derivatives on the platforms of central clearing counterparties is evolving as is its documentation. This article reflects the position according to the author's understanding as at 21st January 2011. Much finalisation work remains to be done.

Background

Traditionally OTC derivatives have traded on a bilateral basis between counterparties who set their own collateral requirements without regard to the ramifications that a default could impose on the financial system as a whole.

Clearing became a big issue following the demise of Bear Stearns and the bankruptcy of Lehman Brothers in 2008. This was because of the risk exposure banks had to each other through billions of dollars of interconnected OTC derivatives contracts.

A default by one bank could threaten the entire financial system. Moreover, these contracts could be worthless, especially if not collateralised, if the bank writing the contract collapsed.

Clearing puts a third party in the middle of each trade which guarantees performance of the contract and means that the risks and costs of defaults are absorbed by clearing house members. So a clearing house stands between the two parties in a trade stepping in to ensure a deal is completed if one defaults.

A central part of regulators' response to the 2008 financial crisis has been legislation requiring that large amounts of the OTC derivatives markets are cleared through exchanges or swap execution facilities ("SEF"s).

The aim is to create a more transparent market, mitigate systemic risk and protect against market abuse.

This initiative came from the G20 meeting of world leaders in Pittsburgh in September 2009. That meeting decided that all standardised OTC derivatives contracts should be traded on exchanges or electronic platforms and cleared through central counterparties ("CCP"s) by the end of 2012. The G20 leaders also agreed that OTC derivative contracts should be reported to trade repositories and be made available to regulators. By sending trades to repositories, the aim is to bring transparency to a market where prices of OTC deals are mainly known only to the club of dealer banks that traded them. Moreover, it was also proposed that any uncleared contracts should be subject to higher capital charges.

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General concerns

So where do we stand on these issues today?

The shape of the OTC derivatives clearing model is still unclear and key issues potential users are considering are when they would need to start clearing, what types of contracts would need to be cleared and whether any of them would be exempt from the clearing rules. Clearing houses are wondering whether they will have to accept smaller members and how their rules may need to change. It may be that new potential users might clear through multiple platforms rather than a single one.

Further concerns are that there might be too much competition for new business and that regulators could demand that clearers are based in specific countries or regions which could lead to inefficiency.

However, unlike the futures and equities markets, OTC derivatives can trade infrequently because many trades are bespoke and have been structured between a dealer and their client to hedge a particular interest rate or currency risk. Often such trades can have notional amounts of hundreds of millions of dollars. A concern which has been raised is that liquidity in swaps could suffer if trading is standardised on to platforms. A large trade could move the market significantly against an investor wanting to buy or sell a USD 500 million swap trade which is a fairly common notional amount for an interest rate swap in the OTC derivatives market.

Some commentators consider that the move from the current OTC derivatives market to one which behaves like a futures market is a massive change and will only happen gradually. They point out that there are millions of trades a day on exchange traded futures markets but far fewer daily in the OTC derivatives market. We shall see.

So despite much international co-ordination there is still much uncertainty about how the global OTC derivatives markets will function and perhaps we can best gauge progress by looking at the current situation in the USA and Europe as far as OTC derivatives regulation is concerned.

US Position

On 21st July 2010 President Obama signed the 2300 page Dodd-Frank Wall Street Reform and Protection Act (the "Dodd-Frank Act" or the "Act") into law.

The Dodd-Frank Act is the most sweeping change to US financial regulation since the Great Depression of the 1930s. Title VII of the Act amends the Commodity Exchange Act 1974, the Securities Act of 1933 and the Securities Exchange Act of 1934 and is designed to provide comprehensive regulation of the OTC derivatives markets. Centralised clearing is a major component of this regulatory reform. The Act reflects the US Congress's view that OTC derivatives trading presented unacceptable counterparty and operational risk concerns and a lack of transparency. The main objective of the Act is to reduce or eliminate these problems.

The Act basically charged the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC") to write numerous detailed rules for OTC derivatives trading by 15th July 2011. It is estimated that the CFTC must issue 37 new rules by this deadlines against a recent year average of 5.5 rules while the SEC must issue 59 new rules compared to an average of less than 10 rules a year before the 2008 crisis. One draft rule issued by the CFTC on 1st December 2010 ran to 483 pages! These regulators are becoming very concerned about the tight deadline for formulating these rules which also involve comment periods by market players who are lobbying hard to dilute their effects. Some commentators worry about the quality of the finished rules because of these factors.

The Dodd-Frank Act contains an end user exemption and provides a safe harbour from clearing requirements for a swap if one party is both not a financial entity and is using the swap to hedge or lessen its commercial risk. However, who is to be classified as a "swap dealer" or "major swap participant" still needs to be finalised. Initial proposals by the CFTC on 1st December suggest a swap dealer is any company that deals swaps on an annual basis with a gross notional amount of USD 100 million or more; deals swaps with more than 15 non-swap dealers or enters into more than 20 swaps a year. Major corporates are lobbying hard to ensure they are exempted from the "swap dealer" classification and be treated as end users because they are worried that they will have to post collateral against their swap positions. Much discussion remains on these proposals.

A major swap participant is proposed to be one who has a substantial position in rate swaps, equity swaps, credit swaps and any other type of swaps. Under the CFTC proposed rule a substantial position is one that equals or exceeds USD 3 billion in current exposure or USD 6 billion in current exposure plus aggregate potential future exposure for rate swaps and USD 1 billion or USD 2 billion respectively for the other swap classes. There are other tests too but generally the bar has been set high. There is a 60 day comment period following publication of the proposed rules in the Federal Register in January 2011.

A clearing member who accepts customers' collateral for swaps must be registered and comprehensively regulated as a "Futures Commission Merchant" (FCM) as defined under the Commodity Exchange Act. It is proposed that any collateral deposited by a customer at a clearing member to secure trades will be segregated in a customer account and not be comingled with the clearing member's own funds. The clearing member is also forbidden to use one customer's funds to secure the trades of another customer. Under current clearing arrangements FCMs which handle cleared derivatives hold these assets in pooled accounts called omnibus accounts. If one of the FCM's customers defaults and causes the FCM to go under too then the clearing house can tap into this omnibus account to cover any losses which are not met by margin payments or the clearing house's default fund.

The current futures model of an omnibus client account held at the FCM exposes clients to the risk of default by other clients of the FCM. Investors now want these accounts to be replaced by segregated accounts. Then if another investor defaults their assets are safe.

They consider that clearing should not result in greater default risk at the FCM level than exists for OTC derivatives transactions today.

If regulators opt for segregated accounts clearing houses will not be able to tap into omnibus accounts where there is a default. Clearers claim the current system of using omnibus accounts gives them extra protection and that removing this protection would mean they would have to find funds elsewhere and this could lead to a 60-100% rise in default fund contributions. The default fund is the capital put up by the backers of clearing houses. A big increase in the fund would cause some banks to think twice about remaining in the clearing business.

As the Act comes into force any swap that is required to be cleared must be executed on a regulated exchange or platform unless no such platform makes the swap available for trading. The Act establishes a new type of regulated execution platform called a "Swap Execution Facility" (SEF). The Act also requires that a clearing house must not engage in discriminatory clearing. In other words a clearing house must accept a transaction for clearing irrespective of the identity of the platform on which it was executed.

The SEC and CFTC proposals are aimed at ensuring that no single group, for example derivatives dealers, have control of an SEF or exchange or clearing house to avoid conflicts of interest such as being able to block the shifting of certain OTC derivatives into a clearing house. In October 2010 the CFTC proposed two alternative ownership arrangements viz:

Either:

- A single clearing house member can own no more than 20% of the voting shares in the clearing house concerned or a 40% voting share cap on a single shareholder and its affiliates; OR
- A maximum of 5% of the voting shares in a clearing house can be owned by a single clearing member including its affiliates.

This is still under discussion.

At this stage entities should begin considering selecting one or more clearing members who must be FCMs in the USA for OTC derivatives and/or broker dealers or securities based swap dealers for securities. They will also need to start negotiating the necessary legal documentation which will probably be substantial in volume. Given the possible need for porting (transferring) open trades upon the default of a clearing member it is probably sensible for an end user to negotiate and execute documentation with multiple clearing members even if the end user ultimately only uses one clearing member.

It is proposed to implement the SEF trading platforms by 15th July 2011.

For banks, the move to SEFs means that they will likely no longer be able to market swap prices directly to their clients via their own Bloomberg screens. Instead, the banks will direct their prices to third party SEFs that transact swaps between dealers and the buyside community of hedge funds, money managers and corporations. What is at stake here are the profits dealers make from OTC derivatives' market making.

The CFTC is focusing on real time reporting of all swap transactions both cleared and uncleared and the need for these to be publicly reported. The SEC is focusing on similar issues for equity derivatives.

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European position

In Europe the legislative proposals are mainly contained in two separate documents i.e. the European Market Infrastructure Regulation (EMIR) proposals published on 15th September 2010 and a possible revision of the Markets in Financial Instruments Directive (MiFID).

The EMIR legislation focuses on eligible derivatives rather than standardised ones (which the US legislation does) and requires that these eligible derivatives are cleared through CCPs. The new European Securities and Markets Authority (ESMA) which started work in early January will decide which derivatives classes should be centrally cleared and will also deal with the question of clearing eligible contracts which do not currently have an authorised CCP to clear them. For those OTC derivative contracts which cannot be centrally cleared market players are expected to measure, monitor and mitigate risks through timely marking to market, reconciliation and collateralisation of their derivatives portfolios. The EMIR proposals also require EU OTC derivatives trades to be reported to trade repositories which will be registered and supervised by ESMA and will make detailed information available to regulators and summary aggregate information available to the public.

MiFID which currently covers trading and transparency requirements for equities is being reviewed with plans to widen its scope to include other OTC derivatives.

Comparison between US and European proposals

US and European regulatory authorities have coordinated their thinking on OTC derivative regulation to ensure a level playing field and little opportunity for regulatory arbitrage. CFTC chairman Gary Gensler and EU commissioner Michel Barnier have each travelled regularly to see each other to try and reinforce transatlantic convergence on these issues. However, there are the following differences in approach:-

- In the US the Volcker Rule restricting the scope of proprietary trading activities of banks is part of the Dodd-Frank Act but not of European legislation.
- There seems greater focus in Europe on mitigating potential conflicts of interest at execution and clearing venues where there is concern that if big banks or dealers have large shareholdings in clearing houses or exchanges that this could lead to manipulation and lessen transparency in the new arrangements.
- There has been great emphasis in the USA on clearing OTC derivatives through exchanges or SEFs while in Europe there is less emphasis on electronic platforms and the International Organization of Securities Commissions (IOSCO) is studying the costs and benefits of trading on these with a view to reporting its findings at the end of the January 2011.
- The CFTC and SEC proposals focus on post trade transparency and require real time reporting for all OTC derivatives while currently the European proposals recommend real time reporting only for cleared credit default swaps. Once again IOSCO has been asked to explore the benefits and costs of requiring public price and volume transparency of all trades including those not centrally cleared. Once again they are due to report by the end of January 2011.

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Other observations

So as we can see, while there are similarities in approach there are also differences in how they will be tackled but clearly some harmonisation is sought through the involvement of IOSCO.

Increasing transparency in the OTC derivatives markets does however appear to be a universal goal but such transparency must be truly useful and not simply add to costs and possibly produce other unintended consequences such as a reduction in liquidity.

Trade repositories will be made transparency providers to regulators who will need to decide exactly what information needs to be captured and how positions across trade repositories will be aggregated so a complete picture can be seen.

Some market commentators have argued that the market only needs one global trading repository for each asset class with information shared with all the relevant regulators globally to avoid fragmentation of data. DTCC particularly backs this proposal. There is a risk that separate trading repositories in Europe and the US could create a distorted picture with trades either going unreported or being double counted after being confirmed on multiple repositories. Another problem with multiple trade repositories especially in the same asset class is that the normal market practice is to give a unique identity to each OTC trade.

Despite the wish for unity on this matter, Bolsas y Mercados Espanoles (BME), the Spanish bourse operator, is launching its own trading repository in Spain.

In addition, LCH.Clearnet's Swapclear is widely used by dealers and it is gearing up its activities for this new market. So is the Intercontinental Exchange ("ICE") both in the USA and Europe.

CME Clearing in the USA is launching an interest rate swap clearing business which is backed by dealers and large derivatives users such as Fannie Mae and Freddie Mac. It has also received regulatory approval to launch an OTC derivatives clearing business in Europe in 2011.

LCH.Clearnet announced on 11th January 2011 that it was establishing a US clearing platform in February 2011.

International Derivatives Clearing Group (IDCG) which is owned by Nasdaq is branching out into OTC derivatives for the first time.

For exchanges, getting paid a small fee every time an OTC derivatives contract is cleared is a potentially attractive fresh source of revenue particularly if equity trading volumes and other activities decline.

Moves are also afoot to establish CCPs in Singapore and Hong Kong by 2012.

In late December the Bank of England questioned whether clearing houses should be profit seeking businesses or be run more as not for profit organisations. Of course, this would be a blow to the dominant business of clearing houses most of which are owned and operated by exchanges. The Bank of England is concerned along with other regulators about conflicts of interest arising between the clearing houses and their owners.

We shall have to see what ultimately happens here but clearly from this analysis a large number of key issues need to be finalised in 2011 and there is much disagreement on some of them globally.

Watch this space.

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