Cutter AdvantEdge

OTC Regulation

Judy Blackwell, CutterResearch

Issue 92, June 2013

OTC Regulation: Are We There Yet?

Since 2009, when the G20 resolved to gain control of the OTC derivatives markets, the industry has been monitoring details of the regulations as they emerge, analyzing the impacts on the derivatives markets and positioning their businesses for the new regime. Both sell-side and buy-side firms have been preparing by finalizing new business relationships and re-designing processes. The three major provisions stipulating **electronic trading**, **central clearing**, and **trade reporting** for OTC derivatives all affect buy-side firms. Many firms have been waiting for regulators to finalize rules, and in some regions the effective dates for some provisions remain to be determined. Implementation too is a gradual process. Target dates for each provision vary by jurisdiction, regulator, and asset type, but as a general rule mandatory trade reporting has come first, followed by central clearing then electronic trading. Global standards for collateral on non-cleared, bilateral trades are also due to be phased in, starting in 2015. But rules are in force now, trade reporting is mandatory in most jurisdictions, and central clearing, already begun in the US, will be mandatory for most buy-side firms in June 2013. Now is the time to make the necessary changes in order to comply.

Is the Buy Side Ready?

Several recent articles and studies claim that buy-side firms are not all as prepared as they should be. The blizzard of new terminology and acronyms has not helped, nor has the lack of alignment of regulations between the regions. The complexity and reach of new legislation, plus the cross-border implications of some rules, have led to delays and revised deadlines. While some firms decided to wait for clarity before starting work on changes, preparation is now an urgent need for OTC swaps subject to the rules.

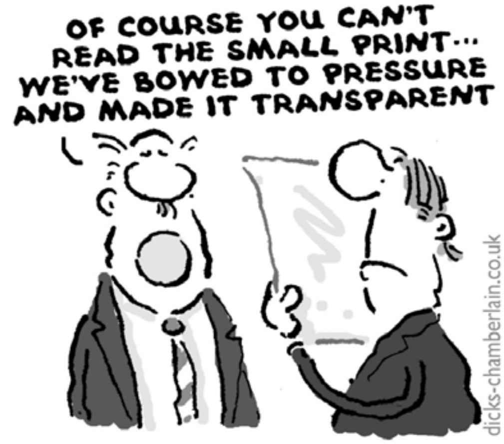
Priorities for Action

Trade reporting is already mandated in many markets, though the detail for buy-side firms varies by region on what is to be reported, the timing, the types of trades involved, and responsibilities. Firms operating in Europe have a greater responsibility than those in the US, where brokers can report trades to a central repository on their behalf.

In major markets, mandated central clearing is now in effect or imminent. Firms must modify some agreements and create new relationships and legal contracts, with the most pressing need being the appointment of clearing brokers. With the legal work involved, and the time required for the on-boarding process, some firms will miss the deadlines for compulsory clearing of certain OTC derivatives and will need to seek alternative asset types. Most firms are well advanced in their preparations for clearing; some have already completed test trades and some have started clearing even in advance of the deadlines. But firms that are in the early stages of selecting and appointing their clearing members may find a bottleneck as brokers struggle to on-board firms that have not yet completed their preparations and are rushing to get agreements in place. As clearing shifts obligations and risks to central counterparties, new collateral requirements take effect. These requirements mandate revised procedures to support initial margin and daily variation margin calls, and they could necessitate new systems, additional messaging, and custody accounts.

Trading on electronic platforms will become mandatory after central clearing and trade reporting are in place. Although final rules are not completed, it is becoming clear which will be the major platforms, and firms can start preparing for connectivity to their preferred venues.

Operational and Legal Considerations



For some firms, the number of new legal agreements required for clearing is substantial, with a contract for each combination of the entities involved: portfolio owners, clearing members, and CCPs. In recognition of the workload, the International Swaps and Derivatives Association (ISDA) provides support with a template for an addendum to their master agreement to include clearing information, as well as a Dodd-Frank Documentation Initiative to aid institutions in redrawing contracts.

Risk Management

New requirements for central clearing and additional collateral bring with them different market, operational, and counterparty risks. At the portfolio level, investment risk can be affected by the movement of collateral for bilateral and cleared trades. Counterparty risk in a cleared trade is concentrated with the CCP rather than with the executing broker, but the temporary exposure to executing brokers and to clearing brokers that pass collateral to the CCP requires attention too.

Margin Requirements

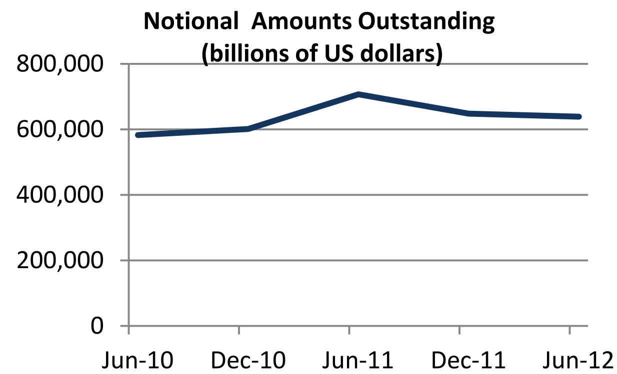
Initial margin is a new requirement for OTC derivatives, and for some firms, variation margin will be required daily, or intra-day. The number of margin movements can grow exponentially, and accordingly so can the job of collateral tracking, including valuation and reconciliation. Given the additional demand for collateral, market participants will look for ways to mitigate the impact on portfolios, including collateral optimization, portfolio margining, and cross-asset margining.

Impact on Portfolios and Investment Strategy

Portfolio managers' models of their OTC derivative trades now reflect the potential impact of regulation on portfolio hedges, risk, and performance. The most pronounced effect arises from new collateral requirements for both cleared and bilateral trades. Very liquid portfolios will have suitable collateral readily available, but others will not, and their challenge will be to reduce the collateral requirement, or to raise the level of eligible assets. Modeling the effect of collateral changes on the portfolio's risk, costs, and performance is a complex process. Some managers are questioning whether it is worth continuing to use OTC derivatives at all, and if they should look for alternatives.

Alternatives to OTC Asset Types

The launch of listed swap futures that aim to match the profile of OTC swaps is a response to increasing operational and collateral costs. Both the CME Group (delivery for swaps contracts) and Eris Exchange (Standards, IMM dated benchmark futures and Flexes, customizable futures) offer swap futures on interest rates. ICE recently announced its intention to launch four credit index futures. These exchange-traded products offer lower margins, and for firms with established exchange-traded derivatives (ETD) procedures and systems, these instruments could save money because they don't require changes to comply with the new regulations.



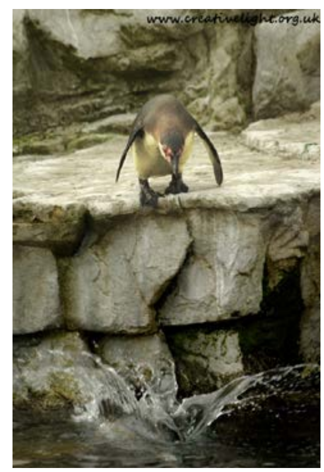
BIS Statistics:
Total Global OTC Derivative Markets Size

Currently, the proposed higher margin requirements for OTC trades compared to futures are being challenged in the courts. Industry players argue that the disparity is unjustified, and that the risk and liquidity of OTC markets are similar to ETD. It remains to be seen how this will be resolved, but with banks subject to the higher capital requirements of Basel III, margins are unlikely to be reduced.

Statistics on OTC market volumes from the Bank for International Settlements (BIS) and others appear to show that the regulatory changes have not yet caused much reduction in OTC trading activity. However, the latest BIS figures available are for 2012, and it will be interesting to see how much trading moves to new instruments offered by exchanges.

Though OTC trades can be more costly in terms of collateral, their advantages remain. For a portfolio manager trying to match an exposure very closely, the flexibility offered by an OTC trade will generally be preferable. In addition, for some types of derivatives such as CDS, no true equivalent is available on an exchange. OTC volumes may decline, but buy-side firms are still likely to trade both exchange traded and OTC derivatives, and they must adapt to meet the new regulatory environment.

Laggards?



There is an impression in the market that buy-side firms have been waiting for certainty—on the regulations and on terms of business with clearing members and CCPs. But certainty has been and continues to be lacking. It has now passed the point where firms can afford to delay, even if rules and terms are not yet 100% clear.

It is too early to tell how much of an effect the appearance of new types of securities will have on OTC trading; volumes so far are in the low billions, a tiny fraction of the swaps market. As regulations start to have an impact on new contracts, the balance may shift from OTC toward the futures model. But firms must decide whether they will continue with OTC derivatives and conform to regulations, or move to ETD. In either case, the need for reengineering processes, documentation, and systems is urgent.

Judy Blackwell is a Director in Cutter Associates' Research division. She has more than 30 years of information technology experience, mostly in the investment management industry. Judy has been with Cutter since 2006 and has authored a variety of research reports involving data management, reconciliation, post-trade processing, and reconciliation. She is co-author of two recent titles on this topic: *2013 Regulation of OTC Derivatives*; and *2011 Preparing for Central Clearing of OTC Derivatives*.