

The future slowly becomes clearer

Overview

While many issues are unresolved, new rules will leave few areas of trading untouched, writes **Philip Stafford**

For some institutional investors and hedge funds, getting Mitt Romney elected president of the US was the last role of the dice.

For more than three years, all parties of the industry loosely described as market infrastructure – exchanges and other trading venues, banks and clearing houses – have been holding detailed, almost exhaustive discussions with global regulators over how to turn a political pledge to reform the derivatives industry into practicable laws.

As debates have ground on, sometimes delving into industry minutiae, it has become clear that the overhaul would be profound and leave few areas of trading untouched.

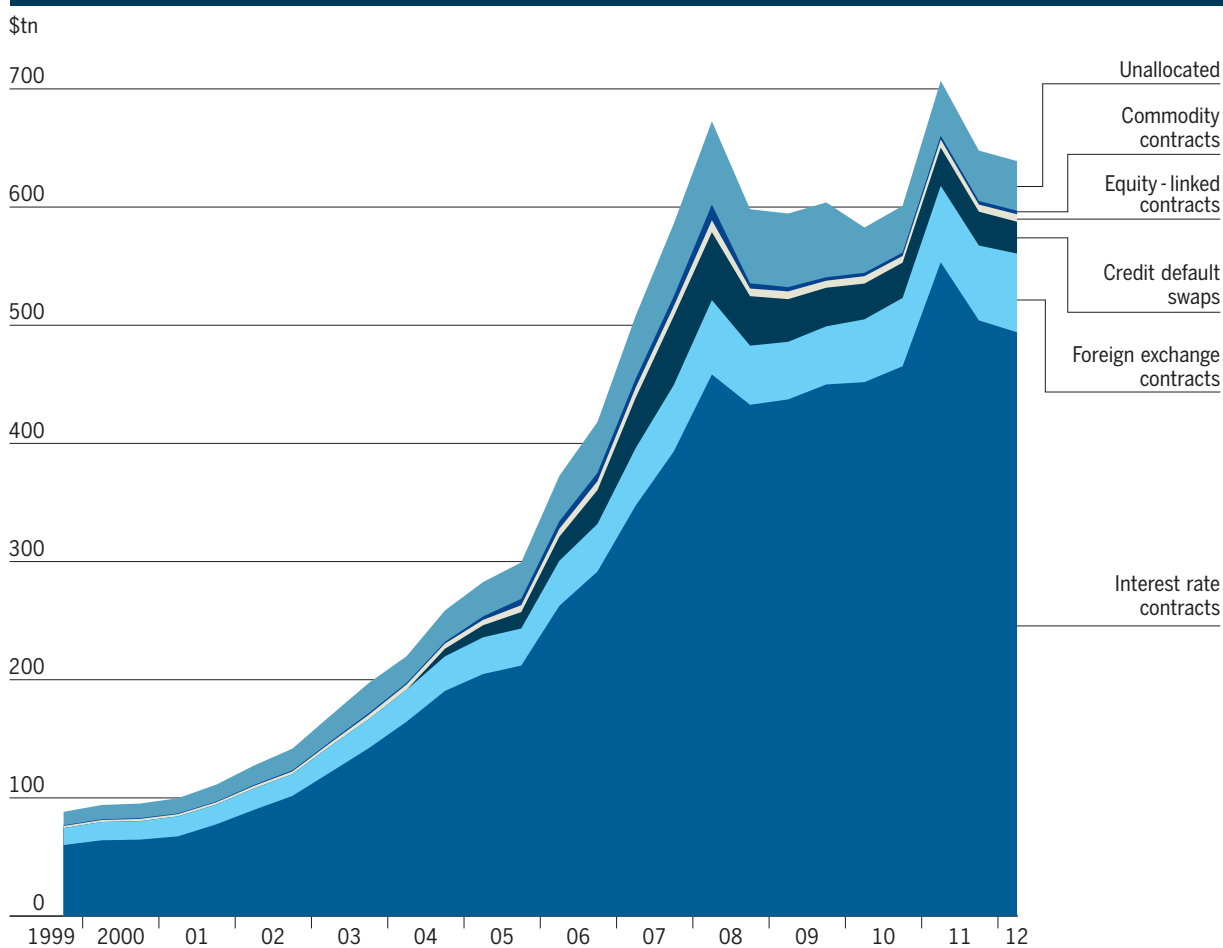
A successful campaign for Mr Romney was seen by some as the final chance to usher in gentler political winds that would take the heat out of the reforms. But Barack Obama's victory, and his promise to reform Wall Street, has ended that hope.

"The process has taken a long time and some clients think it just won't happen. The US presidential election has shifted that. It's given it a bit of a push," says the head of clearing at a large global investment bank.

But the fact that some felt there was a chance to influence legislation more than three years after the process got under way highlights how difficult and profound the journey has been, and how many important issues remain unresolved.

As they surveyed the wreckage of the financial crisis, politicians alighted on the opaque off-exchange derivatives market. Leaders from the G20 agreed in September 2009 that more standardised over-the-counter derivatives contracts should be traded on exchanges or electronic trading platforms and processed through clearing houses. A clearing house stands between two parties in a

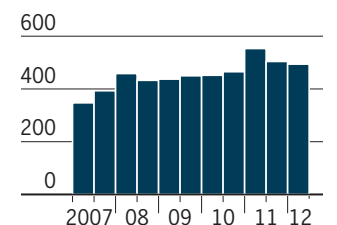
Amounts outstanding of over-the-counter derivatives



Source: BIS

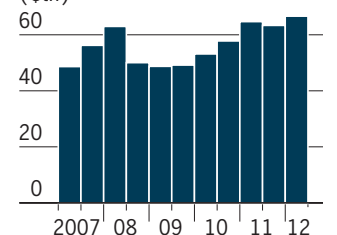
Interest rate contracts

Notional amounts outstanding (\$tn)



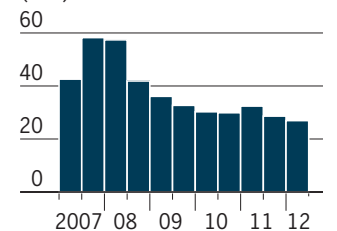
Foreign exchange contracts

Notional amounts outstanding (\$tn)



Credit default swaps

Notional amounts outstanding (\$tn)



trade, guaranteeing the deal in the event of a default.

Since then national and supranational regulators have been busy writing their own definitions of final technical rules. Analysts and executives expect more business in derivatives to be traded on-exchange as a result and there has been an international consensus on large swaths of the reforms.

But the issues to be resolved by regulators and the industry are critical. They include what will have to be traded, who qualifies and how far regulatory jurisdiction can reach. As a result it is slowing down the passing of legislation and the codification of laws, and leaving banks and investors unable to make decisions.

Relevant legislation in the US and Europe, in the form of the Dodd-Frank act and the European Market Infrastructure Regulation respectively, is on its way. But the difficulties contributed to virtually every regulatory authority missing the G20-imposed deadline for the end of 2012. Indeed, Dodd-Frank passed into law more than two years ago.

Some certainties are emerging. For many fund managers, pension managers and other institutional investors, the move is a radical departure from previous practice. Part of the attraction of the OTC market had been that participants needed little, if any collateral or

insurance for trading, for their deals. These reforms are creating greater choice over which markets and clearing houses to go to, and ways to execute trades, when using derivatives to offset risks in a portfolio.

The more illiquid OTC market provides investors with bespoke products such as swaps, forward rate agreements and exotic options. By contrast, exchange-traded futures and options are more standardised products. Contracts are smaller but far more liquid.

But greater freedom also brings greater responsibility. The corollary is that many institutional investors need a fuller understanding of clearing and cannot rely on their broker to make decisions, even if that broker can collect margin and connect to the right venue on their behalf.

"One of the more frequent questions we get from clients is about where to clear. The answer is that we'll go where customers want us to go," says Andrew Ross, European head of OTC clearing at Morgan Stanley. "We don't believe it's the bank's role to tell clients where to clear their trades."

It is also clear that institutional investors will face higher costs for trading. Using an exchange or other electronic venue requires investors to put up collateral against the deal. However, the G20 communiqué also made explicit that contracts not proc-

'Our members... have concerns such as how much collateral they have to put up'

Dan Waters, ICI Global

essed through clearing houses be subject to higher capital requirements.

"Our members aren't against clearing; they have concerns such as how much collateral they have to put up and worries that it might be double counted," says Dan Waters, managing director of ICI Global, a trade association for global fund managers.

These are not idle fears. Research from fund managers has indicated the margin required to be put up could be as much as 10-20 per cent of a portfolio. But as the final rules have not been decided, nobody can put a precise figure on the impact. In Europe, for example, pension funds have been given a temporary exemption for clearing in Emir, but the final details for capital charges on non-cleared derivatives are still to be decided.

"Placing strict requirements on the type of assets that can be used as collateral for derivatives positions will make it challenging for some fund managers to invest in those products," warns Marianne Brown, chief executive of Omgeo,

a post-trade services company. "If a particular firm does not have sufficient eligible collateral on hand, they may need to perform collateral transformation which can be complex and could add operational risk," she adds.

Amid these concerns, some have considered moving more business to Asia and growing financial centres such as Hong Kong and Singapore. Reform efforts are also generally further behind the US and Europe, although Japan has already mandated central clearing of yen interest rate swaps via its domestic banks.

But even here complications arise. Along with their counterparts in the EU, many regulators in the region have voiced their unhappiness with US proposals that could increase the compliance burden on local investors. Measures suggested by the Commodity Futures Trading Commission, the US derivatives regulator, that may force overseas investors to accept tougher and expensive US laws have prompted rare public criticism from authorities in Japan, Australia, Singapore and Hong Kong.

However, regulators are exploring ways to recognise each other's jurisdiction, rather than reject it outright. Furthermore, many markets in the region have little OTC derivatives business and are in

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Cleared for take-off: trades will have to go through clearing houses such as CME Group in Chicago
Bloomsberg

Pension funds face 'collateral damage'

Regulation

Steve Johnson on an unintended consequence of central clearing

A swath of regulations introduced in the wake of the global financial crisis is set to force a host of derivatives to be cleared via central counterparties.

But this seemingly technical change to the over-the-counter derivatives market means the likes of pension and mutual funds will need to post collateral to back their trades – collateral they do not always have, at least not in the form the central counterparties are willing to accept.

The phrase “unintended consequences” is one widely bandied about in discussions of this topic. Raymond Haines, head of European strategy and research at State Street Global Advisors, says, with no pun intended: “Pension funds are collateral damage.”

The tighter regulations are a result of the financial crisis, when the leverage and opacity associated with the OTC market was seen as having contributed to the transmission and amplification of credit losses through the financial system.

These fears prompted a unified regulatory response, with the Dodd-Frank Wall Street Reform and Consumer Protection Act in the US, the EU’s European Market Infrastructure Regulation and similar measures in countries such as Japan, Singapore and Hong Kong forcing trading in some derivatives to be routed via

a central counterparty. First on the list are interest rate swaps – integral to liability-driven investment programmes – followed by credit default swaps.

Around 50 per cent of interest rate swaps are already centrally cleared, but this is mainly dealer-to-dealer business. These traders will tend to have offsetting two-way positions, allowing them to net off the collateral they need to post, reducing it substantially. For those positioned one-way, such as pension and mutual funds, trading will become substantially more capital intensive.

“Collateral requirements on pension funds are likely to be substantial. Most pension funds use derivatives to hedge their liabilities so are mostly in one direction and won’t benefit from the netting that investment banks will see. We are very likely to feel some impact,” says Howard Brindle, chief operating officer at the £34bn UK Universities Superannuation Scheme.

Nadine Chakar, executive vice-president for global col-

lateral services at BNY Mellon, says a typical initial margin obligation for a five-year vanilla interest rate swap might be equivalent to 1-3 per cent of the notional value. However, for long-dated or complex contracts this could rise sharply, to 10 per cent for a 30-year swap and 15 per cent of those of 50-year tenor. Further “variation” margin may be required to cover movements in market prices.

Research conducted by the UK’s Investment Management Association on a series of test portfolios found it was “not unusual” for the collateral required to meet initial and variation margin obligations to equal 20 per cent of the portfolio.

Europe’s Emir requirements could also force pension and insurance funds to hold 10-20 per cent of their assets in cash and near-cash to meet potential variation margin calls, resulting in an annualised yield drag of 2 percentage points for the former and 2.5 for the latter, the IMA estimated.

The Bank for International Settlements has calculated that \$470bn of collateral will be needed to back interest rate swaps in a “medium”-stress environment, or \$700bn in a high-stress one, with equivalent figures of \$168bn and \$319bn for credit default swaps.

This has led to talk of a “collateral crunch”, with most central counterparties accepting only government bonds or cash as collateral,

assets that may not be readily available. This is more restrictive than at present, with corporate bonds and even equities often accepted as collateral in uncleared bilateral deals, if lodged in sufficient quantity.

The problem may be particularly acute for mutual

funds, as an equity or corporate bond fund will simply not possess anything it can use as collateral. Instead it may have to use the securities lending or repo markets to secure suitable assets.

But many pension funds will also be hit. As Mr Haines points out, even the index-linked government bonds that pension funds do tend to hold in abundance are not generally accepted as collateral by central counterparties, even if conventional bonds issued by the same governments are.

Estimates of the cost of using the repo market to access the necessary collateral range from 50 basis points of a pension fund’s assets to several hundred basis points, Mr Haines adds. Alternatively, pension funds may feel pressured to alter their asset allocation so they do have sufficient in-house collateral.

“There is a stir in the market, people saying there is a significant structural shift that will play out,” says Simon Thompson, chief operating officer at

Legal & General Investment Management. “There should be a net shift out of corporate bonds into cash, ironically at the precise moment pension funds might want to move in the opposite direction because of the yield pick-up.”

In a sign of the widespread uncertainty, investment bank estimates of the size of this shift range from \$50bn to as much as \$6tn.

The reality will start to become clearer from the end of February, when the relevant section of Dodd-Frank kicks in, followed by Emir in summer 2014.

In Europe, pension funds have been given a three-year exemption from central clearing, but there is a widespread view that banks will pressure pension funds to switch away from uncleared deals before then, while many schemes themselves may want to get ahead of the curve.

“The bigger clients and more sophisticated users are gearing themselves up to clear as soon as it becomes possible,” says Mr Thompson.

However every cloud has a silver lining, and Ms Chakar believes she has spied one, for some market participants at least. “There is an opportunity here for those institutional investors that are natural holders of central counterparty-eligible collateral. These assets will be subject to intense demand from the banks and other institutional investors to cover margin,” she says.

“The ability to lend such assets could therefore be a means of offsetting some of the costs of compliance with the new rules, as well as augmenting depressed yields.”

‘Fund managers didn’t cause the crisis’

Interview

Brian Bollen talks with Peter de Prof, director-general of Efama, about the big issues facing the industry

What does the European Fund and Asset Manager Association (Efama) view as the big issue in the midst of all the regulation that is being proposed in respect of OTC derivatives?

I see two key issues. First, we have the number of regulations and their interpretation, at global, regional and country level. A safer operating environment for financial institutions is welcome, but the multitude of initiatives do not necessarily have the same definitions or interpretations. There needs to be greater homogeneity and co-operation to improve the existing situation dramatically and to achieve the stated objectives. Second, we have questions surrounding liquidity and collateral, which might reduce risk for investors, but will also increase their costs and reduce their revenues.

What is Efama’s official position as an industry representative?

It is crucial to restore investor confidence in markets, so we believe that the various initiatives must be applied in a co-ordinated and structured manner. If derivatives are forbidden or made too expensive, returns to investors will fall.

What do you see as the key challenges facing your members?

I would say we face strategic and operational challenges, from the governance and organisational requirements of the proposed OTC derivatives central clearing platform, when fund managers have no contractual link with it,

to the holding and delivery of collateral, and the segregation of client assets. How, for instance, do we maintain the level of segregation of assets required to remain compliant with regulatory requirements? There will be higher operational and IT costs involved in aligning reporting to the required standards, as well as risk reporting and risk mitigation. There is a price to pay for safety.

What are the possible implications? Might some fund managers decide to leave the industry?

We face a new environment, one that will change the face of OTC derivatives. There could well be mergers.

At the very least, some fund managers who have previously conducted their own administration in-house will decide to focus on their core business, investing, and outsource the administration, inconvenience and uncertainty to a specialist provider. The technical aspects are challenging. But the industry is populated with intelligent and innovative people. It will cope.

Have the challenges of recent years driven Efama to change or lobby for change?

We work closely with the various regulatory bodies and lawmakers around the world, engaging in debate and dialogue in combined attempts to find common, practical solutions. We gather information on the proposals they make, analyse that information and share it, working to unify the message from the buy side. It’s very much a two-way street.

Do you have confidence in the regulators and lawmakers? Do you think they know what they are doing?

Yes. I do. Central bankers and regulators are an audience with an open mind. We are in constant dialogue with

them, and our meetings are all gatherings of professional, constructive and experienced people.

Is the asset management industry being unfairly treated?

It was not fund managers who caused the international financial crisis, but [like the hero in *Life of Pi*] we are all in the same boat

together today, trying to handle several hungry Bengal tigers at once. There is no distinction being made between different components of the financial services world.

Everything is being regulated because that is the political mood, and we have had to address issues that have historically been the preserve of the sell side.

Like it or not, we have to deal with the situation as it is and as it continues to develop.

Your own role as director-general of Efama must be significantly more of a challenge than in the past. More stressful and demanding? I took the job on in September 2007. I could hardly have started at a more chal-

lenging time. So yes, my own role is changing, evolving as Efama’s role evolves. There is greater pressure from external deadlines to tackle the variety of issues erupting simultaneously in different places. Less than a decade ago it was probably quiet and even boring. You wouldn’t say that now. Everything today is much more intense than it used to be.

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Peter de Prof: industry faces new environment

OTC derivatives

Hedge funds weigh effects of a new way of working

Trading strategies

Central clearing will have some negative aspects but there are good points as well, writes **Brian Bollen**

The implications of central clearing of over-the-counter derivatives for certain hedge fund trading strategies could be significant.

If Olivier Lebleu, London-based head of non-US distribution for Old Mutual Asset Management, is correct in his analysis, the imposition of higher levels of transparency will make life increasingly difficult for hedge fund traders pursuing relative value fixed income strategies.

To illustrate his thesis, he points to two of the most high-profile events of recent years in which one party identified vulnerability in another and constructed customised transactions specifically to position itself to exploit that vulnerability. Centralised clearing of OTC derivatives would diminish de facto and de jure the ability of Paulson & Co to trade against the subprime mortgage market as it controversially did in 2007, and the ability of hedge funds to stage a repeat of the "whale trade" attacks on JPMorgan in the spring of 2012.

"The primary pool of funds this process impacts are sophisticated credit strategies," adds Peter Lau-

relli, a New York-based vice-president at eVestment, a provider of institutional investment data intelligence and analytic solutions.

"But it will impact other groups that trade in the OTC derivative markets on an opportunistic basis as well, including macro and multi-strategy funds. I don't think this process will eliminate the ability of hedge funds to exploit unique opportunities as the bilateral structure for OTC derivatives is not disappearing."

However, he goes on to say, the counterparty risks for those who continue to work bilaterally will be higher than those for central clearing, and the costs more onerous. "This could limit the participation of smaller firms in these opportunities, and counterparty risks are always a concern for institutional investors that are increasingly allocating directly to hedge funds."

Jez Bezzant, an independent consultant to hedge funds and UK pension funds, specialising in OTCs, and previously head of derivatives for Aviva Investors (formerly Morley Fund Management, one of the UK's largest fund managers), takes a more positive view than some market professionals. Much of the talk from liability-driven investment specialists focuses on what they see as the negative aspects of central clearing. He thinks that on balance central clearing will have a substantial positive impact but agrees this is not the case for all participants.

"Rather than diminish activity for hedge funds I think it will open up opportunities since cleared OTC derivatives (and their listed OTC lookalikes) will be attractive to arbitrage strategies and possibly high-frequency firms because they are easier to trade," he says.

If all liquid OTC trades take place within a cleared environment, benefits will begin to flow immediately, he argues. The standardisation and automation of documents and processes should increase access to market for smaller funds that have been unable to trade OTC to date. Those who trade OTC regularly should benefit from lower operational costs and increased ease of trading. Despite the need now to pay initial margins, they may be better off financially in the long term.

This will pave the way for more traders to take part in an increasingly screen-based (electronic) market, and to transfer tried and



Centralised clearing would have diminished the possibility of trading against the subprime market

AFP/Getty

'Rather than diminish activity for hedge funds I think it will open up opportunities'

Jez Bezzant, independent consultant specialising in OTCs

tested arbitrage and HFT models into cleared derivatives. "When you can see prices and have liquidity, you can profit from using investment strategies used in other liquid markets," Mr Bezzant elaborates. "It's easier to implement such strategies in an electronic environment."

Andrew Schneider, chief executive of Global HFA, notes that the investment process will be rendered more efficient by central clearing, and the playing field levelled. He suggests that existing hedge funds are unlikely to change their strategies, as that would involve rewriting information documents and seeking re-approval from investors.

"They may lose part of their performance because of central clearing, but they won't want to

lose investors who might decide to rescind their commitment," he says.

If Mr Bezzant is correct in his assessment, central clearing is potentially a good thing for hedge funds. Paradoxically, however, as has been highlighted before in these pages, pension funds could lose out. The law of unintended consequences means that regulation intended to help protect them could damage their value as they attempt to trade in typically illiquid instruments in order to match their long-term liabilities.

"Most pension funds don't perceive the intended reduction in operational risk from central clearing as a worthwhile benefit because of what they use the OTC markets for," concludes Mr Bezzant. "Many tell me that the additional costs of moving to central clearing of OTC derivatives may outweigh the benefits it is thought likely to bring, since most had already invested in systems and processes to manage their bilateral exposures."

Despite the enduring efforts of regulators, doubts continue to be uttered about their effectiveness. Nagging questions persist. Do

they understand the industry they are trying to regulate? And if not, how can they possibly know what they are doing? The perception prevails that while they are labouring mightily to reduce systemic risk, they share a lack of instinctive awareness of the details in which the devil so often lies.

Michael Levas, senior managing principal at Fort Lauderdale-based Olympian Capital Management, sums it up neatly. "I've said it before, and I'll say it again, liquidity and transparency are the two most important elements of any marketplace; we need more dialogue between market participants and regulators so that the latter are better aware of what they are regulating."

The frustration being expressed by some market participants at the lack of co-ordination between different regulatory bodies in different countries is almost tangible. As is the suspicion that whatever form the final regulatory frameworks take globally, hedge funds and other financial institutions will devise ways to arbitrage them to deliver maximum benefit to themselves.

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Singapore steps up to plate

Asia

The city-state has become the first in the region to meet new standards, says **Jeremy Grant**

It was hardly the most eye-catching of announcements, but it revealed that in Asia there are signs that the region is slowly gearing up for the era of over-the-counter (OTC) derivatives reform.

This month the Singapore Exchange said its two clearing houses had met a new set of standards required by global market regulators for the operation of such institutions, making it the first exchange with a clearing house in Asia to meet those standards.

The standards were developed last year by the Madrid-based International Organisation of Securities Commissions, and the Committee on Payment and Settlement Systems.

They are designed to provide greater protection to investors by tightening up

Already some entities in Asia have decided it is not worth registering as a swaps dealer in the US

on risk management and other procedures at clearing houses, to help reduce the systemic risk associated with another big default – like that of Lehman Brothers, which helped spark the 2008 crisis.

Clearing houses are at the centre of global efforts to make the financial system safer, by requiring that more OTC derivatives be processed through them. Because a clearing house stands between two parties in a trade, ensuring that a deal goes ahead even if one side defaults, it helps reduce the damage caused to the wider financial system if counterparties fail to make good on their promises.

Singapore's exchange is not the biggest in Asia, but it is arguably the most ambitious. It was the first to offer clearing of interest rate swaps in Singapore dollars and US dollars, as well as clearing of Asian foreign exchange forwards, a type of currency derivative.

In November, Singapore amended its securities laws to take account of global OTC derivatives reforms,

including requiring mandatory reporting and clearing of certain OTC derivatives transactions.

The city state's exchange is making a play for what it expects will be growth in the use of OTC derivatives as demand for risk management and hedging increases – itself driven by appetite among Asian companies for such services as their businesses become more complex. Much of that will be due to the expansion of Chinese companies into the region.

Hong Kong Exchanges & Clearing and KRX, the Korean exchange, also plan to offer OTC derivatives clearing, while the Japan Securities Clearing Corporation in October last year started clearing yen-denominated interest rate swaps, the largest by value traded of any OTC derivatives in Asia.

Yet there are complications. The wave of new rules sweeping across OTC markets in the US and Europe – enshrined respectively in the Dodd-Frank act and European Market Infrastructure Regulation – have had a chilling effect on market participants in Asia.

Unease persists over the possible extra-territorial effects of Dodd-Frank, in particular a provision that any bank or OTC derivatives counterparty that carries out \$8bn in notional value of OTC derivatives trades in one 12-month period must register as a swap dealer with the Commodity Futures Trading Commission, the US regulator.

This would trigger compliance with a range of obligations under Dodd-Frank, including reporting trades. It would come on top of having to comply with rules laid out by regulators in the markets where Asian participants are based and would be likely to add to costs, market participants and lawyers say.

Already some entities in Asia have decided it is not worth registering as a swaps dealer in the US. They include Singapore-based DBS, south-east Asia's largest bank by assets.

Yet Paul Landless, counsel at the Singapore office of Clifford Chance, the law firm, points out that the mere fact of dealing with a US bank would suck Asian banks into some sort of extra compliance cost.

“Even if they are not registering, US banks will be and so will Europeans, so Asian banks kind of get dragged into Dodd-Frank life because they are trading with somebody who is having to be Dodd-Frank

compliant,” he says.

Others worried about the effect of the regulations are investment managers, concerned that the new rules will require them to post collateral with clearing houses in order to be able to continue dealing in OTC derivatives.

Yet while such concerns have been given a thorough airing in Europe, there

seems little debate – in public at least – in Asia.

That may be because Asia comprises only approximately 8 per cent of the \$648tn in notional value traded in the OTC derivatives market.

But given that the market is only likely to grow in size, it seems inevitable that the issue will move up the agenda.



Standard approach: the Singapore Exchange

Bloomberg



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