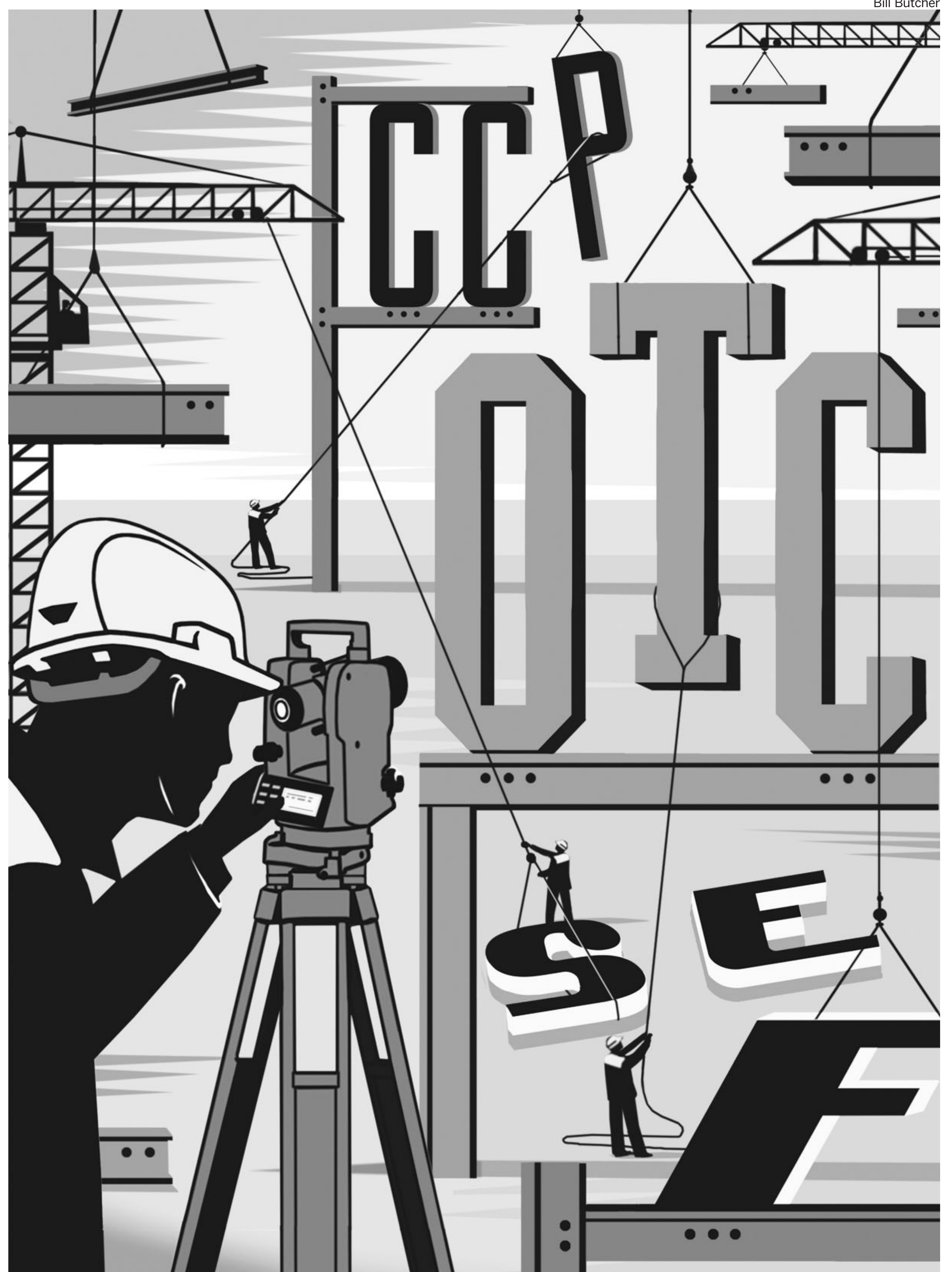
FTfm OTC derivatives

# Buyside seeks clearer view of OTC trading reconstruction




Bill Butcher

## Overview

A number of concerns are clouding efforts to reform the sector in the US and Europe, says **Jeremy Grant**

Working nights and weekends is probably not in the job description of many government employees, and certainly not at the two US market regulators charged with coming up with detailed rules and regulations to implement sweeping reform of the over-the-counter (OTC) derivatives markets.

But Scott O'Malia, a commissioner at one of them – the Commodity Futures Trading commission, the US futures watchdog – said last week that was what some of the agency's staff had been doing, so great is the pressure to get the work done by a deadline of July 15, set by the US Congress.

By then, the precise ways in which large swaths of the financial industry are to deal in credit default swaps, interest rate swaps and other OTC derivatives are supposed to be clear. And by then, in theory, the way OTC derivatives markets function is supposed to be changed permanently, beginning a new chapter in the post-2008 financial crisis clean-up of the financial system. According to the Bank for International Settlements' latest quarterly report, the notional amounts of outstanding contracts totalled $513,275bn as of June.

Charles Marston is chief executive of Calypso Technology, a company picked by CME Group – which recently launched interest rate swaps clearing – to help its members manage intra-day clearing risks. He says: "Given the current regulatory initiatives designed to improve financial stability, we are going to see a fundamental shift in the OTC derivatives market toward the clearing of standardised OTC derivatives on exchanges."

Since passage of the Dodd-Frank act in June, the CFTC and Securities and Exchange Commission have been working on a series of "rulemakings" that set key definitions, such as what constitutes a "major swap participant" in the OTC markets, how big "block" trades should be. They also cover what an appropriate governance structure should be for entities such as clearing houses – through which many standard OTC derivatives are to be processed – and "swap execution facilities", a new type of trading platform created by Dodd-Frank specifically for the trading of OTC derivatives.

The workload is immense. That explains why the CFTC and SEC staff have been working anti-social hours to meet the July 15 deadline. Yet even as all this work is proceeding, what the new regulatory landscape means in practical terms for users of OTC derivatives such as pension funds, asset managers and hedge funds – the buyside – is far from clear.

Mike Cahill, chief operating officer at the Options Clearing Corporation, a Chicago-based clearing house that clears for all eight US options exchanges, has been watching the process closely as the OCC plans to enter the OTC clearing business soon. He says: "The regulatory structure in the US has some significant uncertainty to it right now."

That may seem odd, given that Dodd-Frank set the stage for a revolution in the way OTC derivatives are to be treated. But a host of issues are bedevilling the buyside, including the added costs that use of clearing will impose, a matter of hot debate since last year.

Fresh issues have cropped up in recent months. One is how pension funds and asset managers will be required to handle margin collateral, which is posted to a clearing house, of a central counterparty (CCP), to protect against a default.

Large asset managers such as BlackRock and Pimco have been lobbying for collateral that must be held at a clearing house not to be held in so-called "omnibus" accounts, where such funds are pooled with that of other market participants.

Instead, they are pushing for "segregated" accounts, where each buyside participant's collateral would be ring-fenced from that of others, ensuring each participant is not exposed to the default of another – so-called "fellow customer risk".

Yet futures brokers – which are to play a key role in bringing customers' OTC trades to a CCP – as well as the CCPs themselves argue that switching to this model for OTC derivatives "would bring significant added costs, which they aver would ultimately be borne by the customers", the CFTC notes.

One such cost would be an increase in the money CCPs ask of their customers to maintain an adequate default fund, since the collateral of non-defaulting swaps customers would not be available as a default resource. That, industry experts argue, will be another drag on investment returns for asset managers. The industry has until next week to pitch its comments to the CFTC, which may incorporate them into its final proposals.

Some bankers argue that asset managers and pension funds face an additional headache simply in managing the operational complexity of posting upfront margin. Most will never have had to deal with placing margin before but will soon need to have the back office capability to manage daily changes to margin calculations that are routinely made by CCPs. Dave Olsen, head of OTC clearing at JPMorgan says: "It's something the buyside has spent a lot of time trying to understand. It's opaque and it's reasonably complex."

Another thorny issue is how large-sized OTC derivatives trades are likely to be possible. In equity markets, it is common for institutional investors to carry out large orders on behalf of clients, and the same is expected in OTC derivatives as investors want to get large deals done without revealing their hand to the wider market.

At the same time regulators want to bring transparency to the trading of OTC derivatives, so that as many of them as possible be traded on platforms where prices can be seen by all participants. Reconciling the desire by

**Continued on Page 16**

## Contents

**Q&A**
A discussion with top executives from the International Swaps and Derivatives Association
**Page 16**

**Pensions**
What would be the consequences for pensions of centrally cleared OTC derivatives?
**Page 17**

**Regulation**
Harmonisation of rules in the US and Europe hits a sticky patch
**Page 18**

**Independent directors**
Objections to the plan are ideological and pragmatic
**Page 19**

**Industry view**
PaceMetrics says reform will need a lot of investment in infrastructure
**Page 19**

# The industry weighs up the cost of transparency

**Q&A**
BRIAN BOLLEN

*A conversation with Conrad Voldstad, chief executive of the International Swaps and Derivatives Association and Robert Pickel, ISDA executive vice-chairman*

**Does ISDA have a clear idea of what it would like to see happen in the industry by July 15 2011, the deadline for rule-setting following the Dodd-Frank Act?**
There is no simple yes or no answer. There will be gradations as regulators weigh the costs and benefits of different approaches to rulemaking.

**And those would include?**
End user margin exemptions. The Act exempts end users from its clearing requirements but also gives regulators the power to require them to post margin. That is tantamount to forcing them to clear, as clearing obviously involves posting initial margin to the clearing house and variation margin depending upon market movements. We think companies that are using derivatives to reduce risk in the normal course of their business should not be penalised.

**What would be the consequences if they are compelled to?**
We crunched some numbers at the time Dodd-Frank was finalised that showed it could cost corporate America $1,000bn in capital and liquidity requirements.

**How have you arrived at this figure?**
We analysed 2009 year-end market statistics and determined the total outstanding of end-user swaps with US banks (about $21,000bn). We then estimated, using current industry practices, what the initial margin requirement would be (about 1 per cent of the total, or $213bn). We also determined what the variation margin would be on the portion of end-user swaps that are not currently collateralised (about $112bn). We performed the same exercise for US companies that had swaps with non-US banks (which added another $80bn in collateral requirements). This brings the total to about $405bn.

But you also need to factor in collateral requirements relating to future movements in market prices. We utilised a calculation called potential future exposure and found this would add another $370bn of collateral needs.

Finally, if market conditions reverted to the severe turmoil of 2008, we estimated variation margin might increase by over $200bn for end-users. This brings the total to about $1,000bn.

**Would it be correct to describe ISDA's view on transparency and its limitations as robust?**
We identify two kinds of transparency: regulatory transparency and market transparency, which includes pre- and post-trade transparency. Everybody believes in regulatory transparency, because regulators need to see what is happening in the industry, and where the concentrations of risk are taking place. The industry has already set up three data repositories, for equities, interest rate swaps and credit, supplying the necessary information. Work is progressing on doing the same for commodities and foreign exchange. It is working well. With regards to market transparency, we believe users of most derivatives have tremendous pricing transparency and extremely competitive pricing, and we have research to support this. We are working to further improve transparency, but we need to keep in mind that there is a clear trade-off between transparency and liquidity.

> 'We have said all along that clearing houses are the next "too big to fail" institutions'

**FT Trading Room**

Guy Sears, wholesale director at the Investment Management Association asks who will pay for the changes to regulations for clearing over the counter (OTC) derivatives.

**Can you elaborate?**
Detailed real-time reporting of a very large transaction could affect the market disproportionately, adversely affecting the ability of market-makers to provide liquidity. This would mean more risk for those who want to undertake large transactions, forcing them to drip-feed smaller transactions into the market, thus reducing liquidity.

**What do you conclude from that?**
Block trades have to be exempt, and the exemption must be meaningful in order to preserve liquidity. There is a clear continuum. How much transparency do you want? How much electronic trading and liquidity do you want?

**The market is nervous about the timing of the implementation of Dodd-Frank requirements. Does ISDA see a clear picture emerging?**
We need to think about the phasing in of rules. The process requires that the rules be in place by July 15. But the rules do not take effect for a further 60 days. It is just not possible to flick a switch one day. We need a series of deliberate steps rather than one Big Bang.

**There is a lot of faith being placed in clearing houses as the answer to all kinds of imagined deficiencies in the use of OTC derivatives. Is this faith justified? Or does it present inherent dangers?**
The OTC derivatives industry is committed to the use of central clearing facilities as a means of reducing counterparty credit risk. However, we have said all along that clearing houses are the next "too big to fail" institutions. It is critical to monitor how they are structured, managed and capitalised. Clearing houses can and do fail – since 1974, three clearing houses in France, Hong Kong and Malaysia have done so.

Clearing houses must be designed to absorb the credit risk of each of their clearing members in the event that one of them defaults. If a default were to occur, the other clearing members must manage the resulting risk of the clearing house and, very likely, bid to take on the defaulting clearing member's positions. Clearing members must have the requisite financial strength and product expertise to assume this responsibility.

Because clearing houses concentrate the credit risk of their clearing members, policymakers and legislators recognise that clearing houses might create systemic risk themselves and that the failure of a clearing house could have devastating consequences.

Clearing houses must be able to survive a worst case scenario.

Barack Obama applauds after the signing of the Dodd-Frank Act in July, 2010 Christopher Dodd, left, looks on Bloomberg

# Fresh issues add to OTC rulemaker squeeze

Continued from Page 15

regulators to make swap trading and pricing data available to the public in real-time to promote transparency "while protecting the anonymity of market participants", according to the CFTC, is the balance that the regulator will have to strike as it decides how big a block trade should be.

Equally crucial will be the time delay by when a trade has to be reported publicly. The longer the time, the easier it is for a dealer to be able to hedge his position in the inter-dealer market as there will be less information about that trade in the public market, which rival traders might use to move prices.

A current CFTC proposal suggests, in one of two scenarios, that only 5 per cent of OTC derivatives would classify as block trades.

Lee Olesky, chief executive of Tradeweb, an electronic fixed income and derivatives trading platform, says: "There is a risk that if the rules are not sufficiently protective of block transactions it will be harder for anyone to take that trade on." In Europe, too, uncertainty clouds the picture since reforms are proceeding on a twin – but not parallel – track.

OTC derivatives clearing is being tackled in the European Market Infrastructure Regulation (Emir) proposals, produced by the European Commission in September, while the issue of how OTC derivatives are to be traded is being dealt with separately in a sweeping review of the Markets in Financial Instruments Directive (Mifid).

> '[Smaller investors'] challenge gets bigger each day they are on the sidelines'

Hanging over all of this is a basic question: when will market participants actually have to start complying with the new regulations?

Mr Olsen says: "It will be interesting to see if the requirement to clear will be for a 'big bang' on July 15. If that's the case you're going to have varying degrees of readiness."

Many large fund managers have been quite heavily involved in shaping the new rules by lobbying and attending regulators' public roundtables. They are likely to be able to handle all the changes better than smaller players, he argues.

But he adds: "I think you've got a pretty deep group of much smaller investors that have been less involved and have a less substantial call on the resources of the clearing providers. Their challenge gets bigger each day they are on the sidelines."

*Jeremy Grant is the editor of FT Trading Room*



# Central clearing could damage pensions

**Pensions**

Industry executives tell **Brian Bollen** measures to make financial system safer will add risk

Could the proposals to force pension funds to clear OTC derivatives centrally represent a classic case of the law of unintended consequences in action? If the rumblings from the pensions industry are any guide, this may well turn out to be the case. The central clearing measures dictated from on high with the intention of making the financial system safer could instead increase risk levels.

This emerges as one of the key issues to present itself in even the most cursory examination of the US and European proposals to "improve" the safety of OTC derivatives, and ultimately the value of pension funds.

The pension fund industry argues for exemption from the central clearing requirement on what are in effect the same grounds used to argue for the exemption of companies that use hedging as an intrinsic component of their business model.

Pension funds that pursue liability driven investment strategies often use OTC derivatives to hedge unrewarded risks that can cause fluctuations in their liabilities, such as inflation or interest rate risk. Standardisation of their diverse requirements represents a significant challenge.

The impact would be felt not only on the technical side of the business. It would also affect the financial arithmetic. Central clearing will mean additional costs (widely estimated at the equivalent of 100-200 basis points lower performance), making it a certain drag on income. This could in turn nudge a fund into taking a riskier approach to investment, or demanding more support from its sponsoring employer. "If a pension fund is using OTC derivatives we recommend they hold 20 per cent of their assets in cash or gilts to post as collateral with the bilateral counterparty," says Ben Clissold, deputy chief investment officer at P-Solve, a consultant. "If they are required to switch from collateralised OTC derivatives to central clearing it will reduce capital efficiencies by requiring them to post initial margin, which is not needed in bilateral transactions.

This could cause a drag on overall performance by requiring the amount of assets that would need to be available as collateral by a further 6 per cent, he calculates, as cash will return only Libor. "The other 74 per cent of assets will have to work even harder to compensate, so paradoxically the requirement to post margin to a central counterparty to reduce risk could actually increase risk, reduce income, or both," he says.

Tony Kirby, director, regulatory and risk management at Ernst & Young and chair of the Mifid Forum best execution and trading group, predicts there will be what he calls a rolling wave of higher costs all the way back to the buy side. "In a worst case scenario, a whole range of costs will increase, and the increases will be worse if there is initial and variation margin segregation on top," he says. "These will all be passed on to the buy-side as fees."

Little good will come of it, he argues. "Will it make things safer? Are the measures proportionate? Do they tackle the problem of speculation? No. Speculation is the flip side to hedging, yet some regulators think hedging is good, while speculation is bad. They have to be careful not to stifle growth or pension funds won't be able to plug their deficits."

Neill Pattinson, chief strategy officer, global rates, at HSBC Investment Bank, agrees. "What will be the impact of using a central counterparty? It will clearly be a drag on investment return if they continue to use derivatives in the way they have done until now," he says.

Not only will pension funds have to post initial margin that is not currently required in bilateral OTC transactions, but they will have less flexibility in the assets they must post. "They will have financing needs for the clearing house eligible collateral, which will represent an ongoing cost," says Mr Pattinson.

Tony Kirby: 'a rolling wave of high costs'

He concedes readily that clearing will provide certain benefits, but adds there are other ways of mitigating risk. "No one in the fund manager community is looking at clearing as an immediate imperative; they feel their existing bilateral facilities give adequate credit protection."

Whatever the philosophical and theoretical debates, a readiness to adapt abounds. Stefan Gavell, executive vice-president of State Street Corporation, says: "Clearing of derivatives is going to be a reality – as well as enhanced requirements for OTC contracts. While there are overall benefits from clearing in the reduction of systemic risk, it will also require major changes to how market participants, including buy-side firms, execute, settle, collateralise and report on trades."

A word of caution comes, though, from Philippe Rozental, head of asset servicing at Société Générale Securities Services.

"It's the pre-trade area that pension funds must still concentrate on when making a decision whether to invest in OTC derivatives, not the post-trade processes, however sophisticated they might be."

Mr Clissold of P-Solve believes the worst of all possible worlds would be to require pension funds to clear derivatives before central clearing counterparties can deal with all the types of derivatives pension schemes use.

Making it possible to clear some transactions centrally but not others would defeat the objective of the exercise, he argues.

We're here to *simplify complexity* for you

Central clearing of OTC derivatives has arrived and it will change how you do business. You need a partner you can trust to help you meet your requirement for stability, simplicity and clarity. With our experience, insight and established clearing services across exchanges globally, we are ready to support you.

At UBS, we look to understand your individual needs and build an intellectual partnership in order to provide scalable and flexible solutions; delivering our market-leading innovative services for the success of your business.

We have made significant investment in our infrastructure and are ready to guide you through the new landscape for OTC Clearing.

To talk to us about the opportunities call:

| APAC | David Gray | +852-2971 8823 | david-p.gray@ubs.com |
| --- | --- | --- | --- |
| EMEA | Clive Malin | +44-20-7567 3785 | clive.malin@ubs.com |
| Americas | Reinhardt Olsen | +1-203-719 3408 | reinhardt.olsen@ubs.com |

www.ubs.com

Options, derivative products and futures are not suitable for all investors, and trading in these instruments is considered risky. Past performance is not necessarily indicative of future results. Issued in the US by UBS Securities LLC, member NYSE, FINRA and SIPC. © UBS 2011. All rights reserved. 04502 01/11

# Domestic pressures weaken US/EU consensus

The US midterm election result could mean the Dodd-Frank Act may not be implemented in the way originally intended AP

**Regulation**

The harmonised approach to rule-making is reaching its limits, finds **Philip Stafford**

The political response to the financial crisis has produced a carefully crafted consensus between policymakers in the US and Europe but limits to agreement could be approaching.

Driven by an acknowledgement that financial markets and institutions rapidly and fluidly cross national and regional boundaries, policy-makers within the G20 group of leading economic nations in the past few years have been keen to ensure that the regulatory clampdown leaves few loopholes.

The US, furthest down the road towards implementing reform, passed the vast Dodd-Frank Act for financial services last summer. It laid the foundation for a radical overhaul of off-market financial transactions, known as the over-the-counter (OTC) derivatives markets.

Among other requirements, it stipulates that large volumes of derivatives be traded on exchanges or platforms called "swap execution facilities" (SEFs). Furthermore "standardised" contracts should be processed through clearing houses to help safeguard the financial system against a big default, thus creating a key safeguard against future financial contagion.

Illustrating the broad agreement on the principles by policy-makers, the European Commission soon followed with its own published proposals closer to the US legislation than many had expected. The hope, in passing similar legislation, was that it would reduce the risk of market participants "shopping around" for lenient treatment in different jurisdictions, disrupting markets.

Yet pressures closer to home on both sides of the Atlantic are in danger of putting this hitherto relatively harmonised approach between the US and Europe in jeopardy and potentially introducing more risk into the global financial system.

US lawmakers such as the Commodity Futures Trading Commission and the Securities Exchange Commission are already under huge pressure to meet a deadline of July 15 set by Congress to finish writing the rules for Dodd-Frank.

But November's midterm election result, which saw the Republicans take control of one house of Congress, has thrown into question whether the US will be able to implement the act in the way that was originally envisaged.

The thrust of the Dodd-Frank reforms aimed to shift power in OTC derivatives away from a relatively small group of dealers at banks who have long controlled trading in such instruments, by moving them on to more formal trading venues with prices visible to all participants. However, there are fears that some Republicans are keen to at least tweak key aspects of the OTC derivatives portion of that act. This could open up new areas and require regulators to consider yet more potential consequences.

There are fears that such rule tweaks with highly damaging unintended consequences are under way. Just before Christmas the CFTC voted to limit the derivatives clearing house capital requirements for member dealers to $50m, down from $5bn.

Larry Tabb, founder and chief executive of Tabb Group, the US-based consultancy, has called the move extremely dangerous, even if the intentions were sound. As he pointed out, the large banks are perceived to have locked up the derivatives market and, if clearing did not have lower capital requirements, the dominance of the dealers in this market would never be mitigated.

"Reducing the amount of capital needed to become a member from $5bn to $50m means there will be a larger number of smaller players. If these dealers are not adequately capitalised, then the larger dealers will be financially guaranteeing the smaller ones as larger dealers can bail out smaller dealers. But it would be difficult, if not impossible, for smaller players to bail out the larger dealers."

SEC and CFTC officials fear they could be hauled before Republican-dominated congressional committees for oversight hearings to be grilled on how they were conducting the so-called "rule-making" process for Dodd-Frank.

Some are concerned Congress could even starve the agencies of fresh funding as a way of forcing certain changes to the rule-making process. CFTC chairman Gary Gensler has said he needs 400 extra staff – and therefore more funds – if the CFTC is to fulfil its remit.

While the Senate approved raising the amount requested for the CFTC in fiscal 2011 by 69 per cent to $286m, the CFTC's underlying annual funding is earmarked at $169m.

CFTC chairman Gary Gensler needs more staff Bloomberg

With a lack of funds and an onerous workload, the CFTC could be forced to hand over some of the implementation to industry regulatory bodies, or even require banks and exchanges to pick up some of the task of implementing the regulations.

Meanwhile in Europe, last month saw the publication of the European Commission proposals for reforming its Markets in Financial Instruments Directive.

Brussels went further than the US on OTC derivatives, proposing that pre-trade information on trading in "non-equity instruments" be published "in a continuous manner". It is also seeking the power to ban certain products and activities to maintain market stability.

"With this power the Commission is likely to specifically target OTC derivatives deemed eligible for clearing but which no central counterparty is able or willing to clear," says Helena Walsh, the Brussels-based analyst for Cicero, the financial services consultancy.

However, some feel the importance of the political shift in Washington is overdone. Republicans cannot easily change Dodd-Frank since any proposed changes would be unlikely to get past a Democrat-controlled Senate, and even if they did the White House could exercise its veto. Observers also point out that with large swathes of Dodd-Frank also underpinning likely European legislation, any change could also spark international political problems.

Furthermore any plans to curb OTC reform will also have to compete with issues seen as having broader political importance than OTC derivatives – notably approving the next round of subsidies to American farmers.

Roger Liddell, chief executive of LCH.Clearnet, says there is scope for differentiation of regulation in some areas, such as the CFTC's move to bring down the net capital requirements for swaps clearing from $5bn to $50m.

"You will see divergence in the way the customers are protected."

However he feels a greater split between Washington and Brussels is unlikely. "The convergence has been impressive. They share a common interest in not getting businesses to relocate to prevent regulatory arbitrage," he says.

# Opposition to independent directors plan

**Board members**

The view that only those with 'skin in the game' should be allowed to vote plus pragmatic objections are rife, finds **Brian Bollen**

No representation without loss mutualisation. As a student demonstration chant this mantra probably would not quite slip off the tongue. But as a pithy means of summing up some industry views about the imposition of a minimum number of independent directors upon the boards of clearing houses and swap execution facilities it has its supporters. The essence of the argument is that only institutions that "have skin in the game" in terms of exposure to risk in the clearing of OTC derivatives should be allowed to vote on any planned risk committee decisions.

Andy Ross, head of OTC clearing at Morgan Stanley, elaborates. "When you clear a client trade with a clearing house, there are two main points: one, the client puts up an initial margin as collateral for the trade; two, we put up capital to support the risk of the clients to the CCP [central counterparty clearing house].

"It is not just our own client that benefits from our guarantee; if another party gets into trouble we can lose capital. Our cash is at significant risk."

He goes on to say that while he and Morgan Stanley have no problem with the concept of appointing independent directors, he sees instant inconsistencies. "It would be very interesting for independent directors to make comments on the risks being run when they have no skin in the game and others on the committee do have skin in the game," he says.

The question of sharing risk and possibly sharing the burden of any loss incurred by a clearing house is not the only objection being raised in discussion of the impact of the Dodd-Frank Act and its equivalent in Europe, the European Market Infrastructure Regulation (EMIR, also confusingly referred to as EMIL for European Market Infrastructure Legislation).

There are occasional mutterings to be heard about the precise way in which the proposals might be implemented, but there seems to be no strong wave of protest against the suggestion that increasing the numbers of independent directors might improve governance. And while the "no skin" argument can be interpreted as ideological, the other principal argument against the proposal is based on pragmatism.

"We are generally very supportive of legislation and the move to push more OTC derivatives through clearing houses but we have concerns about the independent director proposals," says Roger Liddell, chief executive officer of LCH.Clearnet. "We can just about live with a requirement that more than 35 per cent of board members be independent, but anything significantly above that is simply too high."

Roger Liddell: more than 35 per cent independents 'is simply too high' Gary Coronado

'They [clearing houses] need deep expertise rather than narrowing the group'

In any event, some ask, where are the numbers of independent directors going to come from? The pool of qualified and available talent is not wide or deep. In an ideal world, it would surely comprise recently retired or soon-to-retire market participants, who understand market customs and market nuances.

One drawback, though, is inherent to implementation: almost as soon as such candidates step off the daily treadmill, their market knowledge begins to decay. "The passage of time is certainly one problem," comments Dave Olsen, global head of OTC clearing at JPMorgan. "You could assemble a group of independent directors today to fill the seats, but move on three or five years, and what happens then? How do you keep that group refreshed enough to see the next problem coming?"

He agrees, then, on the importance of appropriate regulation and for closer scrutiny, but questions preventing the clearing houses from having access to the widest talent pool possible.

"The clearing house system is tried and tested. I believe, having seen at first hand how LCH.Clearnet managed the process through the Lehman bankruptcy, quickly collapsing an enormous portfolio and handing cash over to the Lehman estate, that this is in many respects a solution in search of a problem."

For Florence Fontan, head of public affairs at BNP Paribas Securities Services, the key for clearing house governance is expertise before independence, and this is particularly true for OTC derivative products. "Neither the financial industry nor the public authorities can afford the collapse of a CCP," she says. "We therefore need to ensure that the risk committee and the CCP board both have sufficient expertise to ensure proper risk management and to avoid the drive for profits pushing the CCP into dangerous territory."

Lee Olesky, chief executive at Tradeweb, which he says has been performing many of the functions of the newly envisaged Swap Execution Facility since its inception in 1998, offers a different perspective. For him, one area of concern for potential SEFs and clearing houses is the proposed restriction on ownership (no single person or entity can hold more than 40 per cent of an SEF). "Restrictions on ownership will reduce the constituency of potential investors and raise the cost of capital for SEFs and clearing houses."

As happens so often in any discussion of any aspect of the modern financial services system, capital and its cost sooner or later muscle their way onto the agenda. "Providers [of OTC derivatives clearing services] want ownership structures to access the maximum capital," says Tim Murphy, head of BNY Mellon Clearing Europe. "This conflicts with what regulators and legislators want." A workable solution, he posits, lies somewhere in between the two.

# Revamp requires big investment on buyside

**Industry view**
GERRY GIBLIN

Whether it's the proposed European Market Infrastructure Regulations or the Dodd-Frank Bill in the US, reform is sweeping through the OTC derivatives world. Many buyside firms are concerned about the potential implications of these restrictions on their performance. Others worry about the lack of clarity on issues such as segregation of margin collateral and access to central counterparties. Yet one thing is not being addressed: the major infrastructure investment required by the buyside to survive this shake-up.

To start with, buyside firms need to ensure the systems they use to process OTC derivatives are up to scratch. Many on the buyside have a hodgepodge of disparate processes and systems sitting behind their trading operations. As new derivatives develop, new systems are tacked on to deal with them. Sometimes clumsy manual processes are added into the mix, further slowing business processes. One asset manager I spoke to recently can only trade three of a certain exotic derivative a day, as his back-office staff has to process them by hand.

To comply with coming regulations, these systems need to become streamlined and reportable on. This includes accounting, credit, market and counterparty risk management and settlement systems – to name just a few. That is a big investment, especially when considering the scale of the big buyside firms.

Once new systems are in place, buyside firms need to focus on the calibre of their staff. As new reforms blur the boundaries between technology and business needs, those working in both areas need to develop a more holistic view. This means investment in training and hiring highly skilled people – especially ensuring that those working in technology-driven OTC trading have the financial know-how to understand complex derivatives. More importantly, as new OTC regulations are brought in, many institutions will find they need to increase their operations staff numbers, at least in the short term, to guarantee compliance while maintaining performance.

Finally, asset managers need not only comply with incoming OTC regulation but also be in a position to prove this compliance – both to regulators and clients. A final investment will be needed to implement systems that can report on their positions, as well as liquidity and data quality and provenance. Firms will need to be able to pull up this information on demand and show full audit trails. They will need to both prove compliance to regulators and show their clients they are striving to boost performance while minimising risk.

Many managers will be totting up figures worrying about the effect on their bottom line

Many asset managers reading this will be totting up figures in their heads and worrying about the effect of this infrastructure cost on their bottom line. TABB Group found in November that the top 15 OTC derivatives dealers intend to spend almost $675m on technology in 2010/11 to prepare for Dodd-Frank alone. But as with all clouds, there is a silver lining.

Improving infrastructure will boost performance. Smarter systems mean more transparency and more complex drill-downs into your positions. While those buyside firms with older systems will be concerned about treading too close to their trading limits, those on the cutting edge will be able to increase profit margins and ensure they do not cross the line and risk a penalty. They will also be empowered to make snappier decisions. Crucially, they will be able to trade higher volumes of lucrative exotic OTC derivatives, while maintaining effective risk management.

With regulation comes a number of headaches and costs, but also opportunities. Those who make smart investments, and see the opportunity to boost performance and reduce risk, will come out stronger than ever.

*Gerry Giblin is chief executive of PaceMetrics*