White Paper
An analysis of the Global Market For Derivatives
The impact of new regulation

Adsatis

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SUMMARY OF FEEDBACK

Introduction

During July and August 2010, Adsatis consultants interviewed approximately 40 senior individuals from financial organisations to elicit opinion on the likely impact of the legislation that has been passed in the US and the likely direction in European regulation given recent draft legislation. We had a particular focus in our research on the impact on the OTC derivatives markets, although discussions inevitably extended into the wider areas of financial stability and risk management. The interviewees were based in the US, London and mainland Europe and represented investment banks, investment organisations, clearing houses, exchanges, brokers and market infrastructure companies.

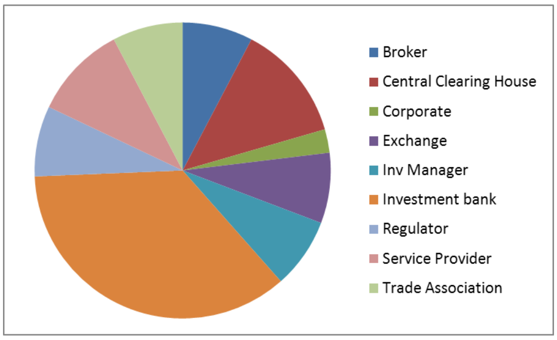

Figure 1: Interview breakdown by organisation type

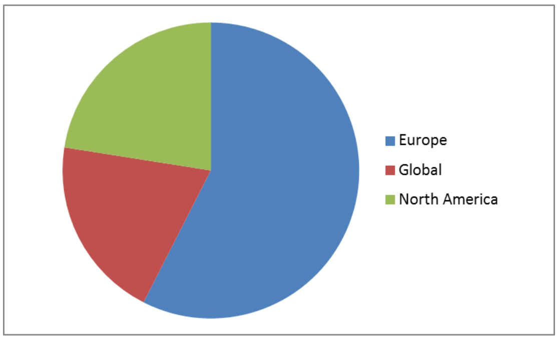

Figure 2: Group breakdown by geographical focus

This report summarises the feedback that we received and observations on likely future developments in this area.

Section A: Regulation in the USA and Europe: It is now clear that as regards regulatory intent in respect of clearing and transparency of OTC derivatives, there has been a substantial degree of coordination between the USA and Europe and a similar approach is intended in both regions. In respect of restrictions on banks' proprietary trading (the "Volcker Rule"), moving OTC derivative business outside the banks ("Swaps Push Out"), mandating exchange trading of standardised derivatives and restrictions of ownership of central counterparty clearing houses, Europe has not followed the US. However, much of the detail regarding rules, institutional status and eligible instruments is still to be defined in both jurisdictions.

Section B: The Move to Central Clearing of OTC Derivatives: Although regulator driven, the industry appears largely to support the initiative to extend central clearing for OTC derivatives transactions. There are, however, concerns that regulators will try and push this too far in terms of suitable instruments. Most respondents articulated the need for any cleared instrument to have sufficient liquidity for margining and for smooth operation of the default process.

The banking respondents largely favoured the industry owned utility clearing house model, whereas many other respondents saw advantage in the greater efficiencies of the profit making, futures clearing model. However, it was not clear that these efficiencies would be realisable for a wider range of instruments. All recognised that it is essential that clearing houses were financially strong with sound default management processes.

Most believe that clearing for Interest Rate Swaps would be extended from current levels and that Credit Default Swaps on indices and major single names would be required to clear. For FX options, NDF's and longer term forwards opinion was divided – some arguing that the authorities would require this for completeness, others arguing that the absence of any real problems in the FX market implied that extension to these instruments was unnecessary. For Commodity derivatives, opinions were also mixed but predominantly interviewees felt the impact here would be limited as most instruments that can be sensibly cleared are already. On Equity Derivatives there was limited feedback but those that did respond indicated that index based vanilla derivatives (swaps and options) and liquid single names would move but that this did not seem to be a high priority with the authorities.

ASSET CLASS	INSTRUMENTS	ESTIMATED PERCENTAGE TO CCP
INTEREST RATE DERIVATIVES	Major currency IRS; vanilla options	Majority of interbank (75%)
CREDIT DERIVATIVES	Basket/Index CDS; major single name CDS	Vast majority of vanilla CDS
FX DERIVATIVES	Major currency long term forwards, NDFs, FXO	No clear opinion at this stage
COMMODITY DERIVATIVES	Most standardised derivatives already cleared – others not suitable	Very limited from current position
EQUITY DERIVATIVES	Index swaps and options; liquid single names	Over half of those instruments cited

The legislation and proposals look likely to exclude Non-Financial Corporate entities (although leaving the precise definition of these somewhat uncertain) but most other organisations will be required to clear. Many (uni-directional) buy-side firms felt this placed an unfair burden on them in terms of margin/collateral but they were not optimistic about their exclusion. Most respondents also felt that sovereign bodies and other government agencies should be required to participate in clearing but these organisations themselves hoped for exemption from the process.

A slight majority of respondents felt that clearing would widen bid/offer spreads to compensate for higher transaction costs. Also, for the banks there would be loss of cheaper funding opportunities from the re-hypothecation of collateral as this was moved to the CCP. However, some felt that spreads would narrow over time as the market became more efficient. Most respondents were optimistic about market volumes growing for most OTC derivatives, although a number commented that this may be reflected more in the number of trades rather than overall value of transactions.

Section C: Exchange Trading, OTC and the Need for Transparency

The original, post-crisis position of the authorities appeared to want most "standardised" derivatives to be traded on exchanges. This position has softened on both sides of the Atlantic. Our research indicated that many buy-side participants liked the idea of a greater range of exchange traded instruments but that many sell-side interviewees pointed out that the OTC market largely existed because of the bespoke transactional requirements of many customers and that mandating exchange trading would be counterproductive and would leave more risk un-hedged by genuine end users.

Most recognised that greater transparency would be achieved through requiring electronic execution of trades (either on exchange or through a Swap Execution Facility ("SEF" - though what this constitutes has still to be defined) and reporting through trade repositories.

No respondents had any real issues with regulatory reporting though many questioned the ability of the authorities to get a comprehensive picture of positions and risk. Likewise, there were few issues with pre-trade public transparency of pricing of derivatives. However, the sell-side respondents indicated real concern with early post-trade public transparency of deals, indicating that this achieved very little and had a material negative impact on liquidity for anything but small size transactions. Many (mainly sell-side) questioned whether increasing transparency would benefit users in terms of narrower bid/offer spreads relative to trade size. These claimed that derivative markets were already as efficient as the different instrument/asset types could be, relative to risk and liquidity.

Section D: Amendments to Capital Requirements

Many respondents were, at this stage, uncertain of how capital requirements would actually develop although, unsurprisingly, there was a general expectation that these would tighten. Of those that did reply, there was a fear that capital requirements for trades not centrally cleared would be significantly increased to a "punitive" level, although regulatory responses indicated only that these would be "appropriate" (to the risk). On the other hand, concerns were expressed that the favourable treatment of capital with CCPs would be modified.

Many buy-side respondents expressed concern that the extra costs would be passed on directly to the users, although many sell-side commentators felt that competition would limit the extent to which this would happen.

Section E: Other Moves to Reduce Systemic Risk from Derivative Trading in Banking Organisations

These moves now seem to be largely US focused, as the EC has not followed US authorities on the key elements.

Most interviewees felt that Swap Push Out would have a very limited impact on most banks and could take a long time to implement.

The proposal to give the CFTC (subject to further study) the authority to limit positions taken in derivatives by market participants raised few concerns, although some buy-side interviewees said this could become an issue if applied rigorously.

The proposed restrictions on proprietary trading by banks (the "Volcker Rule") were also thought likely to have a limited effect from current levels of proprietary activity, given modifications to the legislation and the probable further qualification that would take place as the rule was defined in detail. It was observed that this would be difficult to implement effectively, particularly as trading to facilitate client liquidity was to be permitted.

Section F: The Impact on the Market Landscape

Although opinion was divided on the overall impact of the measures, a majority of the interviewees felt that the combined impact of the rules would reinforce the oligopolistic market structure that effectively exists in global derivatives. The measures will favour (certainly initially) the bigger banks with the operational capacity, technology and management bandwidth to embrace the changes and that these are likely to be the same organisations that currently dominate activity. In the longer term, some felt that central clearing could create a more level playing field and facilitate the development of some specialist organisations but that these, by definition, would not become systemically significant.

For the clearing houses and exchanges there will be an obvious boost to activity. However, it was felt that this was not guaranteed to generate significant extra returns on capital for these organisations, as costs will increase and competitive pressures will curtail the ability to pass these on in higher fees.

The wild cards were thought to be the brokers and independent trading platforms where the general opinion was that these organisations had proved to be both durable and flexible in the past. If they embraced the changes through the provision of SEF capability and continued to facilitate intramarket liquidity, these organisations could benefit significantly. The big uncertainty was whether the definition of a SEF would exclude single dealer platforms. If this were to be the case, this would provide considerable stimulus to the brokers and multi-dealer platforms.

It was expected (and now seems clear) that Non-Financial Corporations ("NFCs") will be exempted from clearing for transactions that hedge the risks arising from their mainstream business. It was also expected (as mentioned above) that sovereigns and some government agencies would be exempted from clearing. However, on this market opinion was pretty unanimous that this would be a mistake. It was observed that leaving any large institution outside the rules could sow the seeds for the next crisis!

APPENDIX A: MARKET CHARACTERISTICS GRID – COMPARING OTC WITH SEF AND EXCHANGE TRADING

	OTC	MDP/SEF	Exchange
Description	Bilateral deals between dealers or between dealer and client. Pricing provided by phone or electronically via Single-dealer trading platform.	Multi-dealer platform. An electronic platform where multiple dealers post prices and transact using a variety of protocols: direct dealing, RFQ etc	Open all-to-all market where participants all have equal status and transact by posting orders. Orders are matched either by electronic systems or by traditional open outcry.
Contract definition & terminology	Often agreed bilaterally, but generally follows standard terms. Some terms (eg tenor, strike prices etc) always agreed bilaterally.	Standardised contracts based on highest-volume in OTC market.	Only standard contract terms defined by the exchange
Trading terms	Often agreed bilaterally, but generally follows standard terms.	Standardised	Only standard contract terms defined by the exchange
Examples	Market for equity swaps.	Tradeweb, Marketaxess, Bondvision, Brokertec etc	CME, LSE, NYSE, NASDAQ, ICE
Price matching method	Direct communication by voice or electronically. Deal executed after verbal acceptance of dealer offer.	On-screen. Dealers post quotes which are lifted by other dealers or by clients.	On-screen. System matches orders placed by all participants or displays market maker quotes. Alternatively, prices matched by open outcry.
Pre-trade information	Dealers provide client-specific pricing via phone or own electronic platform.	Indicative prices supplied to e-platforms by dealers. RFQ process establishes deal price. Transparency through RFQ to multiple dealers.	Available from the exchange. Top of book and depth of book available. No customer-specific pricing.
Post-trade reporting - regulatory	Reg requirements vary by market. CDS trades must be reported after trades executed.	Requirements met as per OTC, but where reporting is required it's facilitated by the e-platform.	Exchanges report all transactions near real-time.
Post-trade reporting - public	Reg requirements vary by market. CDS trades must be reported after trades executed. Aggregated information often reported by clearing houses and brokers.	As OTC	Transaction size and price reported publicly - not party information.
Participant roles	Differentiation between dealers and customers clearly established by practice. Dealers set prices and provide liquidity. Customers deal based on price and other factors in customer/dealer relationship	Conventions vary but it is likely that the model will be similar to existing multi-dealer portals with counterparties identified and price makers and price takers established. Not clear whether single dealer portals with additional market price feed will be eligible but, if so, this would reinforce the OTC style roles.	No differentiation of roles between exchange members. Members approved by the exchange according to established criteria. Non-members execute through brokers who pass price and other information to participants, generally through electronic platforms. Identity of participants is hidden. Legal counterparty for all deals is the exchange.
Clearing arrangements	Accelerated move of more OTC trades into clearing: SwapClear for IRS and ICE Trust for CDS.	As OTC	Clearing handled by exchange through vertical model for all trades
Credit management arrangements	Dealers provide credit facility to customers based on ratings and other criteria. Collateral is generally not required, except under Prime Brokerage agreements. Terms defined in Credit Support Annex in ISDA agreement between dealer and counterparty.	As OTC	All participants must post margin with the exchange. Non-members post margin with brokers, who pass this through to exchange (but benefit from netting).
Governance and ownership of venues	No specific OTC regulation – subject to national and international regulatory supervision within banking and investment framework	MDPs ownership varied - some owned by group of banks, others by financial services intermediaries.	Exchange ownership varies - many are publicly quoted. Governance appointed by board of the exchange.

APPENDIX B: LIST OF RELATED ORGANISATIONS

The table below gives a summary of some of the relevant organisations in the management, delivery, regulation and control of the financial markets in the USA and Europe, particularly in relation to the derivatives markets.

Name	Full Name	Role/Function	Location
BBA	British Bankers Association	Leading trade association for the UK banking and financial services sector.	UK
BCBS	Basel Committee on Banking Supervision	Part of the BIS tasked with preparing the new regulatory reform proposals	Global
BIS	Bank for International Settlements	An international organisation which fosters international monetary and financial cooperation and serves as a bank for central banks	Global
CESR*	Committee of European Securities Regulators	Independent committee of European Securities regulators established by EU on June 6 of 2001. Mandated to: ▪ Improve the coordination among securities regulators ▪ Act as an advisory group to assist European Commission ▪ Work on implementation of community legislation in EU members	EU
CFTC	Commodities and Futures Trading Commission	An independent agency of the US government. Mission is to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options, and to foster open, competitive, and financially sound futures and option markets.	USA
CLS	Continuous Link Settlement	The process by which a number of the world's (largest) banks manage settlement of foreign exchange amongst themselves (and their customers and other third-parties). The process is managed by CLS Group Holdings AG and its subsidiary companies and include a settlement bank regulated by the Federal Reserve Bank of New York. Established to eradicate settlement/Herstatt risk.	Global
CPSS	Committee on Payment and Settlement Systems	Part of the BIS, CPSS contributes to strengthening the financial market infrastructure through promoting sound and efficient payment and settlement systems. The CPSS is a standard stetting body for payment and securities settlement systems.	Global
EACH	European Association of CCP Clearing Houses	Industry body comprised of senior executives specialising in clearing and risk management from European CCPs, both EU and non-EU. Role is to promote discussions on clearing and settlement in Europe and globally, and to provide expertise and opinions to those responsible for providing central counterparty clearing services.	EU
EC	European Commission	The executive body of the EU. The body is responsible for proposing legislation, implementing decisions, upholding the Union's treaties and the general day-to-day running of the Union.	EU
ECB	European Central Bank	The ECB is the central bank for Europe's single currency, the euro.	EU
ESCB	European System of Central Banks	The European System of Central Banks (ESCB) is composed of the European Central Bank (ECB) and the national central banks (NCBs) of all 27 European Union (EU) Member States. Responsible for conducting monetary policy for the economic and monetary union (EMU). The ESCB is governed by the decision-making bodies of the ECB.	EU
ESMA	European Securities and Markets Authority	European Securities and Markets Authority gives CCPs authorisation to operate in the EU. To ensure adequate on-going supervision at European level, the EC seeks an appropriate allocation of responsibilities between ESMA and national supervisory authorities.	EU

ESRB	European Systemic Risk Board	EU organisation, which monitors and assesses risks to the stability of the financial system as a whole (macro-prudential supervision).	EU
FED	Federal Reserve System	The Fed is the central banking system of the United States. Its duties are to conduct the nation's monetary policy, supervise and regulate banking institutions, maintain the stability of the financial system and provide financial services to depository institutions, the U.S. government, and foreign official institutions.	
FDIC	Federal Deposit Insurance Corporation	FDIC is a United States government corporation created by the Glass-Steagall Act of 1933. It provides deposit insurance, which guarantees the safety of deposits in member banks, currently up to $250,000 per depositor per bank. The FDIC insures deposits at 7,895 institutions.	USA
FSA	Financial Services Authority	The FSA is an independent non-governmental body, quasi-judicial body and a company limited by guarantee that regulates the financial services industry in the United Kingdom. Its board is appointed by the Treasury. The FSA is being abolished by the new coalition government.	UK
FSB	Financial Stability Board	The Financial Stability Board (FSB), successor to the Financial Stability Forum, was established in April 2009 following the 2009 G-20 London summit, and includes all G-20 major economies, FSF members, Spain, and the European Commission. The FSB represents the G-20 leaders' first major international institutional innovation. Secretary of the US Treasury Tim Geithner has described it as "in effect, a fourth pillar" of the architecture of global economic governance.	Global
FSOB	Financial Stability Oversight Board	FSOB is created to review and make recommendations regarding the Treasury's actions. Its purpose is to review the operation of TARP, to make recommendations to the Treasury for improvements, and to watch for fraud and misrepresentation. FSOB has the power to ensure that the Treasury follows policies in accordance with the Act and the economic interest of the U.S. It is to meet on a monthly basis and report to Congress and the Oversight Panel quarterly.	
OCC	Office of the Comptroller of the Currency	The Office of the Comptroller of the Currency (OCC) charters, regulates, and supervises all national banks. It also supervises the federal branches and agencies of foreign banks.	USA
SEC	Securities and Exchange Commission	The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.	USA

*There are 3 Level-3 committees of the EU in the Lamfalussy process. They are CESR, CEBS and the CEIOPS.
(Source: organisational websites and BIS/CPSS glossaries)

Adsatis Ltd – Sept 2010

If you wish to discuss any of the views expressed in this paper or require further information, please do not hesitate to contact us:

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