



The Basel III Accord – What Is It For?

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CENTRAL COUNTERPARTIES FOR DERIVATIVES – MYTH OR REALITY

Dennis Cox is the Chief Executive of Risk Reward Limited and chairs the Chartered Institute of Securities and Investment Risk Forum based in London. In this article he considers the likely impact of the development of OTC central counterparties and clearing facilities.

Why the Determination for Change?

There appears to be a commonly held view that credit derivatives, themselves over the counter products, were at the heart of the crisis and that they therefore need to be reined in. There is actually very little evidence to support this conjecture – yet it is widely believed. Indeed I am of the opinion that derivatives were actually part of the solution rather than part of the problem.

The view is recognised that the size of the derivatives markets is much larger than the underlying market and that they can distort trading patterns. If the concern was that there were large undisclosed transactions being conducted then the clamour should have been for post trade reporting, rather than for clearing systems to develop. The over the counter derivative operates with the legal certainty resulting from the great work conducted by the International Swap Dealers Association. It involves professional counterparties who utilise these instruments for a range of purposes, only one of which is speculation.

However a scapegoat was sought and derivatives do make a possible scapegoat. They are hard to value, potentially very large and powerful, whilst currently not transparent at all. Their complexity makes them an easy target for the public and the politicians since few understand them. In the need to be seen to do something the over the counter derivatives market was an easy target.

What is Likely to Happen?

There can be no doubt that central counterparties and exchanges will develop and that there will be increasing pressure for over the counter transactions to move to such exchanges. Regulators will use various means of persuasion, including capital charges, to ensure that this happens. The exchanges will develop – and then they will slowly decline and merge. This will waste significant sums of money and will result in a reduction in risk management hedging being undertaken for true business purposes.

There is already a well established derivatives trading market on exchange – the exchange traded derivatives market. There has never been a barrier to these exchanges developing new products which could be standardised and meet with customer demand. That no such instruments have been successfully launched leads to part of the problem. The demand will be to develop a series of standard contracts to launch on the exchanges. These will need to achieve general acceptance and volume to be successful which few are likely to achieve. Over the counter derivatives are bespoke transactions which are designed between the two counterparties and are able to meet specific needs. Standardisation will remove much of the volume and result in many of the transactions failing.

Exchange traded derivatives operate through the market participants placing margin with the exchange to cover the risk of the transaction for its open period – normally one day. Since over the counter contracts for difference by their nature cannot achieve this there will need to be a longer time period for the margin to address. If the proposals currently being discussed actually come to fruition then this is likely to be at quite a high confidence level and will therefore be considerably higher than the levels of margin that market participants have become used to.

This major debate will run for a while but my expectation is that the level of margin required to provide adequate protection to the exchange will undermine the cost effectiveness of the instrument.

Next is the mark to market problem. In exchange traded derivatives the market participants typically transfer or receive daily margin from the exchange. In over the counter markets counterparty credit risk management is applied through the operation of collateral management accounts to reduce the incidence of payments. Indeed for many over the counter derivatives the only actual payment is at the expiry of the instrument.

Standardisation of course runs directly into the accounting rules for hedging to be permitted for accounting purposes. The requirement is for a hedge to be near perfect – an 80-120 hedge. Many standardised contracts will fail to achieve this.

Then there is the final problem. For every contract for difference a solution can be designed which achieves the risk management objectives without any requirement for margin. So in fact the risk management transactions are unlikely to transfer to the exchange and will either be replaced by other products or will not take place at all.

Of course you would not expect us to explain in this article exactly how to replace your over the counter derivative transactions, but it will be important for all firms to think through their options and solutions rather than just rushing towards a solution which will not work or be effective.

The post trade reporting solution makes so much more sense. It provides the transparency that is sought without damaging a part of the industry which does not actually need to have either volume or capital extracted from it.

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