

How Are the New Rules for OTC Derivatives Working?

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The Leaders' statement issued after the G-20 meetings in Pittsburgh in September 2009 included the following paragraph:

"All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse."

Six years on, it seems appropriate to review the changes that this has led to.

The key objective immediately following the crisis was to reduce systemic risk by requiring more collateral to be posted when financial institutions trade with each other. As I explain in Hull (2015), this objective has been largely achieved. Standard transactions between financial institutions are cleared through CCPs and attract both initial margin and variation margin. Non-standard transactions between financial institutions continue to be cleared bilaterally but variation margin must be exchanged and each side is required to post initial margin with a third party. The initial margin for non-standard transactions is based on ten-day movements in market variables in stressed market conditions. More capital is now required for non-standard transactions.

One result of these changes is that there has been a trend away from customized OTC derivatives toward more standard products. This should reduce systemic risk, but there are potential disadvantages. If dealers are less willing to customize transactions, end users may make less use of derivatives for hedging. (This is particularly likely to be true if the standard derivative does not qualify for hedge accounting.) Also, there is a danger that the new rules will hinder financial innovation by dealers.

There can be little doubt that reporting all OTC derivative transactions to trade repositories is desirable. It gives regulators the opportunity to recognize situations where unacceptable risks are being taken. It also creates more post-trade price transparency. Trade repositories are to some extent still a work in progress, but we seem to be heading in the right direction.

No doubt politicians and regulators were greatly influenced by the AIG fiasco. AIG Financial Products entered into many transactions where it guaranteed the AAA-rated securities created from the securitization and re-securitization of subprime mortgages. The performance of AIG Financial Products was guaranteed by its U.S. parent. It was not required to post collateral on its transactions providing AIG's credit rating remained above AA. In mid-September, AIG's credit rating fell below AA and it was unable to provide the required collateral. Only then did regulators become aware of the risks that had been taken. A massive bailout followed.

A situation similar to AIG should never happen again. First, trade repositories would allow regulators to be more aware of the one-sided risks being taken, making it possible for them to step in earlier. Second, a company entering into trades similar to those of AIG would be required to post so much initial margin and variation margin that its appetite for the trades would be greatly diminished.

CCPs now play a key role in derivatives markets. A sure sign of this is that a current very popular topic of conversation in the OTC derivatives markets is the basis spread for interest rate swaps between the two largest CCPs: LCH.Clearnet and CME Group. On a particular day, the 10-year U.S. dollar swap rate assumed by CME Group when determining variation margin for outstanding transactions might be 2.19% while LCH.Clearnet assumes 2.17%. Both CCPs mark trades to market in a way that reflects the terms of the deals they are currently clearing. The reason for the discrepancy is that the CME Group tends to clear trades between dealers and end users, such as asset managers, and these end users currently want to pay fixed; LCH.Clearnet tends to clear trades between dealers. The above quotes suggest that end users pay two basis points more than dealers on average.

A dealer that receives 2.19% from an end user and hedges by paying 2.17% to another dealer is unable to book the two basis point profit immediately if the first transaction is cleared by the CME Group while the second is cleared by LCH.Clearnet. (Of course, the profit will be realized over the ten-year period.)

There is a danger that the CME Group could lose business to LCH.Clearnet. But it is possible that trade repositories can help CCPs avoid this sort of market segmentation. The CME Group can see all LCH.Clearnet's trades and vice versa. They can base their marks on all transactions being currently initiated, rather than just the flow of transactions that they themselves see.

The least important, and least defensible, of the new regulations for OTC derivatives is the requirement that standard transactions between financial institutions be traded on electronic platforms. The motivation for this seems to be that, if OTC derivatives are traded like exchange-traded derivatives, there will be more price transparency and problems such as those observed during the crisis will be avoided. (In fact, the problems during the crisis were caused by non-standard derivatives and there is no requirement that these be traded on electronic platforms.)

There was not a serious problem in the way OTC derivatives were traded pre-crisis. (Arguably there was not enough price transparency, but trade repositories should take care of that.) There is a danger in trying to trade OTC derivatives in the same way as exchange-traded derivatives. This is because, as pointed out by Giancarlo (2015), there are important differences between the two. OTC derivatives trade intermittently whereas exchange-traded derivatives such as futures trade continuously. The size of a typical OTC derivative is much larger than that of a typical exchange-traded derivative. There are fewer market participants in the OTC market, but they are more sophisticated than the average participant in exchange-traded markets..

These differences mean that we should not force standard OTC derivatives to trade in a similar way to futures and other exchange-traded derivatives. No doubt electronic platforms will play a bigger role in the trading of OTC derivatives as time passes, but we should let the market decide the best way to organize trading. Regulators should determine broad principles and competition between trading venues will then determine the best organization of trading. Arguably, the CFTC in the United States has been too prescriptive about the trading of standard OTC derivatives such as interest rate swaps and index CDSs. Regulators in other countries seem to have a more relaxed approach. There is a danger that

there will be a repeat of Regulation Q where the market for standard OTC derivatives such as interest rate swaps moves outside the United States.

References

Giancarlo, J. Christopher (2015) "Pro-Reform Reconsideration of the CFTC Swaps Trading Rules: Return to Dodd-Frank," White Paper, U.S. Commodity Futures and Trading Commission, January 29.

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