The future of the OTC derivatives market

Under the Dodd-Frank Act in the US, standardised derivatives are required to be centrally cleared and traded on swap execution facilities. Risk *convened a panel in New York to discuss the clearing and execution requirements, and what they mean for over-the-counter derivatives market participants and their clients*

Risk: **How are financial institutions preparing themselves and their clients for the changes to the derivatives market?**

Jack McCabe, Goldman Sachs (JM): We've been busy since 2008 setting up our business to accommodate customer clearing. This focus has increased with the passage of the Dodd-Frank Act. The business, called 'derivatives clearing services', houses our traditional futures commission merchant (FCM) business, swap clearing under the Dodd-Frank Act and foreign exchange prime brokerage activities. The group is integrated within our prime brokerage unit and is an agency-only, customer-driven business. It will cover all asset classes globally as swap clearing rules are relevant to multiple asset classes. We've been integrating it with other parts of our prime brokerage margining and bilateral margining systems while also building collateral conversion capabilities to help clients meet margin requirements. In addition, we are working closely with the exchanges, clearing houses and the regulators as this rule-making process goes on so that we can be best positioned to help our customers adapt to the new environment.

Andrew Huszar, Morgan Stanley (AH): We've had a dedicated team working since 2008 to build a client-clearing business. We view this business as a strategic initiative for the firm where clearing is a valuable way to reinforce a relationship with clients or to create new relationships with clients. The way that we've organised it is to create a team of over-the-counter (OTC) client clearing that spans the globe and is working to create a customised solution for clients that takes into account both the idiosyncrasies of the bilateral and the cleared space. We're very much focused on creating margin solutions and customer service solutions that are helpful to our clients' needs.

Risk: **LCH.Clearnet has a large portion of the interest rate swap (IRS) OTC clearing business in the form of SwapClear. Are you planning on extending those services or building new ones in response to the changes?**

The Panel

Goldman Sachs Jack McCabe,
Co-head of Global Futures and Derivatives Clearing Services
LCH.Clearnet Floyd Converse, US Head of Sales and Marketing, SwapClear
Morgan Stanley Andrew Huszar, US Head of OTC Client Clearing
Tradeweb Scott Zucker, Chief Administrative Officer

To view and listen to the full proceedings of the *Risk* OTC derivatives forum, visit www.risk.net/media-centre

Floyd Converse

Floyd Converse, LCH.Clearnet (FC): It has been a big year for us in the US. The answer is yes. We've been expanding our product scope and staff numbers. We now have around 25 [staff] based in New York, with new members of staff covering sales and marketing, product, risk, legal and compliance. So our footprint in the US is really expanding. In terms of product capabilities, we launched our FCM model on March 8. US IRS clients are now able to access the full capabilities of SwapClear through an FCM, which we're very proud of. The model can handle 14 currencies, flexible payment dates,


Andrew Huszar

overnight indexed swap (OIS) discounting in three currencies and OIS swaps out to two years in four currencies. For product expansion, we're very much listening to clients and trying to anticipate their needs. For example, regional banks – we think that, when the economy turns, their loans businesses are going to increase as well, thereby causing a greater need for amortising swaps. That's a product we're going to be launching later this year, specifically directed at US bank clients.

Risk: **There has been a lot of talk about how Tradeweb is going to position itself in the new environment. Are you planning to register as a swap execution facility?**
Scott Zucker, Tradeweb (SZ): Yes. Once the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) rules are finalised, we will apply for and expect to be grandfathered in as a swap execution facility. We've been offering OTC electronic trading in a regulated environment since 1998 and launched a derivatives platform in 2005. Since then, participants using our system have traded more than $7 trillion notional in interest rate and credit derivatives. That's over 70,000 trades. In 2011, already more than 170 customers have transacted with the largest liquidity providers in the world on Tradeweb. Over the past 18 months we have been following the rule proposals very closely and have been working with the CFTC and the SEC to slightly modify electronic trading so that market participants can have more flexibility in the way they trade. Tradeweb's predominant trading model for derivatives, the request-for-quotation (RFQ) protocol, is allowable under the rule proposals. In addition, we're working with clearing organisations like LCH.Clearnet and with clearing members to ensure not only that electronic trading happens efficiently and transparently, but that clearing and straight-through processing from trading to clearing member to clearing organisations happens in a seamless fashion.

Risk: **To what extent do you have to change your platform to fit in with what regulators define as a swap execution facility?**
SZ: If you had asked us six months ago, we would have said we needed to make a lot of changes. But, when the rule proposals finally came out, there was a little more flexibility than we thought there would be. It was recognised that there are liquidity providers and liquidity takers in the market, and that RFQ trading protocols would continue to be an acceptable form of trading. Around the edges, we'll need to make some changes to our existing electronic markets, the biggest of which will revolve around the core principles that are coming from a more futures-oriented, exchange-like model. But we have the infrastructure that is required from being regulated as an alternative trading system with the SEC, and we'll fit into whatever the final rules say we need to do.

Risk: **Do you have any idea what the regulators think of as a 'standardised derivative', and what would be possible to send to a clearing house? What products do you think might be feasible to clear and trade on a set?**
FC: We probably clear 40%–45% of the overall IRS derivatives market now. Generally speaking, these are plain vanilla trades. This the first go. In 1987, the IRS OTC market was about $900 billion in notional. Today, it's just under $500 trillion. Half of the plain vanilla market is now being cleared. The question is: what is going to happen to the other half in terms of swaptions, options and other less liquid products? That's less certain.

AH: I joined Morgan Stanley from the Federal Reserve Bank of New York, so I view this issue with a policy-making skew. The goal has been to centrally clear derivatives. Similarly, we see there will be some likelihood of a phase-in in terms of plain vanilla products at the beginning and, ultimately, non-linear products. It is a risk-reward question. The reward is centralisation and transparency. From a risk perspective, it's getting to the place where central counterparties (CCPs) and regulators are comfortable with the support of any products from an operational and risk perspective.

Risk: **You mentioned that you were looking at product expansion. Do you have an eye to any particular market?**
FC: We have a feasibility study going on now with European swap options – you can extrapolate that to mean caps and floors. I don't want to say everything will be cleared eventually, and as an industry we really need to be able to walk before we run. Let's get all the plain vanilla stuff cleared, then we will look to the other products. Options on rate products could clearly be the next step once we are comfortable with the default management process around them.

Risk: **Market participants often cite liquidity as a factor, noting there are risks to clearing illiquid products. Would you agree that it is not a good idea to clear the most illiquid products out there?**
AH: To the extent you have trades that remain in the bilateral book versus those cleared, you will have inefficiencies in the netting of risk. From an efficiency standpoint, it would be important to hopefully get to a place where there is maximum clearing and centralisation of derivative products to the extent that we've made this a policy-making objective and it is feasible from a liquidity standpoint.

SZ: On the trading side, the swap execution facility's mandate or the market mandate to trade on a swap execution facility only happens after the clearing organisation makes a particular instrument or asset class available or eligible to be cleared. What the swap execution facility is going to do is to wait until things are going to be cleared and then make those instruments available for trading on that swap execution facility, which will then require the market to trade on a regulated market. We're just watching and trying to provide our clients with a mechanism and a facility to onboard information about clearing, so that – when particular swap contracts are available for trading and are mandated to be traded on a regulated marketplace – they can trade electronically, notify their clearing member and get trades directly to clearing as quickly and efficiently as possible.

Risk: **A case of the execution facility following the clearing houses?**
SZ: To some extent. Even though trading and pre-trading transparency will happen on the execution platform, the way in which the Dodd-Frank Act has been drafted is that the clearing organisation submits to the CFTC and SEC the instruments they want to clear. The CFTC and the SEC approves this. There is then a

ripple effect on swap execution facilities in terms of the trading mandate.

Risk: **What does this all mean for a buy-side firm – a dealer-client?**
JM: As clients think about where they should begin, they've been struggling with what the real timelines will be for mandated clearing. Once that is evident, clients will gravitate towards clearing, some perhaps even ahead of the mandated deadlines. What they're thinking about right now is working with a derivatives clearer that can help them migrate. That migration is really starting with selecting one or more FCMs to clear for them, and reviewing documentation and middleware they will use to face-off against the clearing houses. They're starting to look at their portfolios and think about what products will be clearing-eligible, what the margin requirements will be for those and how they will fund those margin requirements.


Jack McCabe

Risk: **Roughly how many clients are clearing OTC derivatives now?**
FC: We have been clearing client trades in Europe since 2009. Globally, we have cleared approximately $200 billion, the bulk of which is in Europe. A lot of discussions are ongoing to ensure that people have the right piping in place and to establish the correct workflows. We're encouraging people to clear early and clear often. We see different clients – some are going to wait until they have to do it, but others in the US are early adopters and they see the benefits of clearing.

SZ: Tradeweb already has links directly from our trading facility to clearing organisations and we provide the ability for customers to select clearing members at those clearing organisations where they want to clear trades. In reality, there is more adoption of electronic trading in swaps by customers than there is customer clearing of swaps. We've been engaging our customer base to do test trades – from electronic trades through clearing – to see how that workflow works. We arrange with liquidity providers such as Morgan Stanley or Goldman Sachs, and clearing houses such as LCH.Clearnet, to have trades executed electronically and then flow through to clearing so that we can get a response back electronically to the clients on our system saying those trades have been cleared.

Risk: **It is unclear what kind of clearing model the CFTC is going to go for in regulating the swap market. Some market participants have been vociferous in supporting a model of direct clearing membership for buy-side firms. What are the merits of that approach, and has the CFTC endorsed that?**
SZ: We've recently built solutions where buy-side clients will be represented by clearing members, but we can obviously change our functionality if there are some institutions that are going to be direct clearing members. But the models that we've seen and that we've heard from our customers are based around talking with firms like Goldman and Morgan Stanley regarding clearing member arrangements and relationships. The thing they need to start thinking about is the documentation process and the legal process of changing from a world in which they had International Swaps and Derivatives Association (ISDA) agreements to a world in which they have clearing relationships.

Risk: **The CFTC is also considering the issue of margin segregation and how safe margin is. How does the default fund waterfall work? How closely should clients be looking at this and what does it mean for them?**
JM: The CFTC recently released a new rule-making proposal regarding client-level segregation for OTC clearing and legally segregated operationally co-mingled (LSOC) seems to be at the top of the list. This approach offers a good compromise between the segregation and portability that customers want, and the ability to operationally manage the segregation pool versus the clearing houses, which is a more efficient approach for us as the FCM. We recognise that clients want a high level of protection on their assets, as they think not only about the clearing houses they wish to do business with but the clearing members they select to do business. In terms of how the default fund waterfall works, it provides the order of liabilities for clearing members and the clearing house in the event of a clearing member's default. Clients should be thinking about it as the dedicated financial safeguard established to ensure continued operation of the clearing house after a clearing member's default.

Risk: **What is the correct level of segregation? Presumably, additional segregation is going to come with costs. Do you agree?**
JM: There could be somewhat higher margin requirements associated with the LSOC approach as opposed to gross omnibus segregation. That's something that customers will have to think about when they consider the segregation regime that ultimately is most attractive to them. But we consistently hear that asset protection and safety/soundness are top priorities for clients.

FC: We've been an advocate of LSOC for some time now and don't believe it to be more costly in terms of margin. In terms of risk management assumptions and margin calculations, we don't think that customer funds are going to be there in the case of a default. It is likely that most customers will have ported their positions to another FCM, so we think the majority of the customer funds will be gone by the time the FCM has defaulted. In view of that, we don't factor client funds into our risk assumptions today. Therefore, additional costs are zero. Our book right now has around $270 trillion notional outstanding supported by roughly $16 billion in initial margin. Granted, it's mostly a dealer business right now. We have to see where the customer flows end up – if they're more directional than some of the dealer portfolios. It's too early to say the margins are going to be much higher.

Risk: **For some clients, it is going to be quite a change of mindset in terms of liquidity management. Are they going to have to think a lot more proactively about this in the future?**
AH: Very much so. It's a new world with a lot of new challenges, and yet the rules are still evolving. Market practices are evolving, so it's going to be a dialogue that we're going to need to continue to have with clients to help them navigate that world.

FC: Margin is critical. It's one of the important decisions they have to make. We have high-frequency derivatives clients such as hedge funds. They're used to posting margin. But insurance companies that hold a lot of corporate bonds that aren't eligible for initial margin now are very concerned about with what the cost of the collateral conversion is going to be. Is that going to increase their costs and how is that going to get paid? Is it in the overall derivative rate and they actually pass that on to the end-user of their products in insurance customers? We have a lot of input from the buy side to expand our eligible collateral for initial margin. That is something we are looking at.

Risk: **If dealers are standing between the clients and the clearers and helping them with the requirement to post margin, what else can you offer clients to ensure they have the most efficient margining regime?**
JM: The first thing is the integration with prime brokerage and futures, which allows our clients to net down their variation margin calls and face a single point of client service. The other point is that there is a bit of uncertainty around cross-margining. We know that the futures call and the swap clearing-house call must be met in their entirety. How can clients meet those calls and get the benefit of netting? We will look to prime brokerage or bilateral swaps margin requirements for netting benefits. That's something we've been spending a lot of time on and plan to offer to the extent allowed by regulators. In terms of collateral conversion, we're offering a service allowing clients to convert collateral into cash to meet their margin requirements.


Scott Zucker

Risk: **As a market participant looking to get into the swap execution facility space, what are clients really going to be looking for?**
SZ: They are going to look to partners that have experience in this market. There needs to be sufficient liquidity on your platform, so having the right liquidity providers and having a deep pool of liquidity for customers will be key. The right connections to clearing, clearing members and data repositories is important as well. The implementation of the Dodd-Frank Act is going to be phased in. Entities like Tradeweb will register as soon as possible, but the mandate for clearing and trading may come afterwards.

FC: Clients are going to look for people with experience. It is also just as important to consider where the liquidity is. We spend a lot of time educating our clients about our default waterfall and how it works. In the Lehman default, we handled $9 trillion notional and roughly 66,000 trades.

Risk: **In terms of looking at partners, dealers or FCMs, how will clients be thinking under the new regime?**
AH: From a short-term view, many clients are looking at this industry as fairly commoditised in terms of FCMs. They're looking for reassurance that the FCM is dedicated and that the firm has a resource commitment, recognising the significance of the build here. We take some pride in coming up with solutions that cross over bilateral and clearing and give idiosyncratic solutions to clients. We've encouraged clients to think about it as a long-term service provider for them, however, and to think about critical indicators, such as the extent to which a firm can come up with a robust technology solution that can do cross-margining and that firm is not relying on outside vendors or consultants to build its solutions.

JM: At Goldman Sachs, we think it will be a differentiated decision. Clients are going to be looking to affirm that whoever they choose is committed to the business and has the resources needed to offer a global solution. The swaps clearing business is going to be both operationally and technologically intensive. There may be a small field of players that can offer a global cross-asset-class solution integrated with futures and prime brokerage. When you add the additional requirements of cross-margining, collateral conversion, integrated reporting and netting, it has the potential to narrow the field of quality FCM providers even more.

Risk: **This is going to be an issue not just for the derivatives that are deemed standardised and cleared but all derivatives will be subjected to some kind of margining regime in the future, would you agree?**
AH: Collateral efficiency is among the top concerns we have from clients – how we can ultimately help clients in the posting of their margin. Ultimately, they want to know the extent to which we can help them within the applicable rules to gain access to their assets on other parts of our balance sheet. When we speak about cross-margining, we can speak about moving excess collateral, we can speak about risk offset, we can speak about portfolio margining. There are many flavours of cross-margining that will ultimately depend on the rules. Our philosophy at Morgan Stanley is that we have built a technology solution that will provide the maximum capability to our clients within those rules and then we will monitor how they play out.

Risk: **There was a fear that clients would become margin-obsessed and try to clear with the clearers that offer the lowest and the most efficient margin regimes. To what extent is this a risk under the new regulations?**
FC: It's a competitive market out there, but we don't believe our margining methodology should change in a race to the bottom. That is definitely not something we're considering. It's all about safety and security in our interface with our clients – we really make sure they understand our default waterfall, our margining process and that they understand how robust it is. So far, feedback from clients is positive.

Risk: **Is it going to be operationally intensive for dealers and FCMs?**
AH: Of course. Consider an asset manager that has a large number of accounts, has multiple middleware providers and multiple CCPs, and needs to think about cross-margining solutions across multiple products while clearing multiple types of derivatives. This is an incredibly technology-intensive product. It's really important that clients are thinking of this as a partnership opportunity and are doing due diligence on their providers. We hope our clients come in and test us, and that helps us as well in building out a machine. It's an iterative process that's very critical and one that is going to benefit the industry.