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compliance i briefing series

#3 The Future of Credit Derivatives

Raising the Issue

Researched and written by Complinet's in-house team of former regulators, attorneys and industry practitioners, this iBriefing series will provide insight into current key regulatory topics that educate compliance staff, inform business lines and escalate dialogue with senior managers.

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Raising the Issue

Complinet's iBriefings provide a summary of current key regulatory topics that are under consideration for fundamental regulatory reform or a significant shift in approach in the aftermath of the recent financial crisis. The series aims to provide a focused update on the main issues, talking points, status quo, trends and potential developments that will impact the compliance teams at financial services firms globally. The commentary will cover the situations in the EU and North America, and will also include any relevant perspectives from APAC and the Middle East if these are divergent.

Researched and written by Complinet's in-house team of practitioners, the iBriefings are meant to educate compliance staff, inform business lines and initiate dialogue with senior managers. More than ever, now is the time to establish a culture of compliance throughout the firm. The iBriefing series provides relevant analysis to demonstrate the issues and convey compliance concepts to all levels of management.

Background

The story of the financial markets over the past decade has largely been one of innovation, with credit derivatives playing a particularly prominent role. When the financial system began to implode, the complexity and opacity of the markets intensified the general unease and distrust that had been growing around the OTC derivatives markets. This distrust was fueled by the astonishing growth in the market for naked credit default swaps, culminating in the AIG débacle. As a result, the need to regulate derivatives trading was one of the first areas in which some level of consensus was reached among the policy makers.

For months, regulation of these markets has been a foregone conclusion. There has even been a comparatively high level of consensus with respect to what regulatory steps should be taken, at least in general terms – namely, greater transparency through additional reporting requirements, reduced systemic risk through the creation of central counterparties ("CCP's") for 'standardized' contracts, and the imposition of higher capital requirements for at least some of the market.

Yet the devil's in the details, and several thorny issues have had to be addressed by regulatory authorities as they put pen to paper. The first is how to draw the distinction between 'standardized' contracts and those that are 'customized' to address specific requirements. Most of the proposed regulatory remedies are only viable with respect to standardized contracts (for instance exchange trading and central clearing), but it is inevitable that any regime which places a higher regulatory burden on standardized contracts will encourage firms to create superficially customized contracts to avoid this burden. Equally, a regime which fails to regulate customized contracts is likely to be criticized as not going far enough.

Secondly, the creation of CCP's (and to a lesser extent the mandating of on-exchange trading) runs against the prevailing tide by concentrating risk in a small number of institutions and actually creating institutions that are too interconnected to fail.

Lastly, the regulatory imperative to restrict the marketing and sale of derivatives creates a new set of complications, as described below.

Regulatory Developments: US

The Obama Administration has proposed wide-ranging legislation to address derivatives. The proposals are driven by the perception that reform is needed in three respects: regulation of instruments, of firms and of markets.

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The proposals that focus on the markets and instruments themselves aim to increase transparency and to reduce the bilateral risk that has been characteristic of OTC trading in the past. The centerpiece of this approach is to require the trading of as many contracts as possible to be executed on an exchange or a similar regulated execution venue, and for the trades to be cleared through a central counterparty ("CCP"). In other words, to eliminate, as far as possible, over-the-counter trading in derivatives. The challenge is, of course, that this approach assumes some level of standardization and fungibility. While there is a significant element of standardization through ISDA contacts and some bilateral risk mitigation through netting arrangements, it is not the case that all contracts could be migrated to a fully fungible on-exchange environment. Some derivatives will always be customized in order to create a hedge to meet the specific needs of one of the contracting parties.

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The proposals deal with the issue of customized contracts in three ways. First, they aim to discourage the use of customized contracts altogether by requiring higher capital levels for firms holding them (this is also meant to discourage dealers from deliberately creating customized contracts as less-regulated proxies for standardized contracts). Secondly, they would mandate that trades in customized contracts be reported to a regulated trade reporting facility, in order to provide some level of transparency in this portion of the market (the precise reporting requirements are somewhat murky, however, resorting to the old stand-by 'on a timely basis'). Lastly, the direct regulation of all dealers in derivatives would, theoretically, capture the risk posed at the firm level by all derivatives contracts, standardized or not.

By requiring execution on regulated venues, the proposals aim to address the concern that the market has been largely invisible and that, as a result, neither the regulators nor the market participants could gauge the risk associated with a particular firm or particular contract. Moreover, the exchanges and other execution venues could set margin standards to help control risk (and the regulators could judge whether these standards are sufficient).

Transparency would come in two forms – detailed position and trade information available to the regulators, and aggregated information available to the market. It should be noted, however, that merely making the information available does not by itself solve the transparency problem. Someone has to review the data, spot the

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problems before they become too large, and take appropriate action. This presents a considerable burden to the regulatory authorities as well as to market participants.

A critical issue is that the imposition of a mandatory CCP would actually concentrate risk, running against the tide mitigating risk by spreading it. Put differently, the government would actually, and deliberately, create an institution which is too big to fail. This is nonetheless viewed by the regulators (and most of the market) as a good thing to do, for two reasons. First, it effectively eliminates the web of counterparty risks that operate at the firm level when trades are done bilaterally. The CCP, as buyer to all sellers and seller to all buyers, becomes the single counterparty to whom they are exposed. Secondly, the CCP is intended to be closely regulated and sufficiently capitalized through margin deposits and commercial fees. Thus, although the risk is concentrated it is closely watched by regulators who will have the tools to ensure that the CCP remains able to fulfill its obligations.

Perhaps the largest open issue will be how to define a 'standardized' contract. The Administration's plan provides factors which will be considered in determining whether a contract is standardized or customized, rather than provide a set definition. This may be wise, as any attempt to construct an airtight definition will be doomed to collapse under its own weight. This leads, of course, to the possibility that a market participant would attempt to craft contracts in such a way as to avoid being captured under the framework of a standardized contract in order to avoid the accompanying regulatory constraints. To address this, the administration proposes to impose higher capital controls on customized contracts, both to deter unnecessary customization and to address the increased risk resulting from their exclusion from the transparency and settlement requirements.

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Proposals to regulate the firms which deal in contracts would be, as Secretary of the Treasury Geithner put it, 'substantial'. In addition to raising capital and margin requirements for derivatives contracts, specific business conduct measures would be established to prevent the marketing and selling of derivatives contracts to 'unsophisticated' investors, both individual and institutional. As discussed below, this is likely to create difficulties for firms, as there will arise the need to determine where to draw the line – which institutions are sophisticated enough to buy which classes of derivatives?

Both the Obama Administration and key Congressional leaders have floated the idea of banning naked CDS's – holding a CDS for speculative purposes rather than to hedge against actual credit exposure. If implemented, such a measure would place an additional compliance burden on the firm, in the same way that a ban on naked short selling of equities does.

UK: The Turner Review and the case for greater regulation

In October 2008, the UK Chancellor of the Exchequer established a committee under the Leadership of Lord Adair Turner to review the causes of the financial crisis and to recommend changes in regulation and supervisory approach to create a "more robust banking system for the future"[1] . The resulting 'Turner Report', published in March 2009, did not propose specific changes with respect to credit derivatives though it did make several observations to them. Among these, the Report noted that a distinction should be made between 'plain vanilla' derivatives used for hedging purposes and more complex derivatives which are often used for speculative purposes, and that capital requirements should be strengthened for financial firms that trade in credit derivatives or which write credit insurance (i.e., CDS's).

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The Turner Review was strongly supportive of developments in CDS clearing. It noted that achieving a reduction in net positions, for instance, would be greatly assisted by the development of clearing systems with central counterparties, which would allow multilateral netting and replace multiple bilateral counterparty exposures with the theoretical exposure to the single counterparty. As Turner pointed out, the UK Financial Services Authority has also been strongly supportive of central clearing for CDS and has been working with other regulatory authorities and potential market infrastructure providers to expedite this.

He expressed the reservation, however, that although these measures were important their potential impact should not be overstated, as such measures would only be feasible for the roughly 50 to 75 percent of the CDS which are standardized.

International Institutions

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The Committee of European Securities Regulators ("CESR") and the European System of Central Banks ("ESCB") have jointly published draft recommendations regarding securities clearing and settlement. The report contains 34 recommendations dealing with central securities depositories and central counterparties, aiming to increase the safety, soundness and efficiency of securities clearing and settlement. Among the recommendations are that European CDS CCP's should aim to have maximum interoperability with similar CCP's around the world, and that measures should be taken to ensure the soundness of CCP's, including access to central bank liquidity and segregation of counterparty funds and collateral.

In May this year, the International Organization of Securities Commissions issued a consultation report on 'Unregulated Markets and Products', with a focus on CDS's and securitization. In addition to recommendations aimed specifically at international cooperation and oversight matters, the paper proposes several measures similar to those outlined by US, UK and EU policy makers. These include encouraging the use of standardized CDS contracts, the establishment of CCP's for clearing standardized CDS's, and disclosure to regulators of price, volume and open-interest data on a timely basis.

In July 2009, IOSCO's Technical Committee also joined the Committee on Payment and Settlement Systems of the Bank for International Settlements in forming a joint working group to review the 2004 *Recommendations for Central Counterparties*, to review the application of their 2004 *Recommendations for Central Counterparties*, to clearing arrangements for over-the-counter (OTC) derivatives. The recommendations deal

[1] Turner Report, p. 5

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primarily with risk management practices for CCP’s and the working group will review the *Recommendations* with a view to the specific challenges posed by the clearing of derivatives.

Areas of Consensus

There are several areas in which the major policy proposals, as described above, take similar views. First and foremost is the agreement that, to the extent possible, derivatives contracts (and particularly CDS’s) should be cleared through a CCP and traded on-exchange or via a similarly transparent system. Secondly, there is a general understanding that this is only possible with standardized and therefore fungible contracts, leaving customized contracts to trade over-the-counter. Lastly, there is a consensus that capital levels for derivatives must be set appropriately to reflect the risk inherent in the securities (and in the case of the US, to discourage the use of customized contracts to avoid regulation).

Impact for the Compliance Department

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The greatest impact likely to be felt by compliance departments will be that which results from the proposals that address the direct supervision of dealers in OTC derivatives described above. Firms will need policies to assist in determining which institutions (municipalities, pension funds, etc) are sophisticated enough to be permitted to trade in different types of derivatives products and strategies. Additionally, firms will need to establish an internal policy for determining whether new contracts are ‘standardized’ or ‘customized’ within the framework provided by relevant regulations (and what to do if the same contract is regarded as customized in one jurisdiction but standardized in another). Accompanying these policies will be a need for implementing procedures, controls, testing, and training of staff.

Compliance Departments (or similar control functions) will also need to establish procedures to ensure that relevant position and trading data is reported to the exchange, execution venue, or repository as required under new regulations. Compliance will also need to coordinate with the accounting and other support departments to ensure that capital and margin requirements are met given the size of customized and standardized contracts.

Impact for Business Lines and Senior Management

There will be both costs and benefits to firms which are participants in the derivatives market. Clearly, the costs will include the expense associated with any additional compliance controls as described above. Additionally, the cost of trading will increase to the extent that margin requirements with the CCP (or CCP’s) used to clear the firm’s standardized contract trades exceed any margin required under existing bilateral arrangements. Firms that are significantly active in customized derivatives will also have higher capital requirements if the proposals are approved.

Trading profits themselves may be reduced if increased transparency narrows the spreads on particular contracts. The extent to which this occurs will depend on the nature of the final transparency rules as the more specific and timely the information is regarding last sale and volume the more likely spreads are to narrow.

Lastly, firms may be required to become members of exchanges to which they do not already belong, incurring membership and trading fees in addition to the margin requirements.

The benefits to these firms will be less easily quantifiable, as is often the case when weighting costs against benefits. The principle benefit stems from the use of CCP's and the corresponding reduction in counterparty risk, as well as the more efficient netting of positions.

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Regulator Relations and Focus

The priorities for dealing with regulators on this issue will vary from firm to firm. However, there are several issues which are of common interest and which most firms should consider in any discussions with or submissions to regulators. First, regulators should be pressed to provide as much guidance as possible with regard to two major points – the distinction between a standardized contract and a customized one, and what factors should be applied when determining whether a client is sophisticated enough to trade in the contracts. This is particularly important with respect to small institutional clients such as municipalities, since there is far less existing guidance on suitability for these clients than for individuals.

Firms whose trading includes a significant number of customized contracts may wish also to engage the regulators in determining the best level of additional capital that will be required for these instruments, in order to minimize the impact on the firm's ability to hedge for its clients.

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Although best execution has not yet been raised as an issue, firms should be sensitive to any indication from regulators that best execution requirements would be applied to credit derivatives, given the fact that execution can occur on a variety of exchanges or platforms. The assumption that only sophisticated investors will be allowed to trade in these contracts is likely the best argument against any move to extend best execution to this market.

Conclusion

The extension of regulation to the credit derivatives market is a given. Over the coming months, regulators will wrestle with the details and the thorny issues raised in attempting to regulate a market which is by its nature complex, but there can be little doubt that the changes already underway will change the way the market operates, placing substantial compliance burdens on market participants.