Lessening Systemic Risk: Removing Final Hurdles to Clearing OTC Derivatives

Systemic risk is a danger to global financial stability. The bilateral OTC market increases systemic risk due to bilateral counterparty risk. Central clearing is one way to reduce the systemic risk posed by the bilateral OTC market as central counterparty clearinghouses ("CCPs") mutualize bilateral counterparty risk and increase transparency.

Most credit default swap ("CDS") and interest rate swap ("IRS") transactions are standardized and can be cleared easily. A market that migrates to cleared transactions becomes more stable with deeper liquidity, yielding efficient pricing and greater transparency. Despite these benefits, impediments to the success of cleared CDS and IRS trading remain and must be addressed to ensure the initiative's success so that the market begins to enjoy lessened systemic risk and greater continuity.

The members of the Swaps & Derivatives Market Association ("SDMA") have identified issues of access, fair dealing and systemic risk mitigation that should be addressed in order for central clearing of OTC derivatives to be successful. These issues are (I) Exemptions – Product & Participant, (II) Broad, Inclusive Access to Clearing, (III) Open and Symmetrical Workflows, and (IV) Unnecessary Legal Constraints that Prevent Openness.

I. Exemptions – Product & Participant

Systemic risks will remain whenever there are exemptions to clearing. Exemptions increase systemic risk because each non-cleared bilateral OTC derivative trade is exposed to bilateral counterparty risk and also prevents transparency about the OTC derivative market, which keeps regulators from understanding the magnitude and interconnectedness of the market. Mandating the clearing of all standardized OTC derivatives without exemptions would lead to broad adoption of CCPs, thus reducing systemic risk.

A. Product Exemptions

Most CDS and IRS trades are eligible for clearing. Most CDS have well-defined economic terms, legal documentation, market definitions and trade protocols. SDMA members, daily participants in these markets, estimate that at least 80% of CDS trades are standardized and ready to be cleared today. Roughly half of these are index (IG, HVOL and HY) product and half are standard single name swaps that make up the indices (248 single name index constituents represent 75-80% of daily market liquidity in single name CDS). At most, 20% of CDS are illiquid and custom-tailored so as to be unsuitable for clearing at this time. All index and all single name constituents are liquid, easily priced and should be centrally cleared. Exempting CDS names today could tier market liquidity and arbitrarily distort the market.

In addition, a large majority of interest rate swaps are eligible for clearing. Interest rate swaps are extremely liquid instruments focused over a finite set of maturity points on a single curve. IRS instruments possess well-defined economic terms, legal documentation, market definitions and trade protocols.

Yet a dangerously large amount of CDS and IRS sits outside of clearing. A clearinghouse acting in its own economic self-interest would naturally want to do as much business as it could, avoid exemptions and clear as much product as possible. This profit motive would lead to transparency though increased clearing. However, the clearinghouses are not acting in their own self-interest; they are influenced by the incumbent dealers and are thus acting in the dealers' economic self-interest when seeking product exemptions. Two attempts at product

exemptions, designed to exclude the majority of corporate credit from clearing, are (i) volume thresholds, and (ii) grandfathering.

(i) Volume Thresholds are a Red Herring

Incumbent dealers suggest volume thresholds to decide product exemptions, using volume as a proxy for liquidity. The incumbent dealers' argument is that increased volume of OTC trades gives more prices which gives price transparency and that price transparency gives more accurate information to create better risk management and ability to price positions at the CCP. But the claims that only high volume credit products can be priced is a red herring because prices are not a function of volume in the credit markets, but are actually a function of yield curves. Volume works as a proxy for liquidity in some financial products but is a poor proxy for accurate pricing in the corporate credit market.

Credit derivatives trade off of yield curves irrespective of volume. Presently, corporate credit yield curves, not volume of trades, give the price discovery needed in the bond and credit default swap markets to accurately determine the clearing price of an individual bond or swap. Volume thresholds are not consistent with current market practice for good reason. For example, a highly liquid 5-year single name swap eventually 'rolls down the curve' over time and thus becomes a 4.5-year, 4.2-year, 3.8-year, etc. As it rolls down the curve, its daily trade volume decreases significantly. Credit traders can still price the particular swap based on an individual credit's yield curve by interpolating the yield spread between two data points on the curve. In fact, were a trade volume threshold to be imposed on a particular swap, would that mean that the swap were to be 'in clearing' one day' but ejected from clearing the next?

Such calls for volume thresholds as prerequisites for individual swap qualification are misguided, not an accurate reflection of longstanding current market practice and are a red herring.

(ii) Systemic Risk Remains with Grandfathering

The grandfathering of existing swaps is another suggested exemption, with incumbent dealers seeking to prevent clearing of existing swaps with any clearing requirements only applying to *new* CDS trades. However, grandfathered CDS presents just as much a risk to the system as new CDS. The same $30 trillion of risk that brought about the recent financial turmoil and necessitated government bailouts would still remain under a grandfathered system. Such gaming of an open-clearing system would prevent CCPs from adequately performing their risk-reducing function. Grandfathering would create a system that is designed to eventually fail.

B. <u>User Exemptions</u>

For clearing to work everyone has to take part. User exemptions mean some trades won't be cleared. End users argue for choice in managing their risks, either through clearing houses, if available, or through bilateral contracts. However this is a self-interested view that ignores the risk to the entire market. Each of their trades poses just as much a risk to the system as other trades. Yet user exemptions mean certain trades won't be cleared, there won't be transparency about these trades, spreads will not reduce as much as possible, and regulators will be in a poorer position to understand the magnitude of what is out there. User exemptions force certain industries to overpay the incumbent dealers upfront to avoid margin requirements, but in the end create extra risk for them and for the system as a whole. Exemptions for some users mean that bilateral counterparty risk will remain in the market for all.

II. Broad, Inclusive Access to Clearing

Open access to clearing ensures increased competition in the marketplace, which ensures greater transparency, lowered transaction costs and increased liquidity. Greater liquidity is essential for markets to operate in a stable and efficient manner. Greater liquidity comes from 50-60 diversified liquidity providers that are *not* correlated as a group, unlike the correlation in the current small group of incumbent dealers that has been further concentrated after the financial crisis. Current rules restrict access to the CCPs, thus increasing correlation and preventing greater liquidity. These rules include (A) the Linkage of Clearing to Execution, and (B) Capital and Sophistication Requirements. These rules are developed through governance committees at the clearinghouses, which are discussed in (C) below.

A. The Clearing-Execution Linkage Red Herring

Clearinghouse membership rules for CDS and IRS currently link OTC derivatives clearing (FCM membership) to the function of a dealer (a.k.a. "market making"). Rules at both ICE and CME require that you must have *both* execution and clearing capabilities in order to become a clearing member. In so doing, the CCPs have developed rules designed to limit access and control solely to the incumbent dealers, who conveniently possess both clearing and dealing franchises.

The incumbent dealers own ICE Trust and can unilaterally maintain its exclusivity. At CME, the incumbents have bargained their participation in CME clearing in exchange for governance positions and CME concessions that now limit independent access. Profits to the incumbent dealers from clearing are approximately $500 million. The effort to protect clearing, however, is actually a proxy war to limit competition to the incumbent dealers' $100 *billion* in profits for derivatives *execution*. The clearing-execution link also blocks access to execution as incumbent dealer clearing arms refuse to accept trades executed by independent dealers who wish to compete and provide liquidity.

Curiously, such linkage of clearing to market making is neither a requirement nor is it normal practice in most other cleared markets, including those where ICE and CME are clearing houses.

The clearinghouses claim the linkage is necessary to accomplish end-of-day pricing and auction pricing. However, the linkage of clearing to the function of a dealer is a red herring designed to exclude as independent participants can accomplish both of these functions.

(i) End-Of-Day Pricing

Clearinghouses currently require IRS and CDS clearing members to provide daily CDS prices from their own internal dealer desks at the end of each trading day in order to mark the book. In other markets pricing is clear and accomplished through an exchange, but for OTC derivatives the CCP needs FCMs to submit prices. Current CCP rules state that prices cannot be from third party services, such as Markit, or from the CMA, which is owned by the CME, nor can they be prices provided by a dealer consortium or execution platform. The CCP rules require pricing to only come from a FCM's own dealer desk.

The view that only FCMs with their internal dealer desks are able to provide pricing is misguided. Independent (non-dealer) FCMs can partner with independent dealers to provide accurate end-of-day curve pricing as independent dealers already make markets in corporate bonds. The incumbent dealers justify the restriction by claiming that only they can provide "actionable" prices. This is again a false argument. An independent FCM and independent dealer can jointly distribute or allocate the risk of taking any positions and build those costs into their business models.

The dealers' have a circular argument because an actionable pricing requirement only exists because of the lack of an exchange and is merely a temporary solution under the current bilateral OTC market that the dealers themselves are trying to preserve. Once price transparency is achieved, volumes will migrate to price-transparent products and actionable pricing requirements will no longer be needed.

Non-dealer FCMs are numerous, sophisticated, span the capital spectrum and operate efficiently and successfully without arbitrary pricing requirements in other cleared markets. The CCPs should allow non-dealer FCMs to submit prices from third party vendors, dealer consortiums or execution platforms. Alternatively, the CCPs should drop the pricing requirement completely. The linkage of clearing to market making is a restriction not seen in other cleared markets, serves no legitimate purpose, limits competition and increases systemic risk.

(ii) Auction Pricing

Another clearinghouse rule requires clearing members to utilize their own internal dealer desks to participate in auctions of the portfolios of any distressed clearing members. This rule limits broader auction participation. The true measure of success of an auction is achieving a clearing price and to achieve the optimal clearing price it is better to have more participants in the auction than fewer participants.

Moreover, there is precedent in the OTC marketplace for rapid and highly organized auctions. For example, ISDA currently manages a default auction process when an event triggers a payout on a default swap and these auctions include many, not a limited few, participants. There were over 400 participants in the Lehman Brothers auction, which clearly yielded better prices than if there were less than 10 participants.

Speed is also not a legitimate excuse to restrict auctions to only a few select bidders as speed is already present in other auction scenarios. For example, successful auctions in CDS for bid wanted in comp/offers wanted in comp ("BWIC/OWIC") exist. For BWICs, institutional investors enter the market with multiple swap positions for auction by submitting them to dealers for bid with time frames as short as 60 to 90 minutes. Market auction participants then bid on these BWICs accordingly and the auctions proceed efficiently. Electronic platforms provide auction venues: Creditex and IDX are such platforms already capable of managing such an auction and other players are likely to follow.

Inclusion of more bidders in auctions, including non-clearing dealers and the buyside, is the optimal solution. Independent FCMs and dealers can agree to jointly participate in portfolio auctions to find the best price in the event of any default and liquidation scenario.

B. Capital and Sophistication Requirements

Capital qualification requirements at the CCPs are random and chosen at levels designed to exclude. There is no doubt that CCPs should move to ensure that all FCMs are appropriately capitalized, especially considering the credit crisis of 2008. But there should be objective risk-based reasons for choosing a level of capital necessary to become a FCM. The CME requires $500 million to qualify as a CDS FCM (plus the additional hurdle of having $5 billion of Tangible Common Equity ("TCE"), calculated daily), while ICE Trust requires capital of $5 billion (or 10 times the base CME amount). Even at these levels many independent players qualify. But there is no risk-determined reason for the different levels. The requirements have been arbitrarily set as a barrier to entry, not as a safety measure.

Regulators should be on guard that capital adequacy requirements may be used as a politically popular but anticompetitive weapon to limit access to a marketplace. Capital qualification rules should be based on objective, transparent and commonly accepted metrics that appropriately match risk to capital, such as *value at risk* ('VAR') modeling, at the CCP. The goal is to reduce systemic risk by ensuring appropriate capitalization. The

current requirements fail in this regard as they are not determined by safety considerations, industry benchmarks or government agencies, but solely by incumbent dealer interests.

In addition to capital levels, some CCPs require a certain level of "sophistication" to become a clearing member. For instance, at LCH Clearnet, a clearing member must have already cleared $1 trillion notional of swaps as a supplementary membership criterion. It is unclear why sophistication requirements are necessary, who defines sophistication, or why amounts such as these have been chosen.

C. Clearinghouse Governance

Restricted access leads to reduced clearing which leads to systemic risk. Restricted access is accomplished through rules developed at the clearinghouses. Incumbent dealers sit in rule-making committee positions at the CCPs. The goal of CCP governance should be development of CCP clearing rules that lead to fair, open and transparent clearing processes. A small group of dealers creating rules to benefit themselves increases risk. The best way to achieve open access is to ensure that a majority of CCP directors are independent of the inside dealers. Independent clearers and next-generation dealers should have seats at the CCP table. Rule-making committees should be subject to clear rules and internal procedures regarding membership, selection and decision-making processes in order to prevent self-interested rule-development that eventually leads to inhibited growth. Opening access to CCP governance is the first step to remedy the anti-competitive and risk-enhancing rules at the clearinghouses.

III. Open and Symmetrical Workflows

The CCPs utilize workflows designed to protect the incumbent dealers' position and force indirect access for others. Indirect access is limiting and dangerous for many reasons. First, indirect access to the CCP means that trades are not anonymous, which greatly increases the risk of front-running. Second, incumbent dealers act as gatekeepers and enforcers to clearing, which acts to prevent competition (incumbent dealers have actually refused to open clearing accounts for non-clearing dealers). Third, indirect access means that buy side firms cannot trade directly or with each other, which increases transaction costs. Finally, inserting an additional unnecessary step into the clearing chain creates a slower and more inefficient process, which increases the propensity for faults and increases the time needed to wait for that extra step to proceed.

ICE does not allow direct access. Trades must be submitted to a member dealer who submits the trade to the clearinghouse. This workflow mandates that one side of the trade is the submitting dealer. The effect is to have only customer-dealer trades. Interdealer trades, customer-to-customer trades and any forms of non-clearing member dealer business are strictly prohibited. To be clear, on every trade cleared through ICE, one leg must be an incumbent dealer bank.

At the CME clearing access is agnostic as to execution platform; so an incumbent dealer is not mandated on each trade and interdealer, customer-to-customer or customer-dealer trades are all accepted. But in practice, restrictions work to limit business to the incumbent dealers. The CME business model presupposes inclusion of incumbent dealers in every trade, as shown through its legal documentation that supports the incumbent dealer model (described below). Anecdotal evidence also suggests that incumbent dealers are pursuing more asymmetric workflows, apparently trying to access customer identities and remove anonymity once trades have been submitted to the CME for clearing and working with vendors to ensure that trades are submitted on an asymmetric basis only (see, e.g., Bloomberg VCON, which allows only dealers to submit trades and presupposes no interdealer or customer-to-customer trading). Finally, showing the risk inherent in asymmetric workflows, CME incumbent dealers are loath to open clearing accounts for well capitalized non-clearing member dealers because, although they may represent a revenue opportunity for their clearing business, the potential non-clearing member customer represents competition for that FCM's dealer desk.

Open and direct access to clearing cannot be accomplished with asymmetrical workflows. Open clearing will reduce transaction costs, increase transparency and create a safer derivative marketplace.

IV. Unnecessary Legal Constraints that Prevent Openness

Certain legal constraints, such as give-up agreements and intellectual property licensing, act to prevent open clearing and allow bilateral counterparty risk to remain in the system. Give-up agreements used in clearing OTC derivatives presuppose the indirect access workflows described above. The 22-page Fried Frank give-up agreement in circulation is a good example. It assumes that one side of every trade is an incumbent dealer. If there is a trade loss, the incumbent dealer decides on its own the breakage amount and who collects it. The Fried Frank agreement does not allow non-incumbent dealers to participate, does not provide for customer-to-customer trading, and is non-anonymous as all trade confirmations are assumed to go through an incumbent dealer. Give-up agreements should have precedent in other market contexts and exist only to decide the rights and obligations of the executing broker vis-à-vis the principal (customer), and between aggrieved and deficient customers, while at the same time tangentially including the clearing broker to recognize its secondary role. Any give-up agreement should be universally utilized, be simple to use, and should not assume that the clearing broker and executing broker are the same entity, or embed any other specific workflows.

Intellectual property licensing is another tool being used to restrict open clearing. The incumbent dealers are majority owners of Markit Group, a data and index provider. Indices are a large part of the CDS market, representing over 40% of all CDS volume. Markit currently requires one side of every trade of its index products to have been granted a license from Markit to be Markit "eligible" to trade the index. Further, clearinghouses are restricted by Markit to only clear "eligible" index trades. And licenses to use Markit intellectual property have been granted only to the incumbent dealers despite the fact that, according to the CME, licenses of Markit intellectual property cannot be "unreasonably withheld." This restrictive use of intellectual property is firmly at odds with the goals of openness and transparency. Such practices prevent any opportunity for trading that is not controlled by the incumbent dealers, such as buyside-to-buyside trading, and perpetuate the systemic risks present in the marketplace.

Conclusion

If any lesson can be learned from the global credit crisis of 2008, it is that clearinghouses must exist to lessen the considerable systemic risk posed by credit default swaps and interest rate swaps. However, rules and workflows at the clearinghouses currently are working to restrict access to only the incumbent dealers. Open access would promote competition, transparency, independence and systemic stability. Without these hallmarks of a strong financial system, derivatives clearing will fail to achieve the desired results and the U.S. economy and its financial payments system runs the risk of a catastrophic meltdown. The United States should take the lead in setting rules that promote safety and transparency in derivatives clearing.

Restrictions on competition come to the surface when drilling down into the above-discussed problem areas. Unfortunately restrictions on competition increase risk by limiting the well-known benefits of clearinghouses. Open access to clearinghouses ensures increased competition in the derivatives marketplace, which will further lead to greater market transparency, deeper liquidity, lowered transaction costs and a greater ability to withstand future systemic crises.

Objective and risk-based capital and access requirements, coupled with symmetrical workflows, will lead to increased use of clearinghouses for OTC derivatives. Systemic risks will be further reduced by avoiding product or user exemptions.

The SDMA would be pleased to discuss each of the above issues in more detail and provide suggestions on how they can be resolved. The goal of minimizing systemic risk in the OTC derivative markets can be achieved through open access and transparency.

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