The end of the OTC market as we know it?

Luca Salerno and **Gil Cohen**
Reed Smith LLP

The collapse of Lehman Brothers, the near collapse of Bear Stearns and AIG, and the numerous defaults of major players in the freight derivatives markets unearthed the dangers posed by unmitigated risks and an opaque market structure in over-the-counter (OTC) derivatives trading.

Though OTC derivatives remain an essential tool in pricing and managing business risks, the financial crisis of the past two years has highlighted some major systemic issues.

In particular, the credit derivatives market exemplified the devastating effects of a lack of public information on price formation. This, combined with the mutual dependence of market players and excessive leverage, created the potent mixture referred to by Warren Buffet as "madmen's poison".

Accordingly, the EC has published proposals to standardise the legal terms of derivative contracts and push market players onto central counterparties (CCPs) with the aim of mitigating counterparty credit risk. Market transparency will be enhanced by requiring the reporting of all transactions to central trade data repositories. This will provide regulators with information on who is trading what and at what value.

It seems likely that the EC will implement two independent directives, one governing CCPs, the other governing trade data repositories, and it has set the deadline of mid-2010 for the publication of the proposed legislation.

It does not appear as though the economic parameters of contracts will be standardised. This is the consequence of strong industry resistance against a proposal that may limit hedging possibilities. It is likely that any standardisation will therefore concern the uniformity of the legal terms of contracts and the standardisation of processing and settlement procedures, though what that means in practice remains to be seen.

It is also unclear what type of contracts will be among those deemed to be standardised. One can certainly be sceptical as to whether more standardisation can be achieved, especially for some classes of OTC derivatives like those that have commodities as underlying. Standardisation has already been achieved with ISDA Master Agreements and with the agreement to use only a handful of standardised coupon values for European-referenced CDSs.

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How the concept of a CCP will fit into the present framework for organised trading venues, as defined in the Markets in Financial Instruments Directive (Mifid), is another area of uncertainty. Specifically, it is unclear how it will sit alongside such other Mifid concepts as regulated markets (ie exchanges), multilateral trading facilities (ie electronic trading platforms) and systematic internalisers (ie investment firms that trade on their own account outside of regulated markets and multilateral trading facilities and hold counterparty risk).

CCPs are considered zero-risk counterparties for capital requirement purposes because of their creditworthiness. This is achieved through their multilateral netting processes, which consolidate transactions and reduce costs, along with their requirements to post collateral. Further, the CCP default fund, which all CCP members contribute to, shares any loss should the collateral provided by a defaulting party not be sufficient to cover the loss. This is referred to as loss mutualisation.

However, by concentrating market risks in CCPs, and turning them into systematically important entities, legislation requiring CCPs to retain sufficient capital, perhaps with access to central bank liquidity, and strict rules on the posting of collateral, will become necessary. Current proposals will ensure CCP governance and risk-management standards.

The expected increase in the cost of OTC derivative transactions will erode the profits of many market participants, though non-financial institutions will not be required to abide by such strict capital requirements as expected of financial institutions.

The EC and the US seem to have carefully coordinated their regulatory efforts in order to avoid regulatory arbitrage between the two global financial capitals, but they will now have to balance their policy changes as exchange-traded contracts may not meet the needs of the marketplace. Overzealous regulatory intervention may therefore drive business away from London and New York to other financial centres like Singapore, Dubai or Switzerland.

• *Luca Salerno is of counsel and Gil Cohen is an associate at Reed Smith LLP*