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**Pushing OTC business into CCP structures – The work of Sisyphus**

It's everywhere: BIS is keen on them, the London Stock Exchange want to buy one, and Paul Volker has gone on record that they are the way ahead; CCPs are the true flavour of the month. They are seen to offer a solution to some of the long term risk issues created by OTC trading in securities, commodities and derivatives. Post trade risk management, once the province of the inner circle of the arcana, is now on everybody's lips. Regular readers of these occasional briefings will be aware that I have been banging on about the need for CCPs to step up to this challenge for several years, so now perhaps I should be leading the cheering section for CCPs; however it is not quite that simple. While there is no doubt that a number of products can and should be moved into a CCP structure, making it happen is not quite that easy...

The size of OTC markets is, even by the standards of international finance, extraordinary. At the end of 2007 BIS estimated that there was $596 trillion outstanding in OTC derivative[1] markets with a gross market value (the amount needed to close all open positions) of $11 trillion. The growth of the OTC markets has been accelerating over the last ten years as most new products created by investment banks have been deliberately placed outside the reach of exchanges and CCPs. The drivers for this have been:

1. The need for speed to market (something which exchanges and CCPs are notoriously bad at)
2. The desire to control one's own business without submitting to bureaucratic rules
3. The desire to make the super-profits which come to the leaders of new product ideas

The standard life cycle of new financial products begins with the newly invented product being offered bi-laterally from the investment bank to a chosen group of its clients. As the product develops, the investor group expands and other investment banks offer similar products. The industry then moves to standardise the terms of the products to allow fungibility and secondary market activity. Only at the end of the cycle, when the marginal profitability of a product is reduced below the attention threshold of the average investment banker, will the products be commoditised and moved into an exchange/CCP trading environment where lower costs and risks means that the reduced marginal revenue still represents a profit for the sell side firms, whose focus has meanwhile moved elsewhere – to the next big idea.

| **Major Instruments which are wholly or predominantly traded OTC** |
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| FX (including derivatives) |
| Credit derivatives |
| Government Bonds |
| Corporate Bonds |
| Swaps |
| CFDs |
| ABSs |
| Stock loans |
| REPOs |
| Interest rates |

What is now proposed is that we short-circuit this process, bringing products into the CCP world at an earlier stage, thus providing a mechanism for reducing bi-lateral risk and thereby increasing the available capital of Basel II regulated firms. The recent BIS paper on this subject[2] contains enough proposals to increase risk weightings and capital requirements that even the most hardened OTC proponent must now look very hard at the impact on their business models of moving to a CCP solution.[3] However before we all rush down to our local exchanges and CCPs let us consider for a moment what ability these entities have to service the needs of the OTC market.

Looking first at the exchanges we can see that they all, in principle at least, are open to new products. New products represent an opportunity for profit, for diversification and, for many, survival. Exchanges facing declining revenues in traditional businesses where they have been squeezed by the new market entrants appear desperate for new product. Yet the track record of successfully introducing new products has, so far, been at best unconvincing. Slowness to market, an insistence on leveraging their existing technology and the heavy hand of exchange bureaucrat has all played their part. The corporate governance, people and culture of exchanges all seem to conflict with the entrepreneurial spirit of the OTC world. On top of this there is one, often insurmountable problem: exchange solutions for OTC trading require CCPs to back them up. Even the most go-ahead exchange is shackled to the CCPs that must provide the post trade risk management of new products and so it is the CCP which dictates the pace.

In Europe this reliance on the willingness of CCPs to support product might have been less of a problem ten years ago when CCPs were commonly tied to, or even part of, an exchange. However the pressure from EU regulators for separation has meant that the ability of exchanges to get CCPs to support their product initiatives is limited, particularly

[1] i.e. excluding OTC cash markets

[2] See '**Strengthening the resilience of the banking sector**.' *Issued* December 2009 BIS *www.bis.org*)

[3] See 'Financial regulation in the wake of the banking crisis on :http://www.cairneagle.com/news/home.html

where the CCP suspects the exchange of long term plans to acquire its own clearing facility. Some exchanges (like Deutsche Börse) have benefitted from ignoring EU pressure and have retained their 'family' CCP, others like Euronext and the London Stock Exchange appear to have come to realise the critical importance of CCPs for product development, hence the recent (seemingly unsuccessful) attempt by LSE to buy EMCF.

So the ability of the markets to move to an exchange-CCP solution for OTC derivatives comes down to the willingness and ability of the CCPs to develop the necessary products.

As to willingness it might be thought that there was little doubt; surely CCPS welcome the opportunity for an expanded role and a greater income? Well yes and no. The management of the CCPs certainly see the potential of moving OTC products into the CCP world but their shareholders (and hence their boards) do not necessarily share their enthusiasm. The shareholders of the CCPs are, in large part, the same banks who have resisted moving their OTC businesses to CCPs so far. The board members of the CCPs will inevitably turn to their banks' in-house business managers for advice on the benefits and costs of a CCP solution, and that advice is frequently negative.

Even those CCPs which have board support for expansion into OTC products face major problems in resourcing the developments. CCP business is complex and requires specialist staff who have valuable knowledge of their business but the corollary of this is that such staff often lack the understanding of products that they do not already clear. Development of new products is therefore very slow as new businesses are squeezed into pre-existing business models. Additionally the CCPs have been through a long period where new products have taken a back seat to increasing capacity and lowering costs for existing products. Therefore the CCPs often lack the culture and indeed the numbers of development staff necessary to build new businesses quickly.

So while we can all support the initiatives to bring more OTC business into CCPs we should not expect quick results. We can however ask the question, "What can be done to accelerate the process?" I would suggest that there are six key ways to accelerate the process:

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| **Prioritisation** | Identify those products where CCP structures offer the greatest benefits and face the least opposition. |
| **Intelligence** | Form action groups including supportive banks and CCP staff to effect the necessary knowledge transfer. |
| **Innovation** | Build CCP solutions on new guarantee pools (thereby by-passing the potentially antagonistic members of existing guarantee pools). |
| **Scale** | Start small with limited product scope.[4] |
| **Partners** | Work with exchanges, where necessary but do not assume that an exchange element is always necessary. Collaborating with groups of Banks may be a better solution in some cases |
| **Profit** | Be entrepreneurial. The clients you are seeking to serve live in a 'for-profit' world. You must understand their motivations and create solutions which compliment rather than reduce their ability to make profit. Revenue and equity sharing may be attractive levers for some players. |

All this will mean significantly increased investment at a time when most utilities (and most exchanges and CCPs are still in culture if not in fact, utilities) are focussed on cost reduction, not investment. However if the major change in market structures is to come about, this is no time to be a piker!

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[4] The much mis-understood B-Clear initiative of NYSE-LiFFE is an excellent example of what can be done here.