

# The OTC Derivatives Market

Issues affecting trading, clearing and regulation



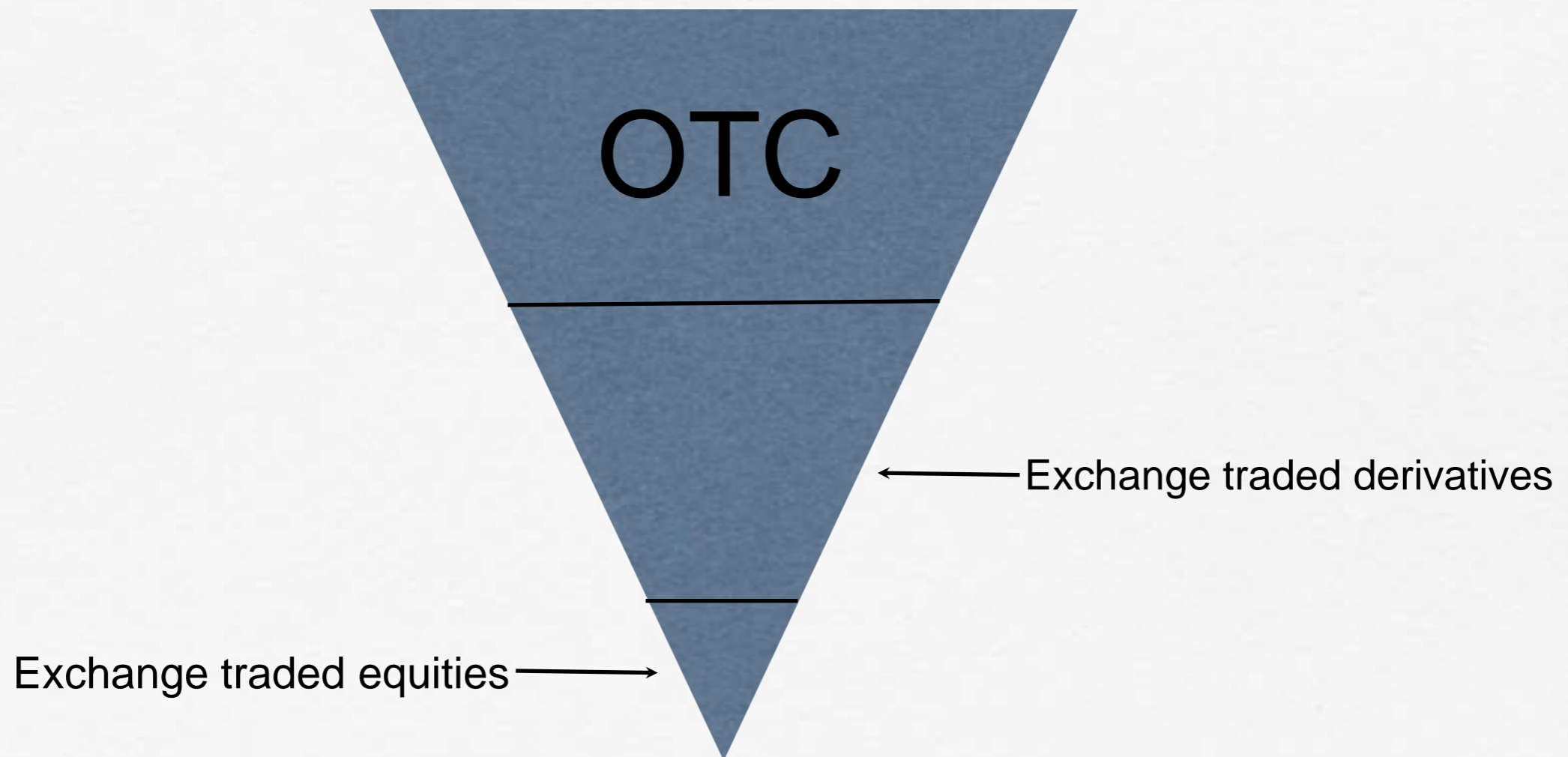
# What does the market comprise?

- Financial Derivatives
  - Interest Rate, Fixed income & Credit Derivatives
- Commodity Derivatives
- Foreign Exchange

# Size of the market

- ❑ Colossal
- ❑ In 2007 BIS estimated market value at \$415 trillion
- ❑ Average daily turnover \$2,544 billion
- ❑ OTC market 8 times greater than exchange traded derivatives
- ❑ Latter 25 times greater than cash equities

# The “Inverted Pyramid”



# OTC market share 2007

- ❑ Interest rate derivatives: 70%
- ❑ FX: 10%
- ❑ Credit Default Swaps: 7%
- ❑ All others: 13%

# Where are they traded?

- EU: 54%
  - Of which UK: 43%, France & Germany: 11%
- US: 24%
- Japan: 4%
- Rest of World: 18%
- BUT 74% of UK trades are cross border

## Which was the “guilty party”?

- ❑ Credit Derivatives, divided into CDS and CDOs
- ❑ CDOs on ABS were way in which banks securitised mortgages - sold into SIVs as bank off-balance sheet entities
- ❑ CDS were traded in much greater volumes but were closed out efficiently during Lehman default.

# CDOs the Guilty party - Why?

- ❑ Highly leveraged
- ❑ Ratings agencies rated them AAA
- ❑ Banks accepted this valuation
- ❑ Regulators did not question this rating
- ❑ In AIG positions intended to make 3/4 basis points ended up costing 800+bp

# Products not the problem?

- ❑ In case of AIG CDOs represented half of notional value but virtually all of total loss (JP Morgan figures, Feb 2009)
- ❑ Existence of these products not the problem but extent of a firm's exposure to them that at heart of crisis
- ❑ Thus high leverage was crucial issue

# Future OTC trading & clearing

- ❑ OTC derivatives need to be traded electronically (spot FX & govt bonds already do this)
- ❑ Also need to be centrally cleared as far as possible
- ❑ But should they be traded on an exchange?

# Exchange Trading?

- ❑ IDB Industry violently against it
- ❑ FESE in favour
- ❑ Latter argue that listing brings advantages of centralised clearing
- ❑ Former say it will kill the market
- ❑ Centralised clearing possible without listing

# OTC future regulation - US

- ❑ Credit derivatives primarily traded in Europe
- ❑ Geithner has said they must be regulated by US & wants single vertical clearing & execution venue in US for entire global market
- ❑ House of Reps has introduced the Peterson Bill to do this
- ❑ IDB community strongly against it

# OTC future regulation - EU

- EU Commission & ECB also want handle on this market
- But ECB only controls Eurozone - most EU trading takes place in EU but outside Eurozone
- ECB view is that if a CCP defaults and a liquidity crisis ensues they could not resolve issue if CCP outside Eurozone

# A Global or Regional CCP?

- IDBs say the market is global therefore should be one or two global CCPs
- But US wants regional CCP for US market
- And EU Commission/ECB want regional CCP for European market
- ECB, France & Germany want CCP inside Eurozone
- UK believes should be global CCP based in London

# Short-listed CCPs

- In US: CME and ICE Trust
  - Latter backed by investment banks, CME searching for backers
- In Eurozone: Eurex Clearing
  - owned by Deutsche Börse, not “utility”
- In London: LCH.Clearnet
  - Anglo-French, linked with NYSE LIFFE, “utility”

# Conclusions

- ❑ Guilty party were highly leveraged CDOs - why punish CDS and all other OTC derivatives?
- ❑ Likely that entire OTC market will now be regulated because politicians feel “something must be done”
- ❑ most OTC products need to be centrally cleared, but not traded on exchanges
- ❑ Problem was rating agencies cavalier modeling, banks believing own hype and and slack regulation.
- ❑ A crisis of mismanagement, not of bad products