

A clear choice

How should custodians support buy-side players in the changing OTC derivatives clearing landscape? *Pascal Scatozza*, fund administration and middle-office product manager, gives his view

One of the outcomes of the financial crisis is that OTC derivatives contracts are coming under increasing regulatory pressure in both Europe and the USA. There are government-backed moves, from the European Commission and the Federal Bank of New York, to drive contracts into using central clearing counterparties (CCPs), to reduce counterparty and systemic risk.

The aims are the following :

- Greater transparency on the number and commitment taken on open contracts
- Better identification of the market participants and improved contract settlement in case of default, for example on credit default swaps (CDS)
- Reduce counterparty risk using deposits, margin calls and trade compression in a central exchange
- Increase liquidity and market efficiency (build prices based on contracts exchanged rather than model pricing)

CCPs' new roles will include central clearing of OTC transactions, margin calculations with specific risk models and management of the guarantee fund in case of default of one of its clearing members. Also on the cards is optimising current infrastructure on golden records' safekeeping, a data repository of contract details.

Clarification

Not all OTC derivatives will be affected. The focus is currently on CDS, partly because they were highly exposed in the recent turmoil and because they can be traded through the main indexes (CDX and iTraxx) which will help contract standardisation. The first half of 2009 saw much progress towards CDS market harmonisation, including: standardisation of coupons and credit



Pascal Scatozza

event definitions in the North American market, International Swaps and Derivatives Association (ISDA) Big Bang and Small Bang protocols aiming at improving credit events management.

Pressure to centrally clear interest rate swaps (IRS) may come next as they represent the largest proportion of OTC derivatives activity, approximately 60%. And one could argue that contracts for difference (CFD) are already more 'listed' than OTC in the sense that underlying assets are usually listed equities or indices.

However, there are many types that are not immediately suitable to the same treatment as standard CDS. Single-name CDS will be more difficult because of their often lower liquidity, as the main difficulty for clearing single-names through a CCP lies in the margin-call calculation (dependent on the availability of daily and historical market data) and the management of credit events. This means that CDS contracts on illiquid issuers are likely to remain OTC.

Even IRS, apart from a small proportion of high-volume contracts, are designed to fit a specific asset manager's strategy. And it's difficult to see how any of the more 'exotic' instruments, for example real estate or weather derivatives could be easily cleared on a CCP.

Whatever changes do come about

should preserve the flexibility and innovative aspects of these instruments.

Whether CCPs are used or not should not necessarily affect the choice of the asset manager's custodian who continues to play a crucial role. Asset managers must be able to rely on a securities services provider that has the necessary OTC derivatives expertise, has invested in the appropriate platforms and has a local presence around the world.

A leading custodian's job is to process and clear transactions efficiently in a timely manner, and to comply with regulatory changes. An asset manager can exploit the custodian's general clearing member (GCM) status with CCPs at a better cost.

The same custodian should also be able to support 'pure' or off-exchange OTC derivatives clearing by reinforcing collateral management, reducing counterparty risk and providing reliable prices using independent valuation models. The custodian should have built the appropriate links with industry-standard tools using matching platforms and record-keeping trades centrally, ensuring commitments are known at any point on a portfolio level.

The asset manager should also be in a position to benefit from the custodian's economies of scale, derived from continuous platform investment.

Whatever the instrument's clearing venue, on or off exchange, the custodian should be the unique gateway to asset managers' OTC transactions. A custodian that is part of a large universal bank with a high credit rating can also be reassuring in these troubled times!

It is the role of a reliable custodian to monitor such changes in the OTC derivatives sector and to participate in the industry's development, for the ultimate benefit of the end investor. ■

For more information on OTC derivatives clearing, please email pascal.scatozza@bnpparibas.com