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The Third Way: OTC Derivatives Markets for End Users

For a long time, we have been concerned by the common practice in Over the Counter ("OTC") derivative markets of end users conducting all their hedging activity with a small group of their "relationship" banks. Our concerns related partly to the lack of price transparency arising from having only a small number of derivative counterparties (who in addition are often exclusively their lending banks). However, we have also worried about the systemic risk exposures of the end users created by this concentrated hedging activity, in a world where the banking system takes at least one side of all OTC derivative transactions.

Our concerns were not alleviated in the wake of the financial crisis when it became clear that policy makers around the globe would hurry through complex regulation to force the bulk of OTC derivative business through exchanges. With the imposition of a central clearing obligation on "financial counterparties", this regulation will in theory go some way towards reducing systemic risk, with the clearing houses providing the circuit breaker in the event of another catastrophic market failure. However, it is becoming increasingly clear that incoming OTC regulation could have numerous unintended costs and consequences for our clients, who are part of the wider community of OTC derivative end users. This community includes all the non-financials, as well as the ultimate investors such as pension funds and insurance companies.

Of course, end users only wish to be able to hedge their commercial risks in a simple and efficient way, and at a fair and transparent price. End users were never part of the systemic risk problem in the first place and should not be tasked with clearing up the mess. End users certainly should not be penalised by a set of rules intended to fix a broken banking system. Whatever form the final OTC derivatives regulation takes, it must fairly accommodate the needs of the end users, who are clearly ultimate source of supply and demand of all risk that flows through bank trading books.

Clearing "exemptions" for the corporate sector

In Europe, the corporate sector successfully lobbied regulators to grant them "exemptions" from the clearing obligation under draft EU legislation. The rationale for such an exemption is obvious: the liquidity risk created by daily collateralisation could be so costly and so difficult to manage, that it could perversely incentivise corporates to discontinue the legitimate hedging of their commercial risks. Such an eventuality would clearly not have desirable implications for corporate credit markets or wider economies. And so under the proposed EU legislation, a corporate end user will be "exempted" from the clearing obligation providing it takes positions in OTC derivatives not exceeding a "clearing threshold", excluding those positions that are "objectively measurable as directly linked to their commercial activity".

A number of obvious questions arise from this carve out, in particular the question of what the exemption will really mean in practice to each of the counterparties in an exempt transaction. If the exemption means that counterparty banks are, in effect, also exempt from clearing derivative transactions with corporates, then this could simply mean business as usual for the banks, and the regulators would have achieved very little. Conversely, if regulation imposes much stricter capital requirements on bank's non-cleared OTC books, then banks will simply pass this cost straight through to the corporates and other end users. In such an eventuality, the end users could end up funding the regulatory cost of the banking sector clean up, effectively paying a systemic risk insurance premium to the banking system.

It would seem rational to conclude that the corporates will inevitably have to face up to the emergence of a regulatory system which does not favour their interests: a world in which they either cannot hedge, or cannot afford to hedge. Their current predicament was summed up succinctly by Richard Raeburn, Chairman of the European Association of Corporate Treasurers as well as Chairman of TradeRisks, and leader of the corporate lobbying on OTC reform in Europe, observing that "European corporates appear to have won the battle, but still risk losing the war".

Pension funds will be subject to the clearing obligation as financial counterparties

Corporates are not the only group of OTC derivatives end users who stand to lose out as a result of the incoming OTC regulation. Pension funds (which are big users of long dated interest rate and inflation swaps in their LDI activities) are to be classified as financial counterparties, placing them in the same category of derivatives user as investment banks and hedge funds. For pension funds, this will mean that they have an obligation to clear eligible swaps with other financial counterparties. Asset managers, although in principle supportive of a clearing obligation for pension funds, have raised two major concerns with the regulation in its current form.

Firstly, initial margin will be calculated on pension fund's entire (gross) notional swap positions, while investment banks will be required only to post initial margin on the net notional exposure of their trading books. This means that pension funds could end up posting far higher initial margin to clearing houses than swap dealers, which some pensions industry representatives have describes as "unfair cross-subsidisation" of regulatory costs. The regulation in its current form also makes no distinction between the relative credit risk of different financial counterparties. So pension funds will be subject to the same initial margin provisions as leveraged hedge funds, even though pension funds clearly contribute far less to systemic risk.

Secondly, while government bonds can be posted to clearing houses as initial margin, pension funds will be unable to post anything other than cash as variation margin. Given that pension fund swaps are usually ultra-long dated and therefore highly sensitive to market rates, this could mean that funds have to hold huge contingency cash reserves to meet variation margin, greatly impacting investment performance. Asset managers have proposed that the regulation be amended so that clearing houses are obliged to accept high quality government bonds as variation margin. However, this amendment seems unlikely to go through since the clearing house business model depends on being able to wash through variation margin from out-of-the-money clearing participants to in-the-being able to wash through variation margin from out-of-the-money clearing participants to in-the-money clearing participants. This becomes impractical as soon as it is applied to bonds.

In summary, it seems clear that pension funds will encounter major difficulties in getting these essential amendments to initial and variation margin requirements written into the final derivatives legislation. This is likely to mean that pension fund end users will also incur a disproportionately high cost of OTC regulation, even though, like the corporates, they contribute very little to systemic risk.

Investment banks' balance sheets should be fully marked-to-market to reduce systemic risk

In our view, systemic risk is intricately connected with the fundamental asymmetries that still exist in investment banks' balance sheets. Prior to the financial crisis, piecemeal marking to market and patchwork collateralisation of derivative positions pervaded the financial system. Meanwhile, benign financial conditions allowed the banks to ignore these hidden liquidity risks, and this mistake eventually proved to be fatal. Indeed none of the major bank failures in 2008 were de facto economic failures (where the bank could not meet financial liabilities with income from its financial assets, over time). Rather, each bank failure was the result of a liquidity crisis triggered by systemic instability, in turn deeply connected to asymmetries of bank balance sheets.

In fact, we see that the only solution to the systemic risk problem is in full marking to market investment banks balance sheets and full collateralisation of investment bank derivative books. We also believe that the regulators are right to impose either strict clearing obligations or higher capital requirements on investment banks. However, this need not mean that *the war has been lost* for the end user community. Indeed, the current debate over OTC regulation seems to be largely ignoring a "third way" which could allow end users to circumvent a clearing regime which has been rigged against their interests. We believe that end users should simply seek to hedge commercial risk directly with each other, thus shielding themselves from the clearing obligations and the stricter capital rules that must exist within a reformed financial sector.

We envisage harmonious financial markets where bank balance sheets are transparent and symmetric collateralisation greatly mitigates systemic risk. Meanwhile, end users can lay off standardised risk onto the banking system, but transact tailored OTC structures with one another, allowing them to precisely hedge commercial risk at close to mid-market without the obligation of self-defeating collateralisation of these transactions. In order for such "OTC exchanges" to operate efficiently, end users would require a mechanism for pooling their hedging needs in order to find the perfect counterparty with which to exchange risks.

TRL Exchange – an "OTC Exchange" for end users

TRL Exchange is one such market place created and managed by TradeRisks. The TRL Exchange platform provides non-bank hedging solutions to OTC derivative end users, such as corporates and regulated utilities, seeking to exchange interest rate and inflation risks directly with investors, such as pension funds and insurance companies. TRL Exchange also facilitates the direct placement of rated and listed notes with end investors, and intermediates hedging transactions with banks with whom borrowers have no lending “relationship”, i.e. no product tie-ins or bundling of loans and hedging.

Through the TRL Exchange platform, an “OTC Exchange”, end users subscribe to a standard set of market place rules with transactions governed by best-practice ISDA principles. On top of this core market infrastructure, end users are encouraged to bilaterally agree ISDA terms and credit support arrangements with one another, and achieve optimally structured pass through of risk in transactions which are not subject to the hedging inefficiencies of a centrally cleared banking system. This major development in OTC markets for end users is seen as highly desirable by the Bank of England and HM Treasury.

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