OTC Markets and Clearing

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What are OTC Products?

ICAP

- Over-the-counter cash (FX, Bonds, Equities,...)
- Over-the-counter derivatives are financial instruments not traded on an exchange whose values are derived from the value of something else.
- OTC markets have a crucial role to play in all national and international economies alongside and complementary to exchange markets. They have played a major role in global economic development and have been the hub of developments that benefit savers, investors, businesses and governments.
- In credit default swaps (CDS), the protection seller promises to compensate the protection buyer for the economic loss associated with a material decline in the value of a reference asset that is triggered by the occurrence of a predetermined “credit event,” such as a filing for bankruptcy or default on a debt payment by the issuer of the reference asset.

OTC products and the financial crisis

- Credit and other derivatives are in our view a symptom of the underlying problem rather than its cause.
- The market crisis is caused by a lack of confidence in financial reporting and by the actions or omissions of individual market participants – not by a lack of confidence in market structure or processing.
- Rather than rushing to develop new infrastructure, better and more extensive use should be made of the tremendous capabilities of the existing OTC market infrastructure, which has been battle tested and shown to operate very effectively, even at moments of severe market stress.
- The “turnkey” development of completely new market infrastructure is unnecessary and will require significant implementation time and incur a high level of risk.

Summary Observations

- The OTC markets play a crucial role in today's economy
- Perceptions that OTC markets are unregulated are uninformed
- While regulatory overhaul in some areas is necessary, beware of 'unintended consequences'
- Transfer of OTC trading onto exchanges is both impractical and likely to increase risk for those who are ill-equipped to manage it

- Concentrate on existing OTC infrastructure to: (a) simplify processes, (b) bring greater transparency and (c) increase robustness where needed
- **Over-riding issue:** wider adoption of CCP give-up and/or central clearing for OTC cash & derivatives

Summary Recommendations

Other key issues:

1. Wider adoption of Electronic Trading
2. Quicker settlement cycles in all securities markets
3. Faster and automated affirmation/confirmation of all derivatives trades
4. Greater use of pre-booking netting
5. Wider adoption of portfolio reconciliation
6. Wider adoption of portfolio compression in derivatives markets

Utilize the tremendous capabilities of the existing OTC infrastructure

Clearing Benefits and Issues

Benefits	Issues
• Reduced credit risk • Reduced collateral • Greater transparency over positions • Reduced systemic risk and capital • Clearing house manages operational processes centrally for all	• Multiple clearing houses vs. single clearing house • CCP capital requirements/ robustness • Standardised vs. non-standardised contracts

Many OTC markets are already cleared

Cleared OTC markets	Clearing house/CCP
Interest rate swaps	SwapClear
US and EU government bonds	DTCC, RepoClear
US and EU repo	RepoClear, DTCC
Corporate bonds	Euroclear, DTCC
Equities/Equity derivatives	Various incl. LCH, Eurex Clearing, OCC
Energy derivatives	Nymex Clearport, LCH, ICEClear

Wider adoption of electronic trading

- The benefits of electronic trading are numerous:
  - price transparency is greater;
  - trade capture is simpler and can be automated more easily;
  - trade affirmation and confirmation are easier; and,
  - regulatory reporting requirements are easier to fulfill.

- Electronic trading needs to be adopted by more OTC market participants for more markets than at present.

- Electronic trading of credit default swaps in North America and of interest rate swaps globally would be a major step forward for the industry.

OTC products should not be required to be traded on an exchange

- The solution to current problems in financial markets does not lie in attempting to mandate the transfer of OTC trading onto exchanges.

- The OTC markets have traded, and need to continue to trade, separately from exchange markets for many reasons.

  - OTC markets are a vital risk management tool for governments, corporations, investors and individuals worldwide. Unlike exchange contracts, which are standardized, OTC contracts allow users to hedge risk precisely because they are individually tailored.

  - The experience of previous attempts to move OTC market trading onto an exchange format has been very poor. The majority of participants in the FX and CDS markets need the flexibility that OTC markets allow and cannot accept the standardization that exchanges enforce.

  - An exchange solution needlessly grants the exchange a monopoly on trade execution (which is usually accompanied by restricted access to clearing), which thereby leads to increased trading costs and risk and diminished flexibility.

OTC products should not be required to be traded on an exchange (continued)

- Exchanges provide a trading venue for assets that are simple and have characteristics that can be standardized.

- By contrast, OTC markets offer a deep and liquid trading venue for professional market participants, such as major banks and financial institutions, to execute transactions, the key terms of which are individually negotiated, rather than standardized.

- OTC markets are more attractive, and suitable, for hedging risk.
  - Since "real world" economic risk is normally non-standardized, traders who use exchanges for hedging purposes have to continue to live with the differential between their real underlying exposure and the payoff on their hedges. Users of the OTC markets can hedge their risk precisely and transfer to professional OTC market participants the residual risk they would otherwise be forced to live with if they had used an exchange product.

- Many OTC products, such as treasuries, are already cleared but not traded on an exchange.

- CCP and clearing house functions do not have to be tied to exchanges and these functions already provide valuable services to the OTC market, independently of an exchange, just as much they can as to the exchange traded market.