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Danger of OTC clearing risk being moved downstream?

Are CCPs really the answer to reducing risk in the OTC derivatives market?

As global markets edge closer to a new regulatory landscape for OTC derivatives, questions remain as to whether the new world will result in a safer environment or simply shift risk from banks to clearing houses.

This year's Osaka conference explored this issue with a new debate format known as the Sibos Colloquium, sponsored by the SWIFT Institute, which pitted the views of Manmohan Singh, senior economist at the International Monetary Fund, against Godfried De Vidts, director of European affairs at ICAP.

Emanating from the Group of 20's 2009 Pittsburgh summit, the new swaps rules will push a portion of the OTC derivatives market through central counterparties (CCPs) with the aim of reducing systemic risk.

Singh estimated the cost of this risk to be USD 2 trillion, which comprises the under-collateralised portion of swaps held by banks.

But he warned that the new rules would only transfer the risk to a new type of entity, rather than reducing it, and could eventually lead to another situation that requires a taxpayer bailout.

"Instead of 10-15 pockets of risk held at banks, we are moving to 20-40 pockets of risk at banks and CCPs combined," he said. "If the plan is to give CCPs the same job as banks, in terms of risk mitigation, there better be good economics behind it."

Possible ways to increase the effectiveness of central clearing, said Singh, would be to funnel cleared swaps through a single CCP that would be backed by a host of central banks. The primary benefit of this structure would be the greater possibility for netting, i.e. the ability to reduce the collateral needed against contracts by setting them off against related products. However, the complexities associated with this model mean it has not been considered by regulators.

"Another alternative would be for CCPs to interoperate, but this is unlikely because clearing houses have targeted niche markets and the differences between national bankruptcy laws pose challenges," said Singh.

Complicating the situation further, are the firms that will be exempt from the new swaps rules, such as sovereign entities, insurers and corporate firms, in addition to the exotic products that CCPs will have difficulty in valuing and therefore can't be cleared – referred to by Singh as a "time bomb".

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Manmohan Singh, International Monetary Fund

Exemptions and exotic products combined could represent a large part of the market and means banks will still hold significant risks on their books.

"If everyone posted collateral there would not be a need for CCPs," said Singh. "Those firms that have exemptions to the rules creates an asymmetry, which means the risk remains in the system."

Proactive on risk

Taking the stand after Singh, ICAP's De Vidts agreed that moving OTC derivatives from a bilateral world to a cleared one would not eliminate the associated risks, but noted that a number of solutions are emerging that would help to limit the dangers.

One of these cited by De Vidts is TriOptima's triBalance tool, which attempts to reduce portfolio risk exposures across bilateral transactions and cleared swaps.

By taking steps to reduce the risk exposure associated with bilateral counterparties and CCPs, banks can decrease margin requirements and the regulatory capital required for new rules like Basel III, contributing to the decrease in systemic risk that regulators crave.

"Margin and capital for OTC derivatives do address the risk in the system but don't address the underlying cause," said De Vidts. "Banks should be proactively looking at what's happening in this market and looking for ways to reduce risks."

The Colloquium session was designed to promote the work being carried out by the SWIFT Institute, a new initiative created to better link academic research with financial market realities. The session was introduced by SWIFT CEO Gottfried Leibbrandt, who said the aim of the scheme is to "answer those deeper questions that are not easily solved."

From 2013, the Institute will offer 12 grants per year for research projects targeting issues related to transaction banking. This follows on from the grants already issued in 2012, which include research on the challenges associated with internationalisation of the RMB and how to reach the 'unbanked'.