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CDS Clearing, Data Repositories & Regulation for the Derivatives Market

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DerivSource has launched a new reference guide to track regulatory activity

Regulation Timeline

Greetings!

Changes in the industry are already under way and this month we have some excellent food for thought as we prepare for 2010.

In a monthly column, Sapient consultants **Peter Meechan** & **Bill Hodgson** discuss central clearing for credit default swaps and warn that the buy-side's involvement is still very tentative.

In a Q&A, Preqin senior analyst **Amy Bensted** shares valuable insight into the evolving role of institutional investors in the hedge fund industry.

In part 2 of "When a Data Repository is Not...", industry consultant **Simon Hopper** offers analysis on the use of data warehouses for the purpose of financial markets' oversight and for use in the OTC derivatives market.

Enjoy the rest of '09 and happy holidays.

Julia

Julia Schieffer
Founder of DerivSource.com

Central Counterparty for Credit Default Swaps:The Buy-side Perspective

Financial authorities, keen to reduce levels of systemic risk arising from potential counterparty defaults, are pushing for the introduction of central clearing for credit default swaps. If this initiative is to succeed, the buy-side, as well as the sell-side, must become fully involved. As yet, argue Peter Meechan and Bill Hodgson of Sapient, the buy-side's involvement is still very tentative. Read full column

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Central Counterparty Clearing for Credit Default Swaps: The Buy-side Perspective

By Sapient

December 1st, 2009

Financial authorities, keen to reduce levels of systemic risk arising from potential counterparty defaults, are pushing for the introduction of central clearing for credit default swaps. If this initiative is to succeed, the buy-side, as well as the sell-side, must become fully involved. As yet, argue Peter Meechan and Bill Hodgson of Sapient, the buy-side's involvement is still very tentative.

Credit default swaps (CDS) – private bilateral deals which offer protection against banks, corporations and governments defaulting on debt – have been blamed for exacerbating the current financial crisis. As a result, politicians and regulators on both sides of the Atlantic have been pressing for the clearing of credit default swaps (and, indeed, all over-the-counter products), via central counterparties (CCPs). A number of exchanges and clearing houses have responded to financial regulators' call to action: the ICE Trust and Eurex are currently live with clearing services for credit default swaps – ICE's US offering launched in March 2009 and Eurex cleared its first CDS contract at the end of July this year. A joint initiative between the

Chicago Mercantile Exchange and Citadel Investment Group, aimed at providing clearing services for the nearly $27trillion credit default swap market, is also under way.

For the major dealers of the sell-side, to whom membership of a centralised counterparty is usually restricted, there are a number of very powerful arguments for the use of clearing via a central counterparty. These include balance sheet netting, which reduces capital adequacy requirements and minimises counterparty risk, credit line release, as well as the reduction of settlement and operational risk. In contrast, the benefits of centralised clearing are a little less obvious for the buy-side. In particular, because of their size and credit profile, buy-side firms only usually have access through a third party clearing member. Under this arrangement the buy-side firm clears its trades via a third party clearing member, which then passes them to the CCP. In effect, the clearing member is acting in a similar fashion to a prime broker in an intermediation trade. As a result of the potential increases in risk and the additional infrastructure that the dealer will need to introduce, it may only be willing to offer such a service at a high price. This cost may prove prohibitive to some buy-side firms, precluding access to the CCP for many smaller companies.

Other difficulties exist, too. Consider, for example, the question of margin. Clearing houses generally take a conservative approach to margin management, meaning that three layers of margin must be posted – variation margin, initial margin, as well as a contribution towards the default fund. Putting up the necessary margin is a costly business and can therefore prove a sticking point for some buy-side firms. In addition, the trading profile of most buy-side firms is such that the potential for netting is very limited, removing one of the chief attractions of central counterparty clearing. Finally, the product scope of the CCP means that only a limited set of trades is cleared, removing them from a client's ISDA CSA, potentially also having a negative effect on its bilateral exposure.

As a result of the drawbacks outlined above, it might appear that central clearing provides few benefits for the buy-side. Yet central clearing does, in fact, offer important advantages. Take, for example, the portability of collateral and trades should a clearing member default – following a default, any trades and collateral can be transferred to another, non-defaulting, clearing member. In contrast, when Lehman Brothers failed last year, many firms had great difficulty gaining access to the collateral they had posted with the bank, in addition to having to write off defunct trade positions.

In reality, it is not so much that central clearing per se holds little attraction for the buy-side but that initiatives tend to be designed primarily with the requirements of the sell-side in mind and therefore do not cater adequately for the needs of the investment community. To illustrate this point, a parallel can be drawn with the introduction of central settlement. The central settlement service, launched by the DTCC and CLS Bank International, enables firms to settle credit default swaps as a single net payment within the CLS bank, rather than as multiple bilateral gross settlements. At present, only major dealers have access and participation by other firms is via third party membership. To date, access through third party membership has been provided by dealers where they have been able to earn high fees or where a buy-side firm has brought a portfolio of business with it. Not surprisingly, there has been limited buy-side interest. Indeed, such has been the difficulty of finding third party CLS members that the Federal Reserve target of including 96% of eligible trades within central settlement by November 2009 was recently moved to March 2010.

Nevertheless, there are certain indications that suggest CCP clearing will be taken up by the buy-side at a more rapid pace than has been the case with central settlement. Importantly – and in a deviation from usual practice – investment managers are being consulted by clearing houses. Indeed, one of the clearing services that is currently being launched by the Chicago Mercantile Exchange and Citadel Investment Group counts several major buy-side firms, including PIMCO, BlueMountain Capital Management, BlackRock, AllianceBernstein and the D.E. Shaw group, as founding members. Not surprisingly, this aspect has also obliged the major dealers to take serious note of the particular venture.

Equally critically, prime brokers have identified a potential commercial opportunity in offering buy-side firms third party member access to central clearing. Prime brokers, whose business has historically been based on financing, have, as a result of the reduction in leverage, seen their traditional business model shrinking. Keen to replace lost business with a new source of revenue, a number of prime brokers have begun to investigate the possibility of providing hedge funds with third party member access to CCP clearing. Particular interest has been generated by the fact that the margin clearing members post to the CCP is based upon an exposure netted across all their original counterparties, while that which they receive from their hedge fund clients is not. This, in turn, creates a spread that makes the provision of third party clearing attractive either generating profits for the prime broker or enabling it to offer a reduction on the margin clients have to post on bilateral trades. Tellingly, conversations conducted by the authors with investment managers reveal that discussions held between buy-side firms and potential CCP clearing members are already progressing speedily.

Interestingly, prime broker sponsored access to a central counterparty may even give a boost to central settlement. As trades between clearing members and clients are settled in a similar fashion to the prime broker client leg, central settlement becomes unnecessary (client to prime broker legs are excluded from the central settlement mandate because they settle as a book entry at the prime broker and no cash is physically moved from one entity to another, except, of course, in the case of margin top-ups). With the clearing member and central counterparty already part of central settlement, the clearing member to central counterparty leg is automatically included in the service, increasing the total percentage of gross trades settled via central settlement.

Prime brokers are also likely to play an essential role in driving buy-side CCP participation through their interest in the provision of transaction-based services to clients. To date, the buy-side has lagged behind the sell-side in terms of automation: while the majority of inter-dealer trades in over-the-counter contracts are automated, and notably those in credit, dealer to buy-side trades are still dominated by manual processes. The introduction of central clearing will bring change, forcing the buy-side to adopt greater levels of automation and obliging it, and its service providers, to revise the manner in which business is carried out. Forward-thinking prime brokers have already realised that offering transaction-based, back office services to hedge funds, thereby enabling funds to connect to central clearing or central settlement services, represents a commercial opportunity. Indeed, the authors have observed that a number of prime brokers have already embraced this trend. In contrast, others appear reluctant to adapt, preferring to adhere to existing leverage-based business models.

In conclusion, the omens for centralised buy-side clearing of credit default swaps look more hopeful than, at first glance, may appear. The importance of the buy-side to the success of central clearing is beginning to be acknowledged, with one of the three central counterparties actively enlisting the support of several major investment managers. Importantly, central clearing also offers commercial opportunities to prime brokers, which have seen their traditional, leverage-based business models battered by the current financial crisis. As a result, a number of prime brokers are already showing interest in providing clients with third party member access to central counterparties or are investigating the possibility of offering transaction-based services to buy-side firms, thereby providing investment managers with the level of automation necessary for connection to central clearing services.