INVESTMENT
INDUSTRY ASSOCIATION
OF CANADA

Letter from the President

OTC Derivatives: Progress on Standardization and Building Clearinghouses

The Case for Clearinghouses

Over-the-counter derivatives play a critical role in capital markets, most notably by helping market participants effectively manage their risks. For example, OTC interest rate and currency swaps enable a better alignment of cash flows to meet payment obligations for financial liabilities and OTC equities and foreign exchange and commodity futures contracts provide important vehicles to hedge balance sheet exposure. The recent financial crisis revealed that derivatives cleared through clearinghouses, with the facility to offset matching trades, rather than executing transactions through bi-lateral arrangements, boosted investor confidence and liquidity by reducing counterparty risk, and contributed to lower systemic risk.

The G20 countries have embraced reforms that mandate OTC derivatives transactions flow through clearinghouses, similar to conventional debt and equity securities, to improve trading efficiencies, reduce counterparty risk and the potential seize-up of transactional flows, and mitigate systemic risk. Market participants will benefit from clearinghouses in terms of lowered transactional risk and the ability to offset transactions and economize on capital. The shift to clearinghouses will also bring greater transparency to the opaque OTC securities markets and contributing to the development of central repositories.

Transition to Clearinghouses: The Challenges

The centralized clearing of the OTC derivatives markets is a complex task. Clearinghouses will likely require a high degree of standardization and commonality within the cleared securities to close out open positions quickly and mitigate losses in the event of transactional default. On the other hand, market participants want as much flexibility as possible in structuring OTC derivatives to hedge unique market risks and highly specific balance sheet exposures.

The decision on standardization will be a consultative and collaborative exercise involving market participants, CCPs and regulators. OTC securities generally fall into four broad categories: (i) plain vanilla derivatives with standard maturity dates, (ii) plain vanilla derivatives with non-standard maturity dates, (iii) non-standard derivatives with well-established pricing models, and (iv) highly structured bespoke derivative products. The first two categories would likely fall into clearinghouses. The key variables for plain vanilla derivatives with non-standard maturity dates can be interpolated to determine interest rates, spreads, pricing, etc. These two categories would account for most interest rate and cross-currency swaps and standard futures contracts. Most OTC derivatives that fall into the third and fourth categories (including basket options, accrued swaps, etc.) would not trade actively enough for inclusion in a clearinghouse. As a result, under much stiffer capital rules contemplated for OTC derivatives, many of these structured products will become more expensive and some may actually disappear from the marketplace.

OTC derivatives trade in a highly integrated global marketplace with transactions in multiple currencies executed by global institutions. This includes financial intermediaries and buy-side investment funds across many jurisdictions. Some clearinghouses for conventional debt and equity securities, such as LCH. Clearnet and ICE, have expanded to include swap transactions. It is anticipated that these clearinghouses and others will expand operations to include most plain vanilla OTC derivatives. As well, new clearinghouses may set up to clear transactions in OTC markets. It will be important to ensure these clearinghouses adapt similar standardization procedures and rules, similar inter-operability standards to deal with issues such as participant bankruptcy and appropriate inter-connectivity and linkages to operate seamlessly across differing time zones to capture market efficiencies and achieve effective market and product access across jurisdictions.

What the IIAC is Doing

The Investment Industry Association has established a national IIAC Derivatives Committee with a mandate to monitor global developments in the area of OTC clearing, identify OTC asset classes and securities that can be standardized for inclusion in a clearinghouse, and determine a process for selecting one or more clearinghouses for Canadian dollar-dominated OTC derivatives. The Committee will benefit from earlier work undertaken by the Industry Advisory Group (IAG) of the chartered banks, and from the work of the IIAC Repo Committee, leading efforts to build a CCP netting facility for repo and debt transactions. The IAG mapped out the scope of the Canadian dollar inter-bank OTC derivatives market, identified the relevant policy issues and provided a direction for future work.

The IIAC Committee includes representation from all the Canadian bank-owned dealers that dominate the OTC marketplace, foreign affiliate dealers whose parent firms trade in Canadian dollar and multiple currency OTC derivative securities, representatives from buy-side investment funds and pension plans, and representatives from ISDA (the standard setter in international swap markets) and the Canadian Foreign Exchange Committee. Bank of Canada officials are observers on the IIAC Derivatives Committee.

The Committee has set up a Standardization Working Group to identify the asset classes in OTC derivatives securities for clearinghouse eligibility, and a CCP Working Group to examine clearinghouse options. The CCP Working Group will examine the operational, legal and regulatory merits of a domestic clearinghouse for Canadian dollar denominated OTC derivatives versus linkages to existing offshore clearinghouses. The two working groups had been meeting through the summer months to design a strategic plan to transfer most plain vanilla OTC derivatives, and possibly some non-standard OTC derivatives, to clearinghouses.

As the Derivatives Committee carries out its mandate, it will monitor similar OTC derivative clearinghouse developments in international jurisdictions and consult with industry associations, such as the International Council of Securities Associations and International Swap Dealers Association, and international regulatory bodies such as IOSCO, to advocate for inclusion of similar OTC asset classes and securities in clearinghouses, and similar operating standards and linkages between clearinghouses. This outcome will require close coordination among securities regulators. The detailed rule-making for clearinghouses in derivative markets in the EU and in the United States where legislation now mandates clearinghouses, is still in its early stages. Further, if the Canadian industry moves forward with a domestic clearinghouse for OTC derivatives, efforts will be made to create a utility-based model to avoid monopolistic pricing of clearing services and market data.

The Committee will present its findings to the Heads of Agencies meeting, a group comprised of the Bank of Canada, the provincial securities commissions and OSFI, on September 16, 2010.

Yours sincerely,

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President & CEO, IIAC

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