

Markit Conferences

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Markit OTC Cash & Derivatives Markets Conference – New York, March 9th, 2010

A summary of the discussions and regulatory insights

Key findings

- **Investors still face a high degree of regulatory uncertainty. Regulators, including CFTC Chairman Gary Gensler, addressed the conference. Attendees gained insights into the direction of future regulation.**
- **Experts in derivatives trade processing have ambitious targets for continued reduction of backlogs and faster settlement times, but noted that the gains already achieved by the industry in processes and infrastructure made the credit crisis “survivable” from an operational standpoint. Further to this point, professionals from the leveraged loan industry are studying the over-the-counter derivatives trade processing model in order to design a more robust system in that asset class.**
- **Progress has been made in the standardization of contracts and in the clearing of dealer-to-dealer trades. However, more work is needed to further progress central clearing of standardized**

products. For credit default swaps, expanding clearing for buy side trades and single names will be the focus in 2010.

Introduction

There was a time when talking about the regulation, trade processing and central clearing of over-the-counter (“OTC”) derivatives would relegate the offending individual to the corner of any reputable gathering. The credit crisis in 2008 and early part of 2009 brought these issues to the forefront. Last Tuesday, these topics literally took center stage at Markit’s OTC Cash & Derivatives Markets Conference held at the Times Center in New York City. Close to 400 individuals, representing nearly 200 firms were in attendance. Similar events were held across Europe and Asia with similar success, a testimonial to the timeliness and importance of these topics.

Jeff Gooch, CEO of MarkitSERV, boldly stated in his opening address that those looking for answers regarding forthcoming regulations or how the markets may evolve would be disappointed as definitive answers are simply unavailable at this time. Rather than feeling disappointment, attendees were riveted to the discussions that took place as they searched for the slightest bit of nuance from high profile regulators and industry experts into how some of the major issues may be addressed in the months ahead.

Keynote Address – Gary Gensler, Chairman of the Commodity Futures Trading Commission

The most important and awaited event of the day was the address given by Gary Gensler, CFTC Chairman. In his remarks, Mr. Gensler focused his attention on credit default swaps primarily but did state that a comprehensive regulatory framework must include all dealers and all OTC derivatives regardless of where they are traded.

Prior to sharing his personal views on the types of reforms needed for credit derivatives, Mr. Gensler offered his thoughts on the role of CDS during the recent credit crisis and the Greek financial situation. Chairman Gensler indicated that effective reform requires three critical components: 1) explicit regulation of derivatives dealers particularly around capital requirements, collateral, market integrity and strict recordkeeping; 2) promotion of market transparency by requiring standard OTC derivatives to be traded on exchanges or swap execution platforms; and 3) the use of centralized clearing for standard OTC derivatives to reduce counterparty risk.

In addition to these core areas of regulatory focus, Chairman Gensler provided additional insights. First, as there is a belief by some that bondholders and creditors with CDS protection may benefit from a company's bankruptcy, particularly if such positions are "naked" or in excess of their cash position, he suggests that such "empty creditors" be required to disclose their positions. He also suggested that it may be possible to authorize bankruptcy judges to restrict or limit the participation of such institutions in bankruptcy proceedings.

In accordance with Basel II capital regulations, banks have often used CDS to hedge their risk in order to free up capital from required reserves. Mr. Gensler argued that such use of CDS should be more restrictive than current practice, and that regulators were studying the issue and coordinating on an international level.

On the topic of end-user exemptions from mandatory exchange trading or clearing, Mr. Gensler expressed his view that while such exemptions may be enacted by Congress on other types of OTC derivatives, he would prefer that such exemptions not be included for CDS products.

Mr. Gensler noted that his agency would continue to work closely with the SEC, particularly on issues related to market manipulation and fraud. The SEC would take the lead on single issuer and "narrow-based" CDS while the CFTC would lead on "broad-based" products.

Arguably, the most insightful view that Mr. Gensler provided was in response to a question from an audience member regarding a timeline for the enactment of legislation and regulations. While by its very nature the political process is hard to predict, Mr. Gensler estimated that Congress would probably pass a financial reform bill at some point this summer or shortly ahead of the upcoming congressional elections. As regulators would then need time to draft appropriate rules to comply with such legislation and follow the necessary process for a public review period, he estimated that the impact on the marketplace could come as soon as late 2011.

Regulatory Panel

While Chairman Gensler's address was certainly the draw of the event, the regulatory panel featured a diversity of viewpoints on many of the same topics. Theodore Lubke of the New York Federal Reserve and Elizabeth King of the Securities Exchange Commission shared their views. Associate General Counsel for JPMorgan Chase & Co., Don Thompson, represented the views of the sell side while Andrew Feldstein, CEO of BlueMountain Capital represented the buy side. Cory Strupp of SIFMA, who speaks frequently on the Hill, rounded out the panel. Gillian Tett, U.S. Managing Editor for the Financial Times, moderated the panel.

Panel discussions highlighted the issues of large, complex financial institutions, concerns around regulatory arbitrage, trade and position reporting and the concept of a consolidated tape.

All panelists agreed that large, complex financial institutions could not be allowed to fail in the same way as regular businesses. However, there was some disagreement on how best to address the issue. One panelist suggested that a specific regulatory regime was needed to address the implicit government support that gave these institutions a competitive advantage in the marketplace. Another panelist suggested that such institutions could be allowed to fail but in a controlled manner—through an expedited bankruptcy or reorganization procedure.

There was complete agreement on the need for regulators to coordinate internationally in order to harmonize rules to deter market participants from simply shifting capital and trading activity to jurisdictions with the least regulation. Theodore Lubke cited the OTC Derivatives Regulatory Forum which includes over 40 different regulators, central banks and bank supervisors on a global basis, as one example of how regulators are working in coordination. Some panelists noted that regulatory coordination could be for naught if lawmakers, who are more subject to political pressures, do not take some care to coordinate as well.

There was also total agreement on the need for greater transparency. All panelists agreed that the formation of trade repositories to provide regulators with insights into trading activity and positions was essential. There was however a range of views on the use of a consolidated tape for reporting, particularly as to whether this would increase or decrease market liquidity. Panelists had a lively discussion on the appropriate timing for such reporting and how it would even practically work for complex instruments that were not necessarily fungible.

Electronic Processing Panel

While a consistent theme for most of the conference was the degree of regulatory uncertainty in the markets, the panelists on the electronic processing panel noted that this was not the case for much of the agenda in the trade processing area, with only about a third of the current agenda awaiting more direction from regulators. Most of the open questions here are around execution platforms. Thus, processing vendors have taken an agnostic approach to trade execution platforms.

The panel reported that there is significant similarity and harmonization of trade affirmation, confirmation and settlement across OTC derivatives. There is some concern that some of the momentum and recent accomplishments could be lost if the industry did not correctly anticipate the impact of new regulatory requirements around transparency or the possibility of different treatments in cleared vs. non-cleared products.

Continued process improvements and infrastructure investments will be needed as the panel experts noted that central clearing would likely be incremental and that a large proportion of the OTC derivatives markets will not

be clearable due to the bespoke nature of some products caused by client demand or the lack of liquidity.

While the panel noted that there were some challenges due to the operation of multiple central clearing houses were operating, all participants were optimistic that such challenges could be solved as they have been for other asset classes.

As evidence of the progress made in OTC derivatives processing, electronic processing for the leveraged loans market is currently modeled after the lessons learned in the OTC marketplace. The loan trade associations in North America and Europe have done a lot of work on standardization of confirmations but processing is still paper-based. A sense of urgency is building in the space as loan market volumes appear to be ramping back up.

The panel consisted of Jeff Gooch, CEO of MarkitSERV; Colin Heffron, President of GFI; Ric Okun, Senior Vice President at PIMCO; Todd Sullivan, Managing Director at Morgan Stanley; and Joe Widner, Managing Director at Markit. The panel was moderated by Kevin McPartland, a senior analyst with the TABB Group.

Clearing Panel

Kate Kelly of the Wall Street Journal led a balanced panel of buy and sell side participants on the current state of central clearing for OTC derivatives. Representing the sell side were Athanassios Diplas, Managing Director at Deutsche Bank and Thomas Benison, Managing Director at JPMorgan Chase & Co. Both men were instrumental in the standardization of CDS contracts that occurred last year through the Big Bang and Small Bang protocols, efforts that were necessary for central clearing. Ted MacDonald, Managing Director at D.E. Shaw and Randall Costa, Chief Operating Officer for IT at Citadel Investment Group represented the buy side. Both men and their firms have been early leaders in centralized clearing of CDS. Tom Price, Managing Director and Head of Credit Products at Markit, also served on the panel.

The panelists all agreed that significant work had been done in the past year to standardize CDS contracts and to begin central clearing for credit derivatives. Clearing of eligible dealer-to-dealer trades has reached in excess of 90 per cent in a fairly brief time. Similarly, all

concluded that far more work needs to be done. Expansion of eligible, standardized credit products will continue throughout 2010. Buy side participation is expected to increase but there is still considerable uncertainty, more in some jurisdictions than others, around the portability and segregation of collateral. Regulatory uncertainty around the incremental cost of non-cleared products over cleared products and concerns about the netting of margin across clearing houses and asset classes have investors cautious in committing more rapidly to central clearing. Liquidity is of paramount concern for dealers and investors alike.

Clearing of some other OTC products will hinge on the type of standardization. The panel agreed that while standardization is a necessary condition for central clearing, it is not a sufficient condition. Liquidity is also needed lest clearing houses hold positions where they cannot truly manage the risk—little or no price transparency and inability to offset or liquidate positions.

On the issue of exchange trading, most of the panel agreed that while there was nothing wrong with exchange trading per se, they did not want to see it mandated. Rather, they preferred competition across exchanges and execution platforms to offer customers choice. Those that shared this viewpoint noted that central clearing addressed many of the concerns around transparency and counterparty risk. It was also noted that exchange trading does introduce a strong element

of price transparency but a financial product needed to be sufficiently mature in the product lifecycle before exchange trading could be successful.

Conclusion

As disclosed at the outset of the conference, the day would yield few answers and many questions but all valuable. Only a couple of years ago, industry conferences were just that: of the industry, by the industry and for the industry—few else were interested. Times have changed. The conference featured industry experts alongside with regulators as part of an ongoing dialogue on how best to address the issues facing the OTC cash and derivatives markets. As credit default swaps have become a part of the conversation at dinner tables around the world, participants spoke on the record in front of an audience which included eighteen journalists. In something akin to a presidential debate or “Meet the Press”, two of the three panels were led by leading financial journalists who asked tough and probing questions.

We would like to thank all of the conference participants and attendees for their time. We offer special thanks to Chairman Gensler, who rushed to New York following his testimony at the Capitol in order to speak at this event.

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