The future of the over-the-counter derivatives market

by Manfred Wiebogen, ACI The Financial Markets Association*

IT TAKES A FEW SUPERLATIVES TO DESCRIBE THE OTC DERIVATIVES MARKET. HUGE, VAST AND MASSIVE WOULD ALL FIT WELL INTO SUCH A DEFINITION. IT IS REPORTED THAT THE SIZE OF THE OTC DERIVATIVES MARKET EXCEEDS US$600 TRILLION. THIS MAKES IT BY FAR LARGER THAN THE VALUE OF EXCHANGE-TRADED DERIVATIVES, THE MARKET VALUE OF THE WORLD'S STOCK MARKETS AND DEBT SECURITIES COMBINED[1].

Law-makers in Europe and in the US are about to give the OTC derivatives market a big shake-up. The stakes involved are high. For banks they're a good source of revenue and for the industry, a vital product in mitigating risks. The lack of them may be costly for companies and bad for the economy. Meanwhile, governments think that such products can be subsidised by taxpayers' money since main dealers are 'too big to fail'.

It is perhaps only natural that every financial crisis paves the way for a fresh round of regulations and restrictions. Derivatives are used by businesses to transfer risks to other firms, namely financial institutions which in turn run the risk or hedge through on-exchange. Derivatives are extraordinarily useful but can be dangerous if misused, as they are as good at spreading risk as at concentrating it.

Although derivatives did not cause the crisis, their misuse has surely intensified it and made government interventions more complicated.

Size of the OTC market

Crunching the numbers! Exhibit 1 illustrates the main components of the OTC derivatives market which in June 2009, amounted to US$604.6 trillion. This figure includes notional amounts of all outstanding derivatives, namely: foreign exchange, interest rates, equities, commodities and credit default swaps.

The size of the OTC derivatives market may be impressive, but needs to be kept in perspective. The notional amounts provide a measure of 'market size' but in no way quantifies the risks involved; in fact they do not even form part of anyone's balance sheet. Of more significance in measuring

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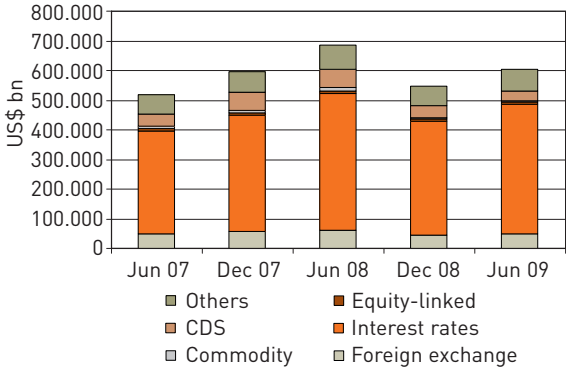
OTC derivative market **Exhibit 1**



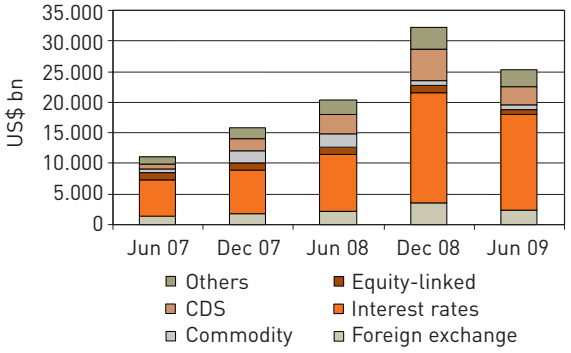
*Notional amounts outstanding

Source: BIS

the risks at stake would be the 'gross market value' and the 'gross credit exposure' on outstanding contracts, published by the Bank for International Settlements (BIS).

Gross market values (see Exhibit 2), which stood at US$25.4 trillion in June 2009, provide a good indication of the 'market risk' involved. This figure represents the value of the money that would have changed hands had the outstanding contracts been sold at the prevailing market prices on the reporting date.

OTC derivative market value **Exhibit 2**



Gross market value

Source: BIS

The 'credit risk' element in the OTC derivatives market is given by the 'gross credit exposure' and amounted to US$3.74 trillion. This figure represents the net exposure after taking into consideration the enforceable bilateral netting agreements in place.

Notwithstanding that US$3.74 trillion may indeed be a large number, it represents merely 0.62% of the outstanding notional amount.

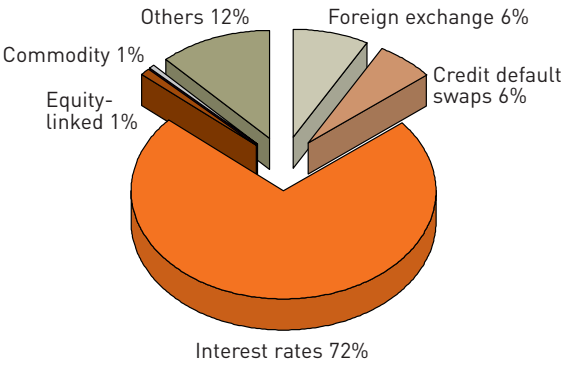
OTC derivatives risk categories

The growth in this market has been tremendous over the past decade. However, the recession of 2008 has interrupted this trend with outstanding notional amounts falling by US$130 trillion in the second half of 2008. However, it had rebounded by around US$57 trillion by June 2009.

The recovery is attributed to increases in foreign exchange, interest rate and equity-related derivatives. On the other hand, notional amounts in credit default swaps and commodity derivatives lost further ground.

The bulk amount of the OTC market consists of around 70% being attributable to interest rate derivatives, which in turn is dominated by interest rate swaps. Foreign exchange makes up 8%, namely forwards and swaps up to one year. Exhibit 3 illustrates the risk categories.

OTC derivatives by risk category – June 2009 **Exhibit 3**



Source: BIS

Main concerns for regulators

Regulators are obviously concerned by the 'systematic risk' posed by such a huge market, which remains scarcely regulated. The size involved is not the only reason for their concern; after the troubles faced in 2009 by AIG, I presume that 'concentration risk' tops their list.

In this regard, BIS quantifies concentration risk by publishing the Herfindahl index for the FX OTC market. This index represents a measure of market concentration and is defined as the sum of the squares of the 'market share' of each institution.

The index shows that over the past three years, concentration risk has actually increased. In the US, five banks dominate 97% of all derivatives, while the largest 25 banks account for nearly 100% of all contracts[2].

Regulators are also concerned by the fact that counterparties to derivatives contracts effectively get a *senior claim on each other's assets*. For instance, in the event of bankruptcy, a loan structured through a 'total return swap' can push the original lending bank up the queue for repayment.

Another problem for regulators is *complexity*. Firstly, clients often enter into such agreements without fully understanding the risks undertaken. Secondly, complexity makes 'fair value' of such products hard to determine in normal circumstances, let alone during a crisis. The latter also makes financial figures opaque and difficult to interpret. Remember Enron!

What to expect

It seems that three proposals are being considered by regulators:

i) having a higher capital charge for OTC derivatives;
ii) having OTC contracts cleared through central counterparties; or
iii) having more derivatives traded on-exchange.

To impose a higher capital charge seems both plausible and reasonable, but the other two are tricky to evaluate and implement. More importantly, their full effect on the financial industry and the economy will be hard to predict.

The very attractiveness of the OTC derivatives market lies in the ability to offer tailor-made solutions suited to their clients' needs. The usefulness for small-to-medium size firms is that they bring added value to their operations. Moreover, OTC derivatives are mostly transparent as end-users may request a quote from more than one bank or even consult real-time prices over the internet.

Thousands of firms use derivatives simply to manage currencies, cash flows and similar related risks. Forcing them to hedge their positions through an exchange-traded derivative will make it costly and awkward to manage.

At this point, new regulations are inevitable and necessary. The crisis has shown that free market forces do not always provide the desired effect. That said, law-makers should distinguish between the entire range of derivatives according to their use, complexity and the role they play in the financial markets and other industries.

Doing away with OTC derivatives anytime in the near future is unlikely. Derivatives remain essential for a well functioning financial system. However, even derivatives require some regulation and oversight. This will ensure that the abuse and greed of the few will not hinder the development and prosperity of the many.

Notes:

* Members of ACI are in a large part engaged within the financial trading or sales environment in the global financial markets representing the foreign exchange, interest rate products and other securities, banknotes and bullion, precious metals and commodities and the various kinds of derivatives. ACI is a leading global association of wholesale financial market professionals. ACI counts some 13,000 international members in more than 60 countries.

1 On-exchange derivatives – notional amount; debt securities and stock markets – market value. Source: Bank for International Settlements & World Federation of Exchanges.

2 OCC's Quarterly Report on Bank Derivatives Activities, http://www.occ.treas.gov/deriv/deriv.htm.