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Comment: risks remain in G20 clearing plan

By Thomas Krantz

The G20's proposal in 2009 to mandate use of clearing as one element of the measures to rein in over-the-counter (OTC) instrument risk is hardly a military matter.

Yet, given the economic harm attributed to OTC derivatives post-2007, the G20's plans merit review. An analogy with one of history's most rigorous military strategies might be appropriate.

The Schlieffen plan of 1905 suited German defence: in the middle of Europe, success required not splitting military resources between east and west. France was judged to be weak, while was Russia stronger but slower to mobilise. Should hostilities commence, Germany would go west first.

As we know, the plan went wrong on the outbreak of the fi rst world war. Britain committed to defending Belgium and Russia mobilised its army faster than expected. German men and material were in concentrated in the wrong place.

Like the German military, the G20 has the right strategic objectives, but this is only effective when context, logistics, and resources are aligned. For many years most clearers have done well assuming counterparty risk in exchange-based cash securities, options and futures – but OTC markets are different.

Perhaps there is a Schlieffen echo 100 years on: is channelling unregulated contracts into regulated central counterparties (CCPs) the financial equivalent of men and material are needed elsewhere at a critical moment?

Much about clearing houses remains unknown. First, how many risk managers work in them? Assuming a few persons per clearing house versed in multi-asset class clearing risk management, expertise is concentrated in few heads relative to the stakes: the Bank for International Settlements fi gure for June 2013 was outstanding notional OTC of $693tn, compared with world GDP estimated by the CIA at $72tn.

The segment's capital base? The Chicago Mercantile Exchange and Korea Exchange have common balance sheets for clearing and trading, ie no separate clearing capital. A global total can only be estimated. Without a firm number, we cannot know the resources available to withstand shocks, although CCPs usually – but not invariably – have guarantee funds and "waterfalls" of additional funding for defence in case of default, notably the margin posted.

Profitability? Some operate as profit centres, others charge minimal fees. Clearing houses grew up with agricultural futures, were judged essential for fi nancial derivatives in the 1970s, and of general utility for exchanges since. Each is local in spirit, built for specific circumstances. There is no pattern.

Investment policy for equity and margin held? Clearers share little despite their vulnerability to liquidity shifts. How quickly can assets be turned into cash? Levels of liquidity are mandated, but even actively-traded assets freeze, notwithstanding central banks' epochal cash production.

How much margin is to be sent by clearing members to secure their positions? What is the quality of those assets? What are the open positions in the market for the asset types accepted? Without answers in a consistent format, no one can calculate an industry-wide ratio of default fund to initial margin, the central criterion for risk mutualisation. Finally, we don't know the resolution and recovery plans for a failed CCP.

Rarely visible, CCPs have been followed episodically by the Group of Thirty, and later the Committee on Payment and Settlement Systems at the BIS and Iosco. In 2009, most clearing houses seemed wary about taking on this work.

Here is why: for a CCP, the difference between an exchange-traded product and an OTC instrument is how the price is formed, the transparency of the process and the breadth and depth of participation. For OTC, there is no organised market. When it clears OTC, a CCP must accept the price from the participants, with less certainty in particular when it comes to testing for potential adverse market movements.

Clearing "standardised" OTC contracts has netted risk. But standardisation is a distraction from the diffi culties of pricing risk, the essential point. If products can be "standardised," then why are they off-exchange anyway?

Introducing OTC risk may make CCPs more fragile. Clearing houses can protect themselves in "normal" trading conditions only if the OTC trade prices are valid and the corresponding margin remains liquid.

The G20's strategic goal of reining in OTC derivatives risk is commendable, yet using CCPs as part of the solution is odd. Six years ago the essential OTC problem was poor information about what was "out there," and what it was worth.

The Pittsburgh strategy does not respond by creating a comprehensive information overview. The "standardised" portion of OTC may be netted, but price information will be scattered across a multitude of platforms.

We are no longer theorising; the fi nancial services industry is advancing into plan execution. We hope that the authorities and market participants will remain adaptable, and that they will watch over infrastructure risk profiles.

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