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Comment: The standard OTC oxymoron

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Product confusion will trip up economies

Like many businesses, financial service providers grapple with a dilemma. On the one hand, they want to offer standardised products – and benefit from volume efficiency – while also striving to build a tailored service that offers more lucrative margins.

But post-crisis we have a new term to juggle; the paradoxically named "standardised OTC". Over-the-counter (OTC) denotes something bespoke, while "standardised" suggests something "off the peg". Investors like OTC contracts because they are tailored to meet a specific need.

The best position for bankers is dealing a lot of high-margin OTC instruments, though history shows that this is not necessarily good for the rest of us: unfortunately, large doses of OTC derivatives were a key component behind the near collapse of the global financial system during 2007-09.

The regulatory response was – curiously – to push the trading of these standardised OTC contracts on to non-exchange organised platforms, mandate the clearing of these instruments at clearing houses and to multiply capital costs for OTC instruments that could not be centrally cleared.

However, applying these principles to a marketplace is likely to prove problematic. In this context OTC also means contracts that have not made the grade of being listed on exchanges. For a start, the marketplace that facilitates price discovery is narrower, and the resulting price less certain as a source of information.

Beyond this, other problems remain. The banks that have found the trading of OTC instruments so profitable have worked hard to assuage regulators' fears around these products, namely by agreeing to clear as many of these contracts as possible at CCPs in order to try to keep them off exchange platforms.

Central clearing is beneficial to the public marketplace, crucially so for derivatives, which settle over long periods of time. The role of a CCP, taking the settlement risk on to its books, responds to a market need.

Historically this has been based on values established on listed and traded instruments. But as the post-Pittsburgh-summit reforms of 2009 are now being felt, the ersatz standardised bespoke is entering the system based on pricing that is not broadly exposed to the public.

Naturally, not all exchange-listed and traded products are liquid; indeed, most of the tens of thousands of such securities across the world hardly trade at all. But the standardisation is there, and however thinly and irregularly they trade, those few signals do reflect market interest – or the relative lack of it.

One area is especially worrisome: what we might call the semi-standardised OTC contract. If liquidity were on a spectrum, from a bilateral financial instrument to a Kospi contract (the most liquid of exchange-traded derivatives) then these hybrids would be contracts that attract modest interest from a few players.

These are neither exclusively bespoke nor belonging to a common category that the market would consider "standardised" and ready for central clearing.

Under Basel III, the pressure on banks to get these instruments off their books has multiplied hugely due to the associated cost of capital. But this throws up a series of other questions.

Will clearing house risk managers be under pressure to take these instruments on to their books in order to satisfy client demand? Will such instruments be shopped around, now that clearing is more often being separated from the jurisdiction where the trade took place? From where will the risk managers source price information in order to request sufficient margin?

CCPs need to be comfortable with, and fully understand, the risks they are accepting, and it is precisely here that doubts are raised.

Recent history has demonstrated that not fully understanding the risk being taken on can lead to disastrous results, and for CCPs looking to – or being prompted to – take products on to increase revenue may prove costly. They did well in 2008, but will they in the new environment thrust upon them?

This juncture has been reached because banks were at best unable, and at worst unwilling, to recognise the risks attached to certain OTC products. Yet the situation remains because it is hard to wean banks away from this cash flow. The regulators' response was to try to switch the risk largely to CCPs, instead of making the parties to OTC contracts responsible for their settlement. This is transforming clearing, and changing its risk profile. There were policy alternatives that were not chosen; one can only hypothesise as to why.

An effective response to the financial crises we have been experiencing will involve identifying socially and economically useful products and services, describing them in simple terms, and providing for them in a straightforward fashion. Continued obfuscation and contradiction will trip up economies.

"Standardised OTC" is an oxymoron, an illogical conclusion from words that do not fit together. That will have consequences. It is too late for "standardised OTC" central clearing only if policy makers choose not to correct a problem once it is identified.

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