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## **The importance of the OTC markets**

The wholesale OTC markets offer a deep and liquid trading venue for professional market participants, such as major banks and financial institutions, to execute transactions, the key terms of which are normally individually negotiated. A difference should be noted between building liquidity in flow markets such as voice executed benchmark products and products accessible via MTFs) and non-continuously liquid markets where voice brokered markets alone play the crucial role. After more than three decades of virtually continuous growth the wholesale OTC markets are, to say the least, very substantial in both volumes and numbers of transactions. Estimates of daily average individual OTC transaction totals are widely accepted to approximate two million individual trades corresponding to approximately \$5 trillion in volume across the range of FX, interest rate, credit, equity and commodity asset classes in both cash and derivative forms (*ICAP: the Future of OTC Markets, BIS: OTC derivatives market activity in the second half of 2008*). As such, it is no surprise that asset class innovation tends to originate within the OTC space.

Factors that have significantly impacted the continuing evolution of the OTC markets over the past decade, and in particular the post-trade environment, are:

### **1. The growth of derivatives trading**

The lower capital utilisation of derivatives makes these products a more efficient and attractive medium for trading than cash markets for many market participants. For this reason, trading volumes in derivatives are frequently a multiple of volumes in the equivalent underlying cash markets. Admittedly, in comparison with the cash markets, OTC derivatives transactions have historically created (a) more complex and longer-lived operational workloads, (b) medium or long-term contingent credit risk for participants on each other and (c) slower trade affirmation/confirmation procedures that can create time delays between a transaction being executed and it being officially recognised in the books and records of each counterparty. As we can all attest, significant measures across multiple constituencies have been taken, and are being taken, by the industry to address these problems (from, for example, such steps as the creation of MarkitWire and the development of the ISDA Collateral Support Annex to the initiatives of the Commission's Working Group on Derivatives). Certainly, the explosive growth of OTC derivatives has marked not only the dynamics of how all assets classes are transacted but all these issues have also increased the complexity of the operational tasks facing all OTC market participants and have created significant capacity challenges for their middle and back offices.

### **2. The growth of electronic trading**

Electronic trading has developed in many liquid, mature OTC markets as commoditisation, competition and narrowing bid-ask spreads oblige market participants (including IDBs) to find cheaper and more efficient execution channels for benchmark products for both themselves and their clients. Electronic trading also greatly increases the transparency of price formation and the resulting market activity. When electronic trading is introduced more advanced trading techniques become possible, such as model-based or low latency algorithmic execution. These enterprising tools boost trading velocity which in turn drives both steep volume growth and the increasing ticket numbers which have been the target of regulatory reforms.

### **3. Increasingly sophisticated investors**

In recent decades, demographic change in the form of globalisation as an educational tool and spur to higher expectations, the availability of a wider array of financial products, the search for yield and the growing focus on absolute returns rather than meeting index performance has led to a seismic shift in the asset management industry generally and rapid expansion in the hedge fund industry in particular. This in turn fostered rapid growth in prime broking where the consolidation of borrowing, clearing, netting and settlement allowed more astute investors to widen their scope (and, over time, were seduced by generous leverage terms to over extend themselves). Now, however, the Infrastructure that supported the prime brokerage industry has been called into question due to perceived

concentration and counterparty risks. Nonetheless, the genie escaping from the bottle to expose end users to an array of derivative products will be a permanent fixture of the derivative markets going forward and, indeed, the requirement from these investors for bespoke products and hedges will ensure that derivatives remain a predominantly OTC market for the foreseeable future.

To expand upon this point further, the bespoke and individually negotiated nature of OTC contracts makes them much more attractive, and suitable, for hedging risk, especially in financial markets. Since exchange contracts are standardised and "real world" economic risk is normally non-standardised, traders and end users who access exchanges for hedging purposes will continue to carry the differential between their real underlying exposure and the delivery dates on their hedges. As a result, exchange contracts very rarely provide a perfect hedge for actual economic risk. By contrast, users of the OTC markets can hedge their risk precisely and transfer to professional OTC market participants their full exposure including the residual risk they would otherwise be forced to bear if they had used an exchange product. This treatment also has important financial accounting consequences. Accounting standards set tests for "hedge accounting" that require very close, or exact, matching of underlying risk with hedges for those hedges themselves to be allowed for capital optimisation purposes. These standards therefore oblige companies and other entities that are subject to these rules to use OTC markets rather than exchange products on most occasions.

#### **4. The relationship between the OTC markets and the exchanges**

The relationship between the OTC markets and the exchanges is often portrayed as competitive, but is in reality more often symbiotic. Certainly the peaks in either outstanding OTC volumes or global exchanges open interest would not have been attainable without the other. As we know, OTC and exchange markets each have separate, distinctive and logical reasons to exist, each of which has been reinforced by the recent market turmoil. One aspect of the professional OTC market which has contributed to its growth relative to the exchange world is the existence of "information symmetry" where the multiple information channels, hybrid execution venues and widely publicised trading prices renders access relatively equal for wholesale market participants. In the exchange arena, the mass arms race led by the most experienced "member" participants to control access to best prices, either in the form, for example, of lightning fast latency or privileged access to specific 'dark pools', renders competition more uneven. This sense of openness has been an important factor in the proliferation of the OTC sphere in our generation and will continue to hold sway going forward.

#### **5. Regulation and Supervision in OTC Markets**

All participants in wholesale OTC markets are professional in nature and are closely regulated as such. This allows the supervision and regulation of OTC markets to focus upon the market participants themselves rather than upon the products traded. It is critical to emphasise that both regulators and national supervisors can and do investigate trades conducted at IDBs to the same extent as at exchanges. The Basel II Accord sets out the framework for the supervision and regulation of these participants by setting up rigorous risk and capital management requirements designed to ensure that a bank holds capital reserves appropriate to the risk to which the bank exposes itself. Generally speaking, these rules mean that the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability.

This uniform regulation leads to an absence of regulatory arbitrage in the OTC marketplace. In virtually every commodity or asset class a wholesale market exists alongside a retail market. The wholesale market exists to allow major participants to assume and lay off risk between themselves in bulk. The retail markets exist to allow smaller participants to assume and lay off risk in the much smaller and specific quantities and description that they need. It is no accident that the two co-exist alongside each other. This symbiosis has also been fundamental to the expansion of the OTC markets. Forcing either large market players to lay off risk in a retail market or small market participants to use the wholesale market, as would be the case by mandating OTC products be transacted in an exchange environment, creates much bigger risk than separating the two sets of players into complementary markets.

Despite the fall-out from the recent financial crisis whose root causes as mentioned above lie principally not in derivatives per se but rather in structured credit products, their accounting and the behaviour of credit rating agencies, the development of the OTC markets has enhanced dramatically global risk mitigation and has contributed mightily to global economic growth over the past 25 years. A lack of comfort in credit and other derivatives is in our view a symptom of the underlying problem rather than its cause. It is important to distinguish between ineffective supervision of individual market participants and changes to, or the regulation of, market structure itself. The fundamental point is that the market crisis was caused by a lack of confidence in financial reporting and by the actions of individual market participants – not by a lack of confidence in market structure or processing. No market structure – neither OTC nor exchange – can determine the correct price for, for instance, a one-month unsecured inter-bank loan if there is material uncertainty about the repayment of that loan caused by overwhelming concern about the real or imagined financial state of the borrower as evidenced by its financial reporting.

The distinction is often made between “regulated” and “unregulated” markets, with exchange markets often presented as “regulated” due to the fact that exchanges are mandated to regulate the content, behaviour and participation in specified products. However, again, the perception that OTC markets are unregulated is incorrect. In contrast to exchanges, the primary regulatory focus in OTC markets is on the participants themselves based on their activity, the nature of their counterparties and type of assets involved.

The CRD extends not just prudential principles but also systems and control requirements to all international parts of regulated groups that have EU headquarters. Automated Trading System and Multilateral Trading Facility regulations under MiFID and equivalent US and international regulations impose additional layers of regulation on electronic markets over and above the usual “regulated firm” rules that apply to operators and participants. The OTC derivative market’s rules of operation, valuation and netting have been agreed by trade associations in conjunction with regulators – such as the Master Agreements published by ISDA, the Securities Industry and Financial Markets Association (SIFMA), and the International Securities Lending Association (ISLA), all of which have been recognised by regulators, most importantly in the EU and US, as a valid basis for netting exposures for regulatory capital and risk reporting purposes.

OTC market activity is also itself subject to extensive codes of conduct set by regulators such as the NIPs Code in the UK, the multiple rules that have been created since MiFID, and international codes of best practice such as those produced by the Financial Markets Association (“ACI”). It may be tempting to regard the “regulated market” as the more robust model, but while exchange rules are certainly aimed at ensuring orderly markets.

## **Conclusions**

Innovations in risk management originating in the wholesale markets, including clearing, have had a profound and hugely beneficial effect on the way in which corporations, investment firms and governments manage their financial risks. The more efficient allocation of resources and freer flow of capital that these tools have allowed has dramatically increased predictability and stability in government, corporate and individual financial planning and enabled much more rapid growth in the global economy relative to what would have been achieved without them.

The effects have been profound, down to the level of many millions of individuals around the world and the way they manage their personal assets, liabilities and retirement funds. Accordingly, the consequences of any changes to the structure or operation of the OTC markets need to be very carefully considered. We reiterate that the laws of unintended consequences may lead to increased costs of capital and reduced hedging capabilities for all participants and end users alike.