

Addressing the Proposed Regulatory Reform

Presented By:
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FTF OTC Derivatives Operations & Processing
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Agenda

- ▲ The Current Market
- ▲ DC Primer
- ▲ Legislation and Regulation
- ▲ What else to watch

The Current Market



A number of myths exist regarding OTC Derivatives

Misconception

OTC Derivatives are evil



Reality

The products themselves did not cause Lehman or anyone else to fall, bad trading decisions did

The current market structure doesn't work



The structure still works, but better risk management is needed

Central clearing will take the risk out of the market



Central clearing will help for "standard" products, but is not a panacea

OTC derivatives must move to an exchange structure



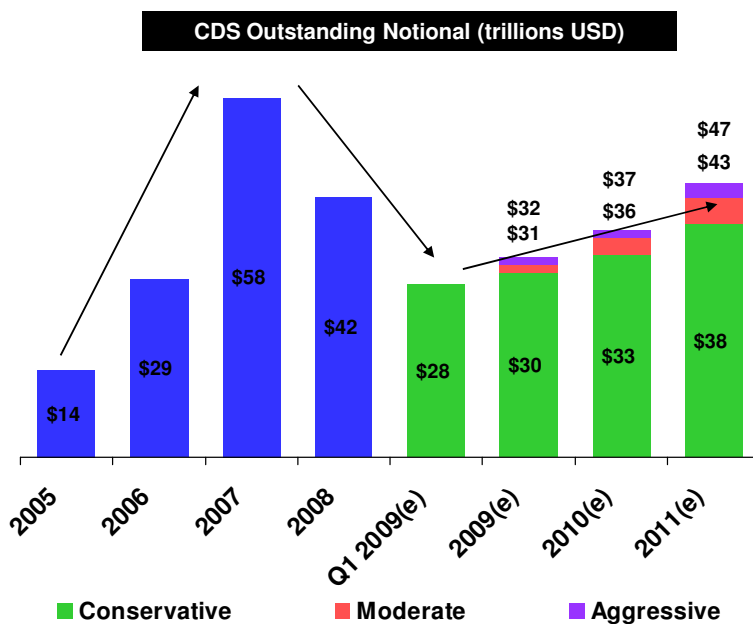
OTC execution needs automation, but not necessarily an exchange

This reform is about market structure



It's about finding and reducing systemic risk

Trade compression caused a drop in notional – not a drying up of the market



CAGR 2005-2007 104%

- ▲ Until mid-2008, rather than unwinding a CDS position it was common practice to enter into an offsetting trade instead of terminating the original one
- ▲ Entering into a new trade was operationally easier than novating or terminating an existing trade

CAGR 2007-2008 -27% / Dec '08 – Mar '09 -34%

- ▲ The drop in notional between 2007 and March 2009 was not driven by a lack of CDS trading, but trade compression efforts
- ▲ Solutions provided by CreditEx/Markit and TriOptima helped to untangle the existing web of trades, netting open positions and leaving a single trade where possible
- ▲ Ongoing compression efforts will keep notional levels under control going forward

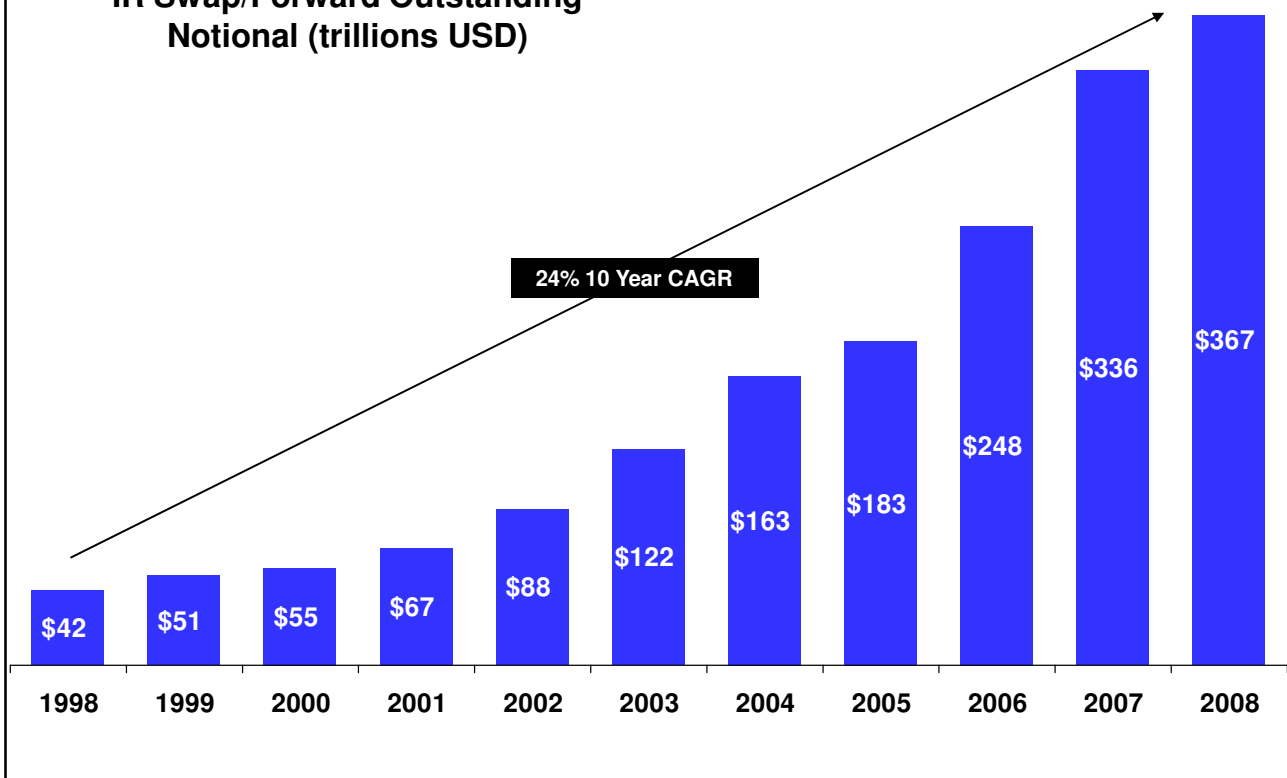
CAGR 2009-2011 11-19%

- ▲ CDS notional levels will grow from early 2009 levels going forward due to increased automation and the efficiency it brings
- ▲ When the new regulatory environment is decided, many will come back to the CDS market

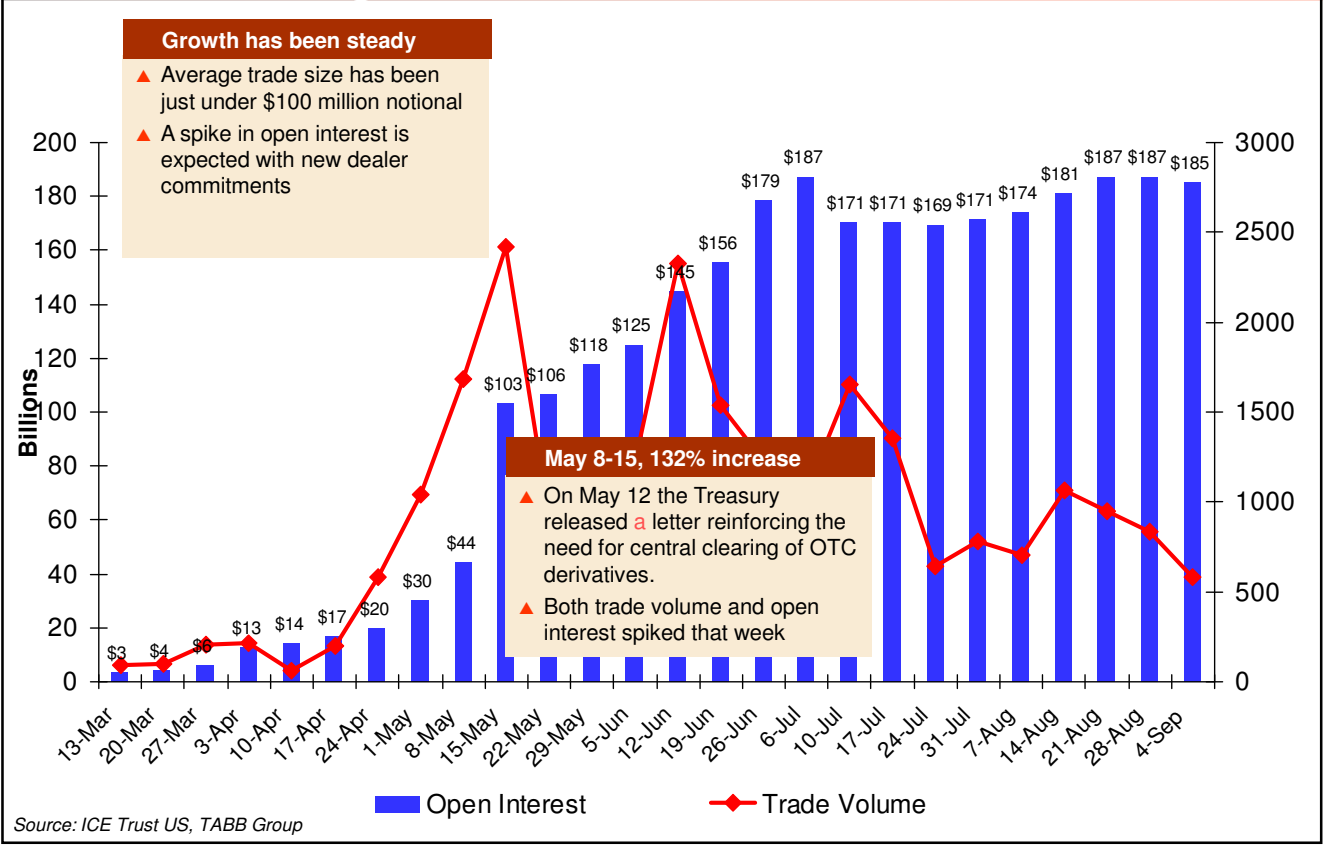
Source: BIS, ISDA, DTCC, TABB Group

IR swap outstanding notional continues to grow

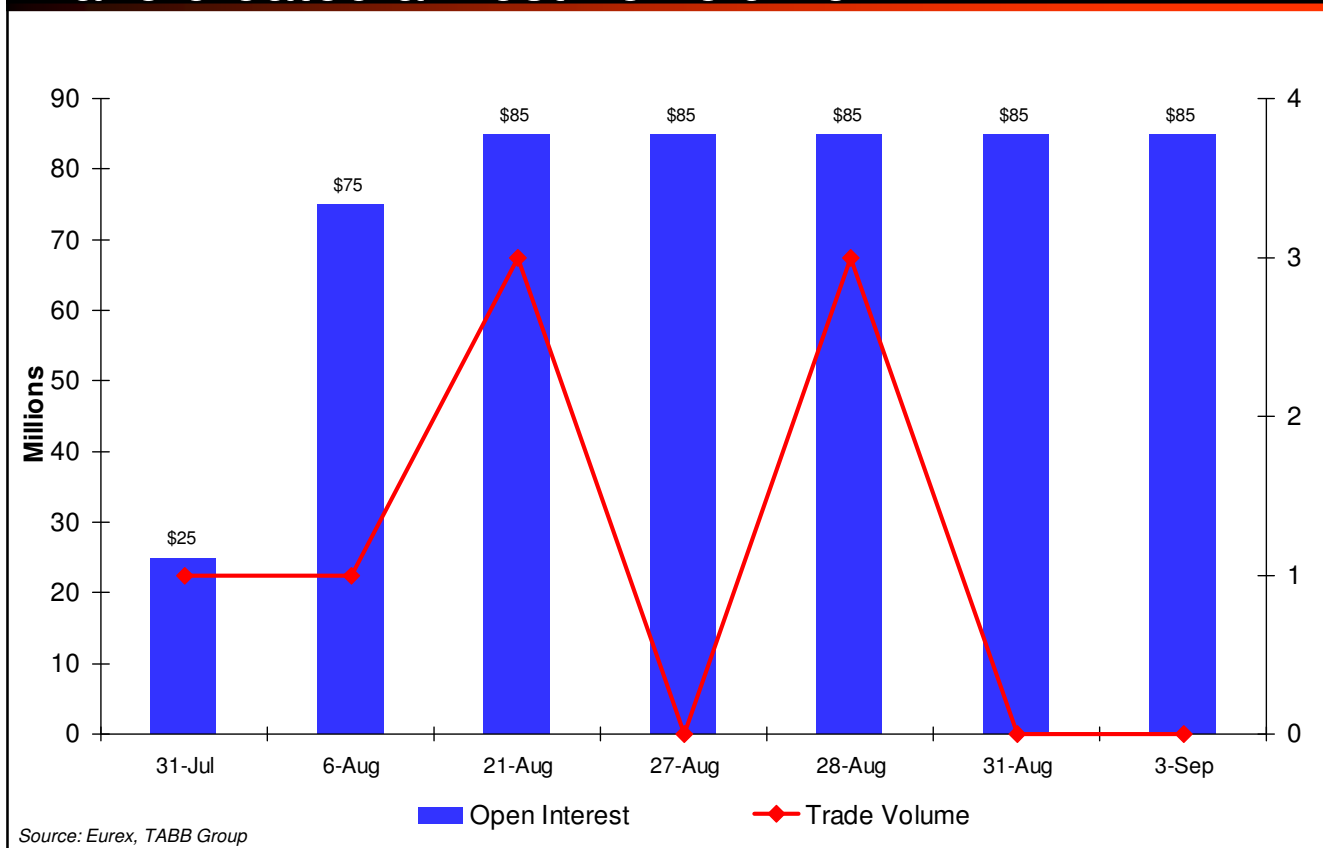
IR Swap/Forward Outstanding
Notional (trillions USD)



ICE has seen healthy growth since launching CDS clearing in March 2009

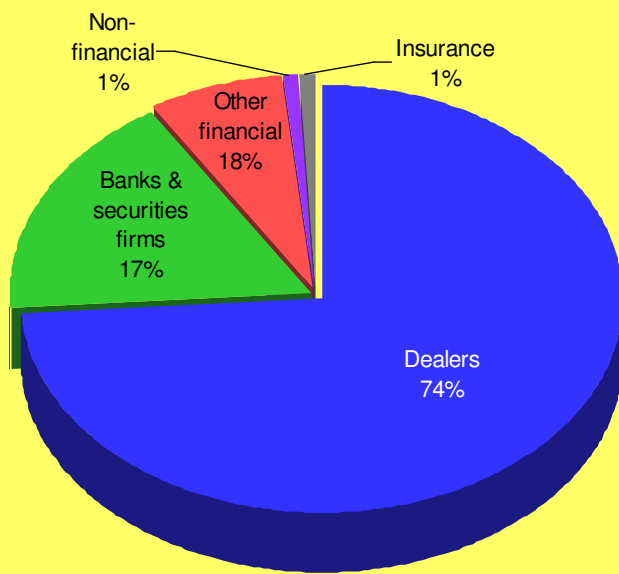


Eurex is live with CDS, but its two members have created almost no volume

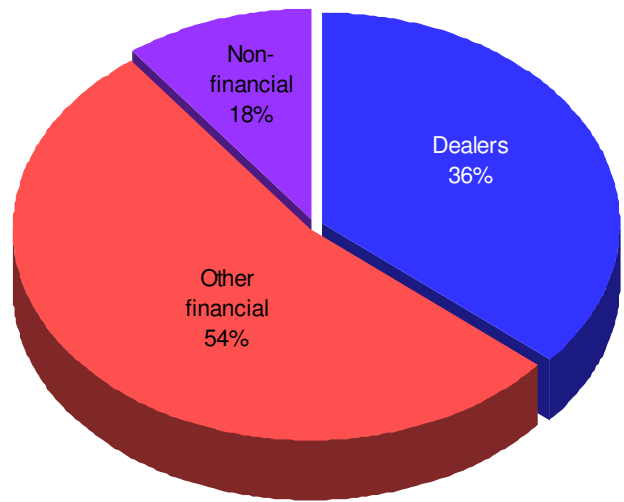


The dealers drive this market, but they do not make up the whole picture

**CDS Holdings by Institution Type
(December 2008)**

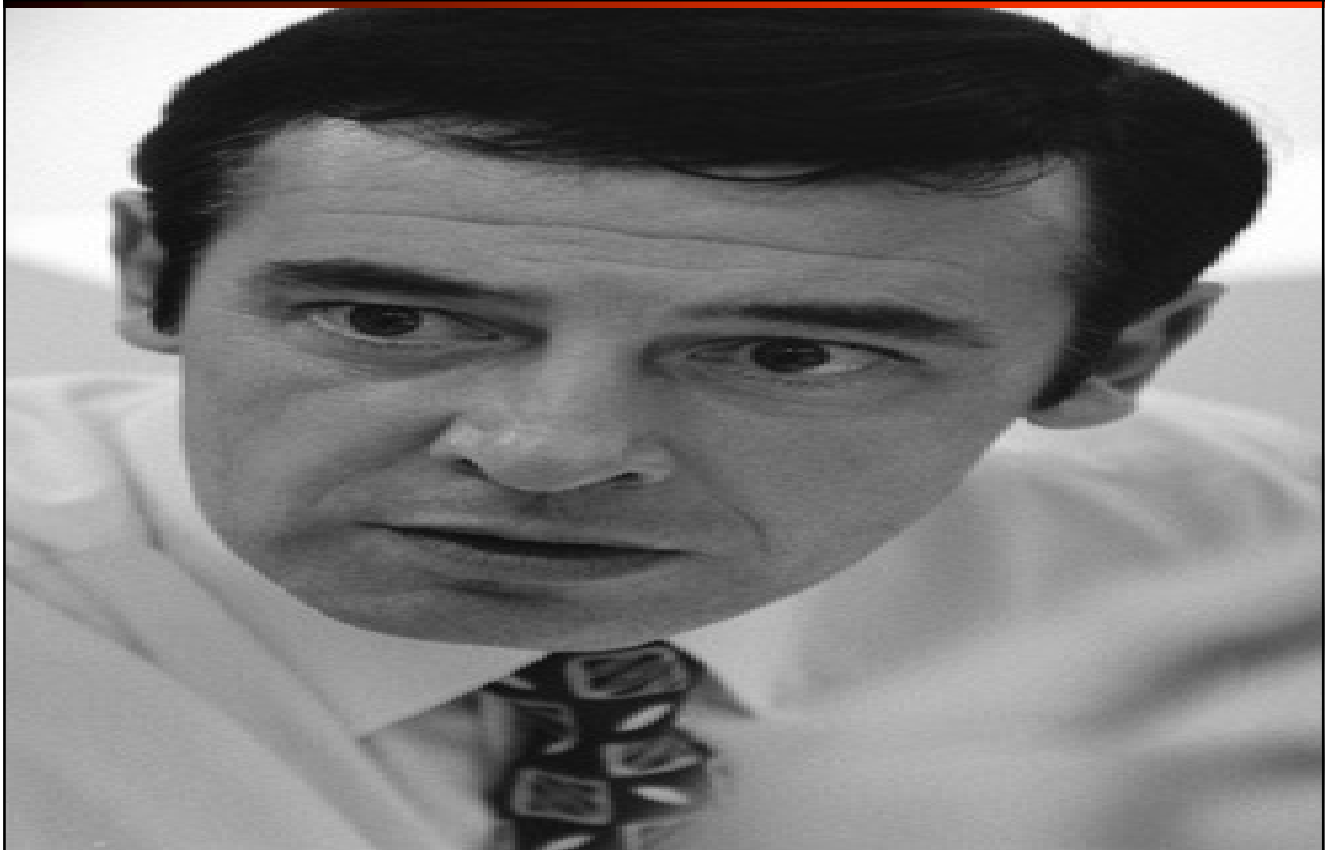


**IR Swap Holdings by Institution Type
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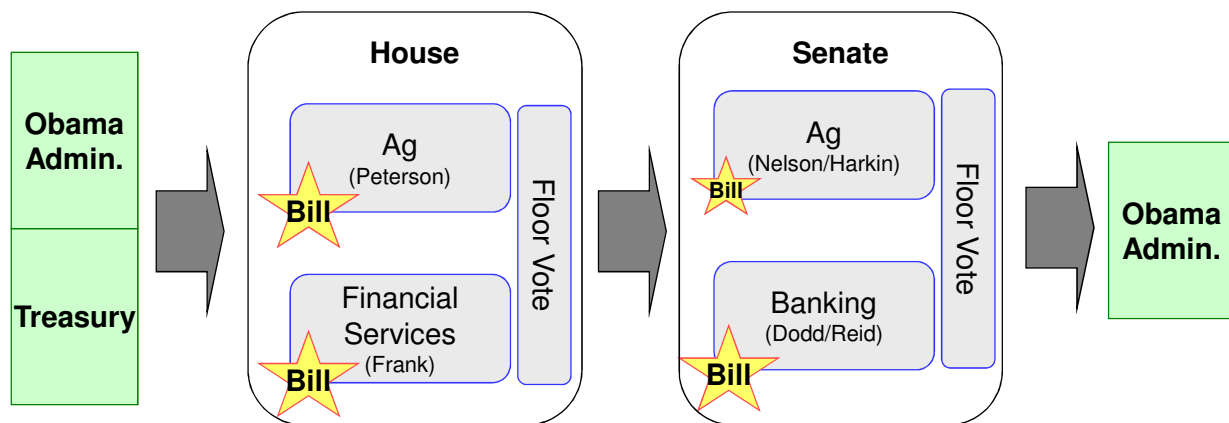


Source: BIS, TABB Group

DC Primer



Lots of touch points, lots of politics



- ▲ Both the House and the Senate have been working to draft legislation based on the Treasury proposal release this past summer
- ▲ A positive House vote by EOY 2009 looks likely, although convergence must still occur between FS and Ag
- ▲ The Senate will then begin deliberations in 2010
 - ▲ 2010 is an election year which could slow things down
 - ▲ Health care reform more likely to get in the way in the Senate

Legislation and Regulation



Focus of the current bills in the House

Focus

Details

Clearing



All products deemed eligible by clearinghouses and regulators must be cleared; end-users are exempt

Trading



Standardized/cleared contracts must be traded on a registered venue (exchange or "SEF")

Registration



Dealers and "major swap participants" must register with the SEC, CFTC or both; capital and collateral requirements will be more tightly regulated

Reporting



All OTC derivative transactions must be reported

Central clearing will help reduce risk for suitable products

Focus

Clearing



Details

All products deemed eligible by clearinghouses and regulators must be cleared. End-users are exempt.

- ▲ Mandatory clearing of **all** OTC derivatives was taken off the table months ago
- ▲ What gets cleared is really up to the clearinghouse, not the regulator
 - ▲ If they can't be valued they can't be cleared
 - ▲ Don't want to introduce unnecessary risk
- ▲ End-users lobbied hard to be exempt; the cost would be too high in many cases

CDS central clearing options abound

ICE

- ▲ ICE Trust US and ICE Clear in Europe
- ▲ Both live and steadily growing
- ▲ Buy Side access in October '09
- ▲ Single names in October '09

CME

- ▲ Approval for both the US and Europe
- ▲ Not live, but close to agreement with some dealers
- ▲ Regulators pushing for second option to ICE
- ▲ Also moving into IR swap clearing
- ▲ Maybe a good home for smaller dealers?

Eurex

- ▲ Live in Eurex, approval to operate in the US
- ▲ Two active members
- ▲ Index and single stock volume, but only a handful of trades
- ▲ Investigating equity swap clearing

NYSE.Liffe

- ▲ Went live late 2008, but saw no volume
- ▲ Project "under review" and likely canceled

Clearnet

- ▲ French based, plans to go live by year's end
- ▲ Little detail released

Interest rate swaps are the next area of clearing focus

- ▲ Three competitors
 - ▲ SwapClear (LCH.Clearnet)
 - ▲ IDCG (partially owned by NASDAQ)
 - ▲ CME
- ▲ SwapClear currently clears roughly 50% of outstanding IR swap notional (>\$175 trillion notional)
- ▲ Possible Differentiators
 - ▲ Location
 - ▲ Buy Side access
 - ▲ Margin/Capital requirements
 - ▲ Fees
 - ▲ Swap vs. Future

Regulated trading is not all about exchanges

Focus

Details

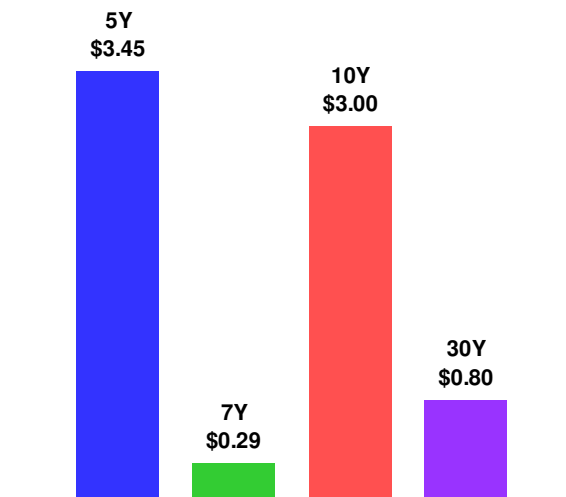
Trading



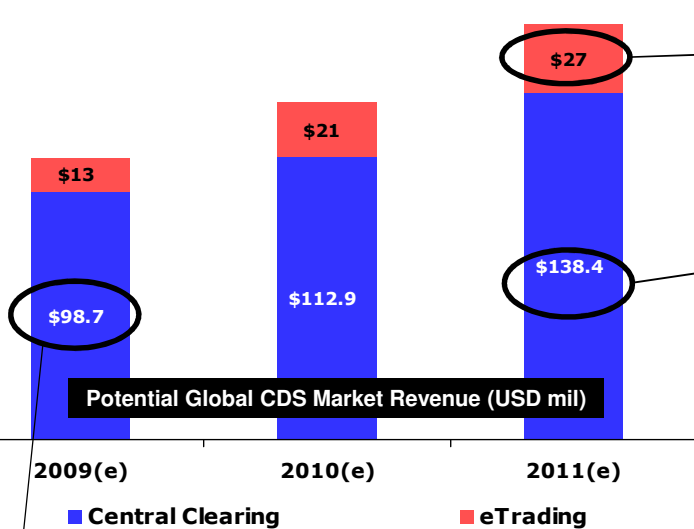
Standardized/cleared contracts must be traded on a registered venue (exchange or "SEF")

- ▲ A move to futures hasn't really worked (billions vs. trillions)
- ▲ IDB's will register as SEF's formalize their OTC market role
- ▲ The "hybrid" model will live on, but with a further lean towards automation

CBOT IR Swap Futures Open Interest
(notional billions)



Revenues from central clearing & electronic trading will reach \$165M by 2011



TABB Group estimates potential yearly revenues for electronically trading CDS contracts will reach nearly \$27 million by 2011. This assumes:

- ▲ an aggressive 50% of CDS trades are conducted electronically, and
- ▲ strong competition between platforms driving low prices

TABB Group estimates potential annual revenues for central clearing CDSs will reach nearly \$140 million. This assumes 55% of outstanding CDS contracts are migrated to a central clearinghouse by 2011.

Factors impacting clearing and execution revenues:

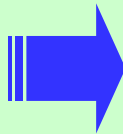
- ▲ A growth rate faster than the estimated 11% CAGR for the CDS market as a whole
- ▲ Quick expansion of the contracts eligible for central clearing
- ▲ Regulations making it impractical for dealers to stay away from central clearing
- ▲ A disruptive approach to electronic trading that brings volumes quickly to the screen

Slower than expected adoption might leave this number a bit too high – but there is still time and dealer commitments left to come in 2009.

Formal registration of swap dealers similar to current broker registration with SEC

Focus

Registration



Details

Dealers and “major swap participants” must register with the SEC, CFTC or both; capital and collateral requirements will be more tightly regulated

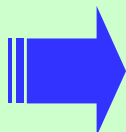
- ▲ Dealers and those with a “substantial net position” must register
- ▲ Key concern is registration of systemically important entities
- ▲ SEC/CFTC will set capital and collateral minimums
- ▲ Transactions with zero collateral will go away
- ▲ End-users are exempt

Reporting all transactions good for (almost) everyone

Focus

Details

Reporting



All OTC derivative transactions must be reported

- ▲ Over 90% of CDS trades already reported to DTCC TIW
 - ▲ Only helped after the fact with Lehman
- ▲ Key to success in OTC derivative reporting is proactive monitoring
- ▲ Regulators need help from the private sector
 - ▲ The CFTC's IT budget is \$26 million; IB's spend on average over \$1 billion *each*

What else to watch

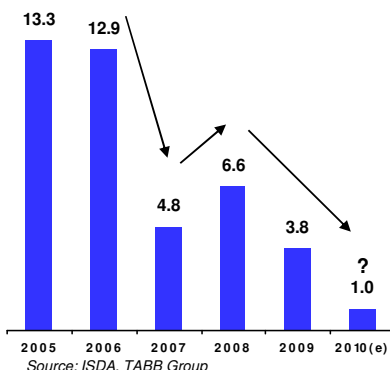


Backlogs, novations and affirmations haven't gone away; they've just been overshadowed

Confirmation Backlog Levels in Business Days

2006-2007 63% Decrease

- ▲ Dealers understand that in order to continue growing the OTC derivatives business, they must be as efficient as possible.
- ▲ Reducing the confirmation backlog for CDSs has been a major success story, with a decline of 63% from 2006 to 2007.



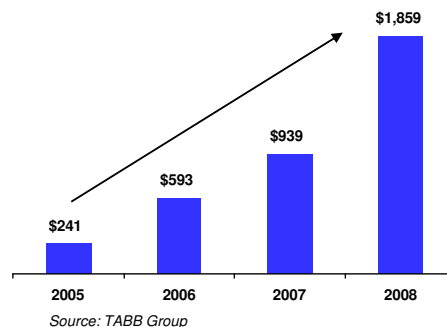
2007-2008 38% Increase

2008-2009 42% Decrease

- ▲ While they're still much lower than a few years ago, the credit crisis has driven the levels back up. The increase was 38% from 2007 to 2008.
- ▲ The confirmation backlog will be helped by the plan for a central counterparty and eventually by electronic trading of some CDS products.
- ▲ A more streamlined workflow will automate the confirmation process for those trades that are electronically traded and centrally cleared.
- ▲ The dealers have set a target of 1 day and may reach that by 2010.

Total Notional Value of Novations (USD mm) 2005-2008 CAGR 98%

- ▲ The 2005 Novation protocol set e-mail as the standard process for novations. An improvement from FAX and phone, but out of date at the onset.
- ▲ Novations moved to automated platforms in 2008, and February 2009 was the deadline for the buy side to move to these new solutions or be cut off from trading with the dealers.
- ▲ Novation automation was critical as the money at risk in this process is substantial; however, a move to central clearing will reduce its importance as centrally cleared trades do not require novation.
- ▲ The next phase will see novation consent become equal to a legal confirmation.



Conclusions and thoughts

- ▲ Most of the big issues have been agreed
 - ▲ Clearing and exchange trading of everything is unrealistic
 - ▲ End-users should be mostly exempt
- ▲ Joint regulation by the SEC and CFTC will be a headache for registered market participants
- ▲ Dealers and buy side firms are looking ahead of new legislation to re-craft business models for the new world
- ▲ IDBs will play a big role for execution, as will exchanges for clearing
- ▲ The end result will not be a risk-free market, but one with more opportunities for more people than before

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