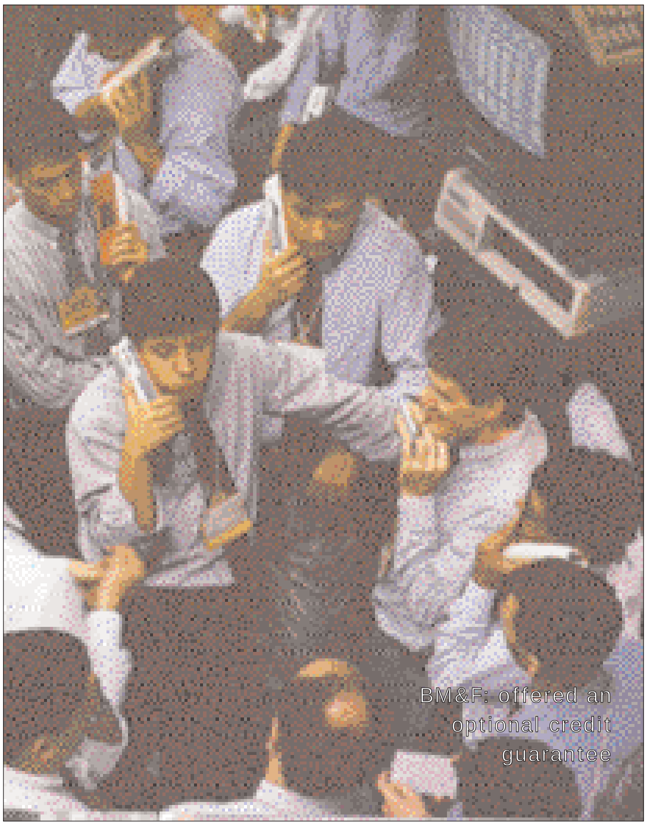
Swaps exchanges



BM&F: offered an optional credit guarantee

While OTC credit risk management techniques such as limits, collateral/margin calls and bilateral netting are good, they are weak relative to the power of a clearing house. Since 1994, Brazil's Bolsa de Mercadorias e Futuros (BM&F) has demonstrated just how powerful central swaps clearing can be.

By substituting capital cushions with structure, a clearing house enables participants to transact high volumes of business while economising on capital and collateral utilisation. BM&F was the first major derivatives exchange to offer a clearing service for the (then) new Brazilian swap market. This initiative was prompted by a regulatory requirement: the Central Bank of Brazil made banks register swap transactions with either the exchange or an electronic book-entry depository system called Cetip.

BM&F was able to differentiate its service by offering an (optional) credit guarantee, in addition to simple registration, and quickly gained a large volume of business. As of January 1998, BM&F was handling some 3,000 swap transactions per month, representing a volume of $21 billion and with open interest of around $7bn.

Several other exchanges and clearing or depository organisations have since become interested in offering OTC clearing services (see page 47 for details). The experience to date of Brazil and others suggests a few lessons.

- Clearing houses can best support simple, standardised, liquid OTC products, for which frequent valuation (eg, daily) can be readily done, based on reliable market prices or universally-accepted valuation models.
- End-users of derivatives (including some financial institutions) are not always fully aware of the benefits of clearing house support. They need education.
- Not all OTC dealers welcome a fully-fledged clearing service. In most OTC markets there is a 'club' of major or primary dealers, typically highly capitalised, strongly rated institutions. There are many smaller or secondary dealers, but they usually control tiny market shares. The major dealers make money by virtue of their role as market-makers, utilising their credit rating to significant advantage and accepting credit risk. A clearing house can erode their advantages by creating an even playing field for credit risk. Smaller dealers are eager for clearing services, but larger dealers are usually reluctant to accept a full clearing service with credit guarantee, except perhaps in commodity products where profit margins have already eroded.
- The value of a central clearing house increases in line with the number of counterparties. As a result, a clearing house will want to adopt a standardised, open architecture systems philosophy. Also, broad coverage is desirable, be that at a national scale or regional/time-zone scale, as well as in terms of products (to enable cross-margining).
- The clearing house may offer several levels of service to the OTC market ranging from registry, standardised valuation services, bilateral netting support, collateral administration to fully-fledged multilateral netting and credit guarantee. Clearly, the service scope needs to be defined so as to appeal to a critical mass of dealers, both big and small.
- Risk management is also a major issue. Once the clearing house is there, offering a guarantee, will there be adverse selection or moral hazard? Will the weakest dealers flock to the clearing service; will most dealers send their riskier transactions to the clearing house? Careful risk management processes must be built into the service.
- Pricing the service is crucial. For basic 'processing' services (such as registry, valuation, collateral management), the clearing house can only charge a modest service-bureau kind of fee. For a credit guarantee, the fee should definitely be significantly higher, or somehow risk-adjusted. If the fee were to reflect the full counterparty credit risk, however, it might become too high to be practical.

As a major dimension of the overall convergence between organised and OTC markets, clearing house services are definitely coming. And, as the BM&F experience suggests, they can be quite successful. The OTC market can clearly benefit greatly from the support of clearing houses, while clearing houses are happy to expand the scope of their services and increase their own volumes. Moreover, in the long history of futures exchanges, there have been very few clearing house defaults and negligible losses. What is clear from the above, though, is that if futures require careful structuring of the clearing function, then OTC products are as, if not more, challenging. δ

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