

The push for standardisation

can we risk changing the future landscape of FX?



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The recent disasters in the global banking system and the ensuing fallout in the derivatives markets fundamentally changed the way market participants use FX derivatives. The crippling widespread disappearance of liquidity and leverage as well as the over-regulation that many doom sayers predicted has not materialised; instead, market participants are refocusing on the core uses of derivatives that built the industry. Concurrently, there are greatly increased efforts at addressing systematic problems with efficiency and operational risk. In addition, regulators are preparing sweeping reforms to the OTC derivatives markets on both sides of the Atlantic and FX derivatives are in danger of being caught up in these reforms.

Over the past decade, structured products, in which FX (and other asset class) derivatives have been used to create ever more complex and often highly tailored risk profiles in bonds and other investment vehicles, have become the driving force of revenue for many derivatives dealers. Over-the-counter derivatives remain the most effective and useful vehicles for hedging a critical commercial risk.

While the use of simple derivatives in liability side hedging, asset side hedging, and hedge fund speculation remained important core drivers of the industry, it became increasingly difficult to see these flow activities through the forest of structured products hands 'high-fiving' each other over the latest highly leveraged and highly complex structured bond issuance. As a natural result of this evolution, competition, for many derivatives dealers, became focused on creating the newest, most innovative structures a few weeks before every other dealer could price them and enjoying a short but very profitable monopoly. Naturally, derivatives technology became focused on valuation and risk managing structured products.

All of this changed, quite rapidly, in the wake of the collapse of Bear and Lehman and the widespread banking system problems having arisen out of the massive over leveraging of the retail and home-buying public. The derivatives dealing community is, as a result, having to rethink its business and retool for a very different reality.

The regulatory environment

There are many solid reasons for the existence of a bespoke FX OTC market and the ability for a counterparty to match exactly their underlying risk. It is important that we have an environment where the risk factors for doing business across the financial

markets are understood as clearly as possible. The markets have witnessed over 25 years of derivatives and OTC growth which has delivered enormous economic benefits.

But these benefits have also carried substantial risk. Many risks associated with derivatives can be mitigated through employing robust, scalable, and transparent technological solutions that help to accurately reflect market prices. This can be supported by better, more robust and resilient industry frameworks and infrastructures.

As such, there is a useful and healthy role for regulators to review and monitor the activities of those they regulate. However it is important that the regulatory authorities act with caution and in consultation with knowledgeable market participants before acting in a way that may ultimately be costly to all.

Regulating swaps, as the US authorities are proposing, is absolutely the right thing to do as these are standardised instruments. However, extending this model to all OTC derivatives and overburdening the regulation of complex options simply won't work. That would reduce the ability to create specific hedging instruments which are useful to help companies manage their risk. The value of derivatives lies in the fact that they allow market participants to take security on underlying assets rather than having to invest cash upfront.

The debate and focus should be about how investment and risk management decisions are taken by individual institutions, not OTC derivatives instruments themselves. It is important that we have an environment where the risk factors for doing business across the financial markets are understood as clearly as is reasonable.

The derivatives industry in Europe is certainly in need of a better, more robust and resilient industry framework and infrastructure. Overwrought regulation could hamper investment and commerce just when markets need them most of all. Regulations that increase trust and ,ultimately, liquidity can only be good for the market.

The derivatives industry has strong foundations which will enable it to successfully address current issues. We champion accuracy in pricing – this is what the market needs. Technology is part of the answer but this cannot be done overnight.

Exchange traded derivatives

Moving derivatives onto an exchange would result in market participants having to post large amounts of cash with the exchange to secure their hedging. Some instruments are ideally suited to exchange trading, notably the simpler options structures which can be commoditised onto an e-trading system, much as has happened with spot FX and other simpler instruments.

But more advanced and customisable FX instruments are simply not suited to exchanges, chiefly because they are just that - non-standard - and they require an OTC market. Companies



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often use OTC derivatives to customise hedges to their specific exposures when standardised, exchange-traded products do not reflect their actual risk. The effect of forcing such companies to go through an exchange or clearing house would limit their ability to manage the risk they incur in operating their business.

Currency derivatives have a number of variables and correlations based on underlying assets and the OTC market is not bound by fixed strikes or expiry dates in the way that exchange traded derivatives are, which is a real restriction for a counterparty. The OTC derivatives market must remain in a flexible form with the ability to enable institutions to establish structures that fit their needs to hedge and manage their risks.

We must not throw the baby out with the bathwater. FX derivatives are useful insurance policies, which allow firms to manage the fundamental risk in currency and commodities fluctuations, interest rates moves, supporting trade, investment and economic output. They have a useful, real world application.

It is very important to be clear that a speculative and unmanaged boom in asset prices as well as leverage and faulty credit decisions on the part of customers and providers, not the financial instruments themselves, have been at the root of recent market turbulence. The issue is to ensure that the underlying assets which underpin derivatives are sound.

The OTC derivatives market has performed very effectively in helping companies and investors to manage their risks in a time of higher than usual rates of default, and the credit events that have occurred

thus far are being settled in an orderly fashion. Moving all instruments to an exchange could make hedging and hedge accounting unworkable, therefore leaving institutions unhedged, just when markets are more volatile and real companies more susceptible to commodity, interest rate and currency movements.

Institutions and investors in the future will still need to be prepared for unusual market circumstances with the proper tools before the event happens, during it and after it. There is also a key role for independent, effective pricing across the whole derivatives universe to set the 'benchmark' price for valuations for derivatives.

We are already seeing growth in the use of FX, interest rates and commodity derivatives because they retain a crucial role supporting real, physical markets, in terms of hedging currency risk, managing resources and enabling cross border trade.

This is backed up by the latest figures from the Bank for International Settlements (BIS). The notional amount of over-the-counter derivatives trades outstanding bounced back to reach USD 605 trillion by the end of June 2009, up 10% on the previous survey released in May.



Push to create a central counterparty

The push to create a central counterparty could prove to be a valuable step to regain confidence in the global financial markets and in these instruments that have a real-world application to help manage risk and hedge effectively against, for example, fluctuations in currencies, energy costs and interest rates.

There will inevitably be resistance to change but the outcome could well be a resurgent market across both vanilla and structured financial products, with clearer, less opaque processes and reporting encouraging more counterparties to use these instruments. Publishing post-trade prices also makes sense and will serve a practical purpose in terms of analytics and analysis. A central counterparty, together with prompt reconciled confirmations and warehouse in our view could help to firewall against failures and ensure accurate reporting of system-wide activity to regulators.

Brave New World

So what is really happening in the world of OTC derivatives? The trends in the industry are quite readily apparent:

- A huge scaling back in the structured products business as gun shy investors lick their wounds and park their money in perceived safer havens
- The last 18 months taught us that even simple derivatives can become difficult to price where markets are illiquid.
- A huge increase in the difficulty of pricing even the simplest derivatives as never before considered systemic liquidity factors drive the short end of yield curves
- An intense focus on “B-School” principles: operational risk, operational leverage, credit exposure, funding exposure, etc.
- A move by an increasing number of dealers to utilise non-traditional derivatives distribution channels such as regional lending networks
- A refocusing of the business around core hedging related activities
- Competition through better client service, rather than through rapid innovation of complex structures
- A major shift in technology spending from the development of sophisticated multi factor pricing and risk management models to the building of integrated front office solutions which address the new reality

The OTC derivatives business has changed dramatically over the past 18 months; those firms who have adapted or are adapting rapidly and effectively to these changes are, while perhaps not thriving, surviving and seeing a potentially bright future. Those who have not adapted successfully are struggling. Critical to adapting to this new reality is technology and systems tailored to that reality.

The new technology of competition

Virtually every derivatives dealer we speak with across the world is, to a greater or lesser extent, trying to adapt or augment their technological capabilities to facilitate competition and efficiency within the rapidly changing landscape of the derivatives market. The simple reality is that an overwhelming percentage of the money spent on system development over the past decade has gone towards increasing the trading desk's ability to price and warehouse increasingly complex risk.

Traditionally, dealer IT and Quant departments are extremely good at delivering complex models and risk management technology to the trading desk; they

have been less successful at delivering the tools necessary for the front office to compete effectively and operate efficiently in the vanilla derivatives space. This is partly due to lack of experience and partly due to an almost obsessive focus on model development.

As the derivatives industry and the nature of dealer competition become centred on client service, technology that supports this service, both indirectly and directly, is becoming the focus of both the IT departments and the front offices of dealers across the globe.

Our discussions around technology needs with almost every dealer we speak to revolve around the same themes:

- The ability to deliver accurate option pricing and high quality supporting documentation and research to clients faster than the competition can manage.
- The ability to efficiently provide peripheral services to clients, such as ad hoc risk analysis.
- Tools that support a more efficient work-flow between sales and trading.
- The reduction of operational risk through integration of front and back office systems.
- The ability to pro-actively sell to clients based on their exposures and needs rather than purely based on the desk's trading axes through better tracking of the clients' activities.
- Foolproof, easy to use pricing and analysis tools to enable distribution channels with less derivatives expertise to effectively sell.
- “Economies of scale” in the derivatives distribution process through better sharing and archiving of information.

There is almost universal recognition among derivatives dealers of the need for scalable, integrated front office and distribution software to address these issues. Dealers are currently facing the age old dilemma of technology procurement: build or buy. Fortunately, a few vendors have emerged over the last few years that are focusing on building these technologies. Those dealers who have embraced the changing landscape of derivatives competition by addressing the need for new technologies are seeing opportunities in the FX derivatives market that have not existed in years; this edge, coupled with the decreased dominance of the franchise players, has created enormous growth potential for the small to midsize derivatives dealer. This has created more business growth potential for a broader spectrum of derivative experts. As long as risk is managed, accurate valuations are adhered to and client service is exemplary this market will continue to be robust.