Risk 25 | Firms of the Future

DTCC

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With over-the-counter derivatives markets in flux, picking winners and losers is a tough job. This is where *Risk's* editorial team nails its colours to the mast. By **Lukas Becker, Matt Cameron, Laurie Carver, Clive Davidson, Ramya Jaidev, Peter Madigan, Mark Pengelly, Joe Rennison, Nick Sawyer, Michael Watt** and **Duncan Wood**

Anyone who wants to understand how OTC derivatives markets are changing should keep an eye on the 74 organisations named overleaf – our *Firms of the Future*. These are the dealers, buy-side firms, brokers, exchanges, technology vendors, clearing houses, regulators, infrastructure providers and trading platforms we believe will be most influential over the next five years.

Compiling this kind of list is tricky at the best of times, but when the OTC market – plus prudential regulation and the banking industry more generally – is changing so dramatically, it becomes even harder. We will undoubtedly get things wrong. Some of the names on the list may fade from view by the time *Risk* celebrates its 30th anniversary, and names we have ignored will surge to prominence.

Two or three years ago, some of these organisations would not have featured – without new trading, clearing and reporting rules, established companies like BNY Mellon, State Street and the Depository Trust & Clearing Corporation (DTCC) had no obvious role to play in the OTC market. As evidence, look at Citadel and CME Group, which had been knocking on the door for years – they too will now have a say. Other names did not exist at all – Eris Exchange, New York Portfolio Clearing (NYPC) and Regis-TR, for example.

The fortunes of many of the listed firms are bound tightly to the market's new rules, which is why we include the regulators as well. One example is TriOptima's new service, triBalance, which has dealers queueing up to praise it, but requires a regulatory safe harbour to work. It may simply be too late in the day for that to be forthcoming. Another instance is Project Trinity, the clearing initiative being explored by LCH.Clearnet, the DTCC and NYPC. It is conceptually elegant, but requires a way of calculating margin offsets across three types of asset at three different clearing venues. That requires careful regulatory scrutiny but if it can be made to work, it could be a genuine alternative to the vertical business models at CME Group and Eurex.

With lots of twists and turns to come, it should be an interesting period – and we're happy to be reminded of our choices in 2017.

Infrastructure

Traditionally, infrastructure has not been seen as the most glamorous corner of the over-the-counter derivatives market, but regulatory reform is making it sexier.

Two of the more interesting ideas to come out of the industry this year – credit checking hubs for trades that need to go to a central counterparty (CCP) and the triBalance risk-rebalancing service offered by TriOptima – have come from infrastructure providers. This is not just plumbing, but an attempt to fix big problems for a market that is changing more rapidly than many participants can handle. There is plenty of scope for further innovation in the years ahead. Interdealer broker, Icap, recognised this when paying $247 million for trade processing specialist Traiana in 2007.

Depository Trust & Clearing Corporation (DTCC)

Over more than 35 years, the DTCC has developed a sprawling array of services for cash and OTC derivatives markets, centred on clearing, settlement and data warehousing. With clearing and reporting soon to be required by law in the US and Europe, as well as other jurisdictions around the world, the DTCC finds itself in an ideal place from which to expand.

It took its first big steps in the swap data repository (SDR) space, winning the endorsement of the International Swaps and Derivatives Association to provide warehouses for the five main OTC derivatives asset classes, and briefly creating the impression that the world would have a single, global repository. But that isn't how things will work out – in the near-term at least – with other competitors refusing to bow down and individual national authorities, like those in Hong Kong and Taiwan, set to insist on the use of a domestic SDR. The DTCC is still hoping to provide its users with a single reporting interface by acting as an agent for the local repositories (*Risk* July 2012, pages 49–51, *www.risk.net/2184995*).

In the clearing space, the DTCC has a hand in the innovative one-pot margining approach offered by New York Portfolio Clearing – the central counterparty (CCP) it owns jointly with NYSE Euronext – and the firms are hoping to expand the margin efficiencies it offers to include OTC interest rate swaps.

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According to Don Donahue, the recently departed chief executive of the Depository Trust & Clearing Corporation (DTCC), the securities market is approaching a fork in the road. In one direction lies fragmentation, stunted competition and poor liquidity; the other leads to margin efficiency, inclusivity, liquidity and transparency. He's talking about the contest between so-called vertical and horizontal business models. The DTCC sits firmly in the horizontal camp, and Donahue is confident about the outcome.

"I haven't lost a minute of sleep wondering who is going to win in the vertical versus horizontal contest in the cash securities clearing space. It seems obvious to me vertical structures have a number of serious and irredeemable flaws," he says.

The over-the-counter markets face the same choice. The vertical model offers execution, clearing and, possibly, data reporting under one roof, allowing a single firm to control the trading life cycle from end to end. It is a model embraced by big exchanges such as CME Group and Eurex, which tie trading customers into their clearing houses and prevent other execution venues from offering access to the critical mass of trades cleared there. Horizontal structures, in contrast, allow market participants to pick and mix their trading, clearing and reporting providers. And the DTCC has designs on the last two areas, launching two innovative clearing initiatives in recent years, while also rolling out swap data repositories (SDRs) to cover the five big OTC derivatives asset classes on a global basis.

"Putting all cash market activities in vertical silos can be a very dangerous thing. It can lead to fragmentation, and that cannot be good for the market. For the DTCC's entire existence it has been a verticalisation atheist, if you like. We don't believe it works for the cash markets. If dealers are locked into rigid structures, then margin efficiency is reduced, costs increase and liquidity falls away," says Donahue. "Further, we don't think boutique repositories in the derivatives market are going to work. That is why we have set ourselves up as a truly central and global repository."

That thinking was behind the DTCC's decision to launch New York Portfolio Clearing (NYPC) – a joint venture with NYSE Euronext. The service allows customers to calculate margin on a net basis for interest rate futures positions cleared by NYPC and cash bonds cleared by the DTCC, with multiple exchanges able to list the futures. The approach has been dubbed one-pot margining, and those involved hope the venture will enable other venues to challenge CME Group, which has a near-monopoly in eurodollar trading – the world's biggest futures market (*Risk* January 2012, pages 66–67, *www.risk.net/2134121*).

The path taken by the Chicago exchange is littered with roadkill – firms that have tried to take the CME on in interest rate futures and been crushed – but Mike Bodson, who replaced Donahue as the DTCC's chief executive in early July, argues NYPC is trying something new. "We are providing a very innovative approach to margining, which is something that no one else has done before. One-pot margining is totally new, and the margining efficiencies this process can provide will be very important as available collateral becomes more constrained," he says.

Bodson is kinder about vertical structures than his predecessor, but still thinks the DTCC's way of doing things will win out in the end. "Vertical structures aren't inherently evil. They've served certain market segments very well, such as interest rate futures, as long as counterparties can opt out of parts of the service and there isn't a monopoly on pricing. With NYPC, we're just trying to provide an open access choice, and dealers have been very positive about this offering so far," he says. The platform cleared an average of 180,000 trades per month from January to June this year.

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The DTCC hopes to add another string to NYPC's bow with Project Trinity, which aims to bring LCH.Clearnet's interest rate swap clearing service, SwapClear, into the one-pot margining structure.

"Once Project Trinity is completed, NYPC will be a very powerful service indeed," says Bodson. "Participants will be able to cross-margin cash positions, futures and OTC swaps in one place. It's the first time this has been done in an open access environment. This is three very different corporate structures – DTCC, NYSE Euronext and SwapClear – joining forces to create something for the benefit of the market. It shows what can be achieved if firms work together."

But there are challenges to overcome before everyone is happily singing around the campfire (*Risk* November 2011, pages 22–25, *www.risk.net/2119631*). Bodson is quick to note that all three parties have to work out how best to put cash and OTC derivatives positions into a single margin pot – the products are liquidated in different ways in the event of a member default (see pages 16–19). Donahue also says that different legal entities may use different exchanges that connect to the service, bringing its own complexities.

While this work goes on, the DTCC is also trying to manoeuvre its repositories into a winning position. The US Dodd-Frank Act mandates that OTC trade information be reported and stored in SDRs, and dealers are hoping they won't need to use too many of them. Concluding in the first half of 2011, the industry ran a series of beauty contests to find the best repository for equities, interest rates, credit, foreign exchange and commodities – with the DTCC winning in each asset class, although it did so in co-operation with other firms for commodities and foreign exchange (*Risk* September 2011, pages 56–59, *www.risk.net/2103476*).

Bodson says the idea of a single SDR is to make life easier for regulators, not necessarily dealers. "We're trying to make data access as easy as possible for regulators. The reporting process will be split up into asset classes, but we are aiming for a central, unified system where regulators can access market exposure data for a specific institution across a variety of asset classes on one screen. That way, we deal with any data fragmentation concerns, and regulators can get an early warning of problems they might otherwise miss. They could have seen the large concentration of credit default swaps (CDSs) at American International Group before the 2008 crisis, for instance. The biggest challenge now is filtering that data so there is a common standard of presentation, and making sure regulators ask the right questions when they use the service so they can see the data they want," he says (see pages 57–59).

Although legislation such as the Dodd-Frank Act has been a boon for the DTCC, it also contains clauses the firm isn't happy about. One such clause demands that foreign regulators agree to foot the bill if their requests for data from US SDRs result in any unexpected cost – lawsuits over confidentiality breaches, for example. Without this so-called indemnity agreement, the DTCC would be banned from passing data to overseas supervisors, encouraging these jurisdictions to set up their own domestic SDRs. The DTCC is setting up repositories in Europe and Asia to work around the problem, but still wants the offending clause struck out and a bill working its way through US Congress would do that.

"We don't support indemnification, and no-one really knows why it was put into Dodd-Frank in the first place. We have been pushing hard against it because it defeats the purpose of a single, global SDR and will only lead to more fragmentation. Regulators have to respect each other's boundaries, but they also have to learn to trust one another," he says.

Trust also crops up in the issue of data leakage. Dealers are worried about what they see as a lack of data protection standards when regulators use SDRs, and fear sensitive trade data could escape into the public domain. These concerns came to light in mid-2010 when it was rumoured that the DTCC had been pressed by European regulators to give up CDS information – the region's authorities were trying to work out what effect, if any, CDS protection-buying was having on European government bond yields.

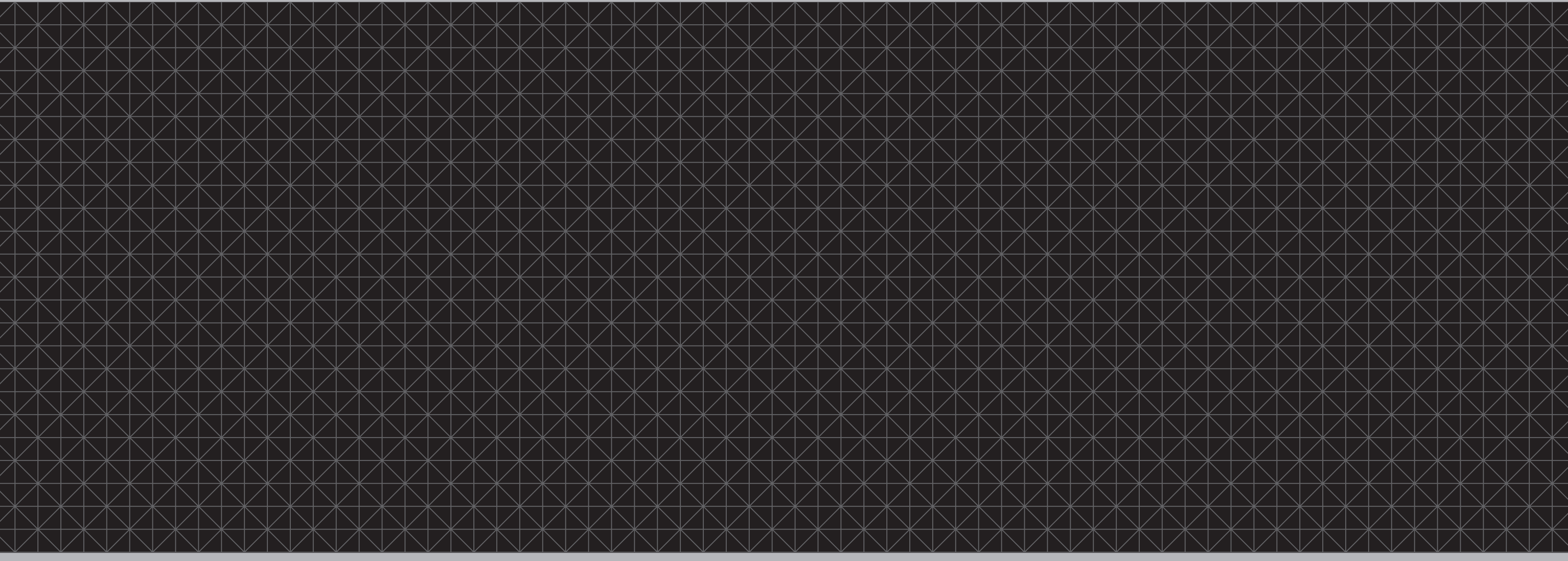
The DTCC declined to comment on the episode at the time but, according to Donahue and Bodson, there has been no problem with regulators leaking data. "No-one gains if people leak data," says Bodson. "If it does happen, it's game over for the SDR model because no-one will trust it. We'll go back to a more fragmented and secretive market-place. We have to rely on the regulatory framework that is built up around these institutions and maintain a dialogue to keep everyone happy."

These are all long-term themes for the industry, but the DTCC also has a more pressing project: the rush to create legal entity identifiers (LEIs), one of the tags that will be used to aggregate and sort data within SDRs. The DTCC, in conjunction with the Society for Worldwide Interbank Financial Telecommunications (Swift) and the Association of National Numbering Agencies (Anna) had hoped to provide a single solution, with Swift handling LEI registration, Anna issuing the new tags to the various reporting entities and the DTCC storing the LEIs and associated reference data (*Risk* April 2012, pages 51–53, *www.risk.net/2163214*).

Mike Bodson, DTCC

Photos: Alex Towle

That plan did not go down well with the Financial Stability Board (FSB), which has been asked by the Group of 20 nations to oversee the creation of a global LEI framework – on June 8, the FSB issued its own recommendations, which diverged significantly from the DTCC's vision. The regulator wants the LEI system to be run by a centralised, not-for-profit foundation – although the foundation's board would be allowed to outsource certain functions – and to be supported by a host of local LEI agents, that would register entities, issue LEIs and maintain the reference data. These local units could be privately or publicly run, so there may still be a role for the DTCC, but perhaps not the grand, global role for which it had hoped. Still, the firm is upbeat about the situation. "While there is great alignment between the FSB's and the industry's model for a global LEI solution, the FSB appears to favour a more immediate implementation of the federated approach. The timetable for that will be a key topic for discussion between the implementation group the FSB forms and the industry experts that can provide much needed guidance and insights into the issue," it says, in an emailed statement. ■



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