



© Total Derivatives Limited, a division of Euromoney Institutional Investor PLC
Total Derivatives content is protected under copyright laws. Reproduction or distribution
of the content of this website is prohibited without the prior consent of the publisher.

USD Bonds: Regulation versus innovation

Article

Thursday, 3rd December 2009. 14:03:07

Author: yiying.luthra@totalderivatives.com,
Tel: +1 212 224 3985

- Gearing up
- How much regulation?
- Is innovation dead?

Gearing up

Derivatives regulation remains in the spotlight as interested parties on both sides gear up. US Treasury Secretary Tim Geithner said yesterday that it is “imperative” that the SEC and CFTC have the authority to require central clearing of standardised derivatives. He added that in his view the government should not rely exclusively on decisions by the private sector to determine the scope of central clearing.

Highlighting the potential risks to the extent of regulation, a Sanford Bernstein analyst this week estimated that JPMorgan could see revenues decline by as much as \$3bn if most derivatives trades are moved onto exchanges.

Also this week, ISDA announced the creation of a committee to oversee market reform efforts, as part of a three layer governance structure. ISDA implemented the new structure in the interest of “more transparent decision-making, and improving the interface between interested parties (such as regulators, vendors and other infrastructure providers).”

In addition, ISDA cited the need to “ensue no undue dominance or preponderance on the part of any given firms.” The composition of the committee will be roughly one third from the buy side and two thirds from the sell side.

How much regulation?

Recently, *Total Derivatives* spoke with Alston & Bird partner Willa Cohen Bruckner about the shifting regulatory landscape for derivatives.

She noted that there is “certainly an emphasis on central clearing and exchange trading as a key feature of proposed legislation for OTC derivatives.” However, she remarked that it continues to be a slow and deliberate process. “Legislators are now considering which products should cleared and exchange traded and who should make that determination, as well as which market participants should be subject to the requirement,” she noted.

Bruckner felt that in future there would be, “No question that there will be more standardization of products, as that is a precursor to clearing and exchange trading” but pointed out that the bigger issue with clearing and exchange trading is “the size and scope” of margin and collateral

requirements.

"To Congress' credit, they have not rushed through with legislation in reaction to the negative sentiment surrounding OTC derivatives," she contended. "Instead, they have listened to numerous market participants and the regulators, and they are now seeing the complexities involved in imposing clearing, collateral and other requirements on OTC derivatives."

Furthermore, Bruckner believed that Congress "understands that the market consists of more than just dealers and banks, and they are trying to craft legislation that is workable and not unduly harmful to market players." She noted that, "Over time, there has been more focus on the impact on end users, whose voices have been heard through trade associations and other industry representatives."

Is innovation dead?

Asked about the fate of those derivatives contracts that cannot be exchange traded and/or centrally cleared, and whether or not they might be in danger of being priced out of existence by capital charges, she felt that Congress is "beginning to acknowledge that innovation is important."

"I don't think innovation is dead, but I believe market participants are approaching the process of innovation in a more thoughtful way - that is healthy," she noted. "I am seeing clients start to look at innovative products." However, "the efforts are smaller and more cautious than in the past, with questions like 'Is this product doable?' followed by longer periods of consideration."

Looking at two of the key principles behind the Commodities Futures Modernization Act of 2000 - namely, managing systemic risk and responsible innovation - she felt that "If market participants can maintain a balance between those principles going forward, then the economy can continue to benefit from innovation."

Still, in regards to more complex derivatives transactions, she believed that "For now, though, the pendulum is swinging back to simpler products and structures."

However, some market participants are also concerned about retroactive application of legislative and regulatory changes. "At least one legislative proposal has taken out retroactive treatment," Bruckner noted.

In the event that retroactive legislation is introduced, Bruckner warned that "If a financial institution holds a certain amount of capital against its existing book of business and suddenly it becomes much more expensive to run the book, the financial institution will have a difficult transition." But she imagined that "there would be grandfathering of existing trades and/or a gradual introduction of regulation."

To request a no-obligation free trial
please call Matthew Webster on +44 (0)20 7779 8529 or, in the US, 212 224 3985
or register at www.totalderivatives.com