OTC regulatory reform: risks of the clearing obligation from a competition perspective

Yaiza Cabedo advocates tougher oversight of over-the-counter markets

In the aftermath of the financial crisis, regulatory reforms have sought to improve financial institutions' risk management in order to prevent another Too Big To Fail (TBTF) scenario that would result in taxpayer bailouts. One of the key regulatory innovations has been the introduction of disclosure in over-the-counter (OTC) markets, which represent an epicentre of systemic risk, given their opaqueness and unregulated nature. Recent scandals such as the manipulation of Libor (FCA 2013) or Forex (US Department of Justice, 2015a) rates indicated a pattern of oligopolistic power and abusive practices in financial markets. This has put emphasis on the need to address anti-competitive behaviours. However, in the context of this article it is argued that new rules, including the introduction of a clearing obligation, rather than reducing, may further concentrate market risks and strengthen a small club of banks which already have a dominant position in financial markets, especially in OTC.

Prior to the financial crisis, the United States and the United Kingdom in their non-interventionist approach towards OTC markets, allowed for a lack of transparency between 'sophisticated parties' (i.e. parties with financial expertise) and, thereby, facilitated the emergence of risky, highly leveraged products that could not have been traded in regulated markets, but were tradable as OTC products. As a consequence, OTC markets saw an exponential growth since 2000, reaching $680 trillion of notional value in 2008 (Bank for International Settlements, 2008). They became critical in the escalation of systemic risk. It was only after Lehman Brothers collapsed that market supervisors fully came to terms with the fact that we had no data to account for systemic risk levels including the interdependency among OTC participants. Thus, in order to stop a 'defaulting domino effect', governments diverted trillions of public money to bail out TBTF entities.

To prevent this from happening again, the 2010 Dodd-Frank Act and the 2012 European Markets Infrastructure Regulation introduced transparency and systemic risk controls through mandatory reporting and clearing for standardized OTC products. On one side, reporting involves disclosing fundamental details of OTC transactions to a *Trade Repository* that operates as a private register, which market supervisors can access. This implies that private shareholders – most of them major OTC participants – are in control of this data. This constellation raises conflict of interest and asymmetric information issues.

On the other side, *clearing* is a mechanism that removes bilateralism in OTC by executing standardized trades through a central counterparty (CCP). CCPs are private, composed of banks – the 'clearing members' – and are generally owned by dominant OTC participants. This presents potential conflicts of interest. The clearing obligation neutralizes credit risk in the case of counterparties' default because it mutualizes losses among clearing members. This means that a party in a transaction executed through a CCP no longer represents a risk, since the CCP, to all purposes, becomes the new counterparty. To cover their exposure, CCPs require 'eligible' collateral through margin calls. This framework is supposed to contribute towards risk mitigation. In practice, risk is now more concentrated in the hands of a small group of clearing members because CCPs are not adequately capitalized to respond to counterparties' defaults. They themselves could therefore become TBTF. Nonetheless, these dangers can be averted by making transparent current conflicts of interest in OTC to assure fair play, and improving CCP risk management and stress testing, which, as yet, remains vague and unfinished.

Why should we be concerned about potential abuses? Recent cases such as the Libor or Forex manipulations have pointed to a pattern of oligopolistic practices in OTC performed by a club of market makers. This included the likes of Barclays, UBS, Citigroup, Deutsche Bank, RBS, JP Morgan, Bank of America, HSBC, Goldman Sachs, BNP Paribas, Credit Suisse, Morgan Stanley, Lloyd's, Societe Generale; some of which, ironically named themselves 'the mafia' or 'the cartel' in online chatrooms through which they

rigged Forex market (US Department of Justice, 2015b). It is not coincidental that the same banks (13 of the 14 above) were also involved in an investigation by the European Commission in 2013 regarding Credit Default Swap (CDS) OTC markets (European Commission, 2013). Preliminary conclusions suggested the presence of coordinated behaviour together with ISDA (International Swaps and Derivatives Association) and Markit to prevent other parties from gaining access to the CDS market. Unfortunately, these are not isolated cases. In 2014, the European Commission investigated four 'cartel' banks for manipulating Swiss francs' interest rates (EUR-Lex, 2014): they were accused of rigging the 'bid-ask spread' – the difference at which a market maker is willing to sell and buy a product, and this blocked third parties from competing on equal terms.

As can be seen, misconduct has repeatedly occurred. Market watchdogs need to be vigilant as clearing presents new opportunities for anti-competitive practices. Why? In the first place, to operate in OTC it is now mandatory to become a clearing member and, notwithstanding the non-discriminatory principle regarding access criteria, CCPs have margins for discretion. Non-accepted entities, in order to continue trading in OTC, will need a clearing member who takes its transactions to the CCP, in exchange for a certain price. This can entail access barriers and margin squeezes that could exclude parties from OTC. The Clearstream case is an example of anti-competitive behaviour as the European Court confirmed in 2009 that Clearstream had violated competition rules by refusing to supply certain clearing services and by applying discriminatory prices to its client, Euroclear Bank. Furthermore, there are other asymmetries to address in the current design. For example, a non-member hiring services from a clearing member must disclose its positions to those clearing their trades, which are, at the same time, major participants in the same market. Again, this mechanism leads to a conflict of interests and asymmetric information between OTC parties. In the context of anti-competitive business culture, clearing members could see incentives to take advantage of clients' information.

Simultaneously, markets become more concentrated and risky. CCPs have now large systemic risk exposure because, in case of default, they will have to absorb losses of (a) clearing members and (b) parties trading through a clearing member of the CCP. The problem is that regulators are not sufficiently strict in their surveillance of CCPs' risk management and their default fund capitalization. But, what would happen if CCPs' bail-in system failed? Could a CCP default?

A pro-active commitment of market authorities is required towards competition law enforcement to stop abuses of dominance and market disruptions, and towards capital controls and CCPs risk management. However, in order to develop a new market culture, regulatory reforms and financial technology development must work together. 'Entrepreneurial states' (Mazzucato, 2013) should not limit their role to fixing market failures, but engage in long-term investment to lead innovation in markets. New systems as 'blockchain', an open trading platform technology, represent new opportunities that need to be explored to improve transparency and trust in financial markets.

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