

Nordic Securities Association

Position Paper

# OTC Derivatives

NORDIC  
SECURITIES  
ASSOCIATION

# 1. Summary

The financial crisis has brought substantial regulatory attention to the OTC-derivatives market in general, resulting in a Communication from the European Commission (EC) in July and October 2009 and a Discussion Paper to Member States in January 2010. Despite the fact that one cause of the crisis may be traced back to a fraction of the OTC-derivatives (structured credit derivatives), the signals from EC is very clear: OTC-derivatives must in general shift from predominantly OTC-bilateral to more centralised clearing and trading.

We support the objective of the EC-proposal to enhance financial stability and improve the soundness and effectiveness of OTC-derivative markets. However, as the EC material appear at present, we notice a serious risk for a worst case scenario, eroding the idea with OTC-derivatives leaving the end users (e.g. corporates) with financial risks they cannot manage and increase financial and administrative burdens on e.g. the corporates.

It appears from the EC material that OTC-derivatives are CCP-eligible if some degree of standardisation can be achieved. However, standardisation (both legal and product wise) is a necessary but not a sufficient condition for a financial product to be clearable. Benefits of CCP-clearing can only be achieved in such products where liquidity is sufficient and reliable closing prices can be obtained. In addition, products should not contain inherent risk attributes that cannot be mitigated by the CCP. It is therefore crucial that CCP eligibility is determined by the industry and the CCPs in cooperation without interference from the regulators.

EC also states that in case a contract is not CCP-cleared, punitive capital charges will be imposed. However, already with the current rules in the CRD there is a big incentive to move to CCP-clearing because of the zero risk weighting in regulatory capital calculations. We do not support this proposal, which will increase cost of OTC-derivatives. It also raises issues for the treatment of products not considered CCP-eligible – should they also be exposed to punitive capital charges then?

In case of bilateral clearing we support better bilateral, collateral management processes and the collateralisation of all interdealer OTC-derivative trades. However, it is important that potential initiatives build on existing markets' infrastructures and market forces.

We do, however, see a need to strengthen the legal security of bilateral credit risk reduction mechanism (basically close-out netting and collateralization). We believe there is a need to improve the existing framework in the EU for close-out netting. We therefore urge the EC to go fast forward with a proposal that could make close-out netting safe in the EU.

EC proposes to establish Trade Repositories to provide regulators with a clear, aggregate picture of the interconnectedness of positions held by market participants and their potential exposure. We support this initiative assuming ideally only one Trade Repository globally for each asset class and under the presumption that issues related to data protection, governance, location, access and regulation are properly taken care of.

We support disclosure to the public of appropriately aggregated information but not information on individual firms due to the harmful consequences of such dissemination on individual firms' future trading positions and therefore the market effectiveness.

In general, to ensure a level playing field we believe it is essential that regulatory arbitrage must be excluded. This demands a global approach in future regulation. Scope and applicability of regulation should also be carefully considered. The upcoming regulation should not be a one-size-fits-all solution, but should enable flexibility on participants' size and business.

## 2. Introduction

The financial crisis has brought substantial regulatory attention to the OTC-derivative markets resulting in a Communication from the European Commission of 3 July 2009 followed by a consultation period, and a more specific Communication of 20 October 2009 on “Ensuring efficient, safe and sound derivatives markets”<sup>1</sup>. Most recently, a Discussion Paper covering proposed regulatory initiatives in the area of OTC-derivatives was distributed to the Member States (January 2010).

The main message is that OTC-derivatives must shift from predominantly OTC bilateral to more centralised clearing and trading. Moreover, the EC states that regulatory arbitrage must be excluded which demands a global approach in future regulation.

The more specific proposals can be summarised as follows:

- Reduced counterparty risk
  - Increased use of Central Counter Party (CCP) clearing
  - Increased collateralisation in bilateral clearing
  - Increased capital charges on bilateral clearing
- Reduced operational risk (standardisation of electronic processing and legal terms)
- Increased transparency
  - Trade repositories
  - Increased trading on organised trading venues
  - Pre- and post-trade transparency
- Increased market integrity and oversight

In chapter 3 we highlight our general positions concerning the proposals, and in the following chapters we elaborate on the specific proposals: Chapter 4 treats the proposals concerning counterparty risk, chapter 5 focuses on operational risk, chapter 6 focuses on transparency, and finally market integrity is dealt with in chapter 7.

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<sup>1</sup> The documents can be found here: [http://ec.europa.eu/internal\\_market/financial-markets/-derivatives/index\\_en.htm](http://ec.europa.eu/internal_market/financial-markets/-derivatives/index_en.htm)

### 3. General positions

In general, we support the objective of the European Commission's proposals to enhance financial stability and improve the soundness and effectiveness of OTC-derivative markets<sup>2</sup>. However, we do not necessarily agree on the means to achieve these objectives.

When discussing future regulation of OTC-derivatives, the purpose of derivatives it is important to bear in mind:

- A significant part of the use of derivatives is for hedging purposes, meaning protecting the end user (e.g. corporates) from the risk he is exposed to.
- Derivatives can also be used to offset price differences between markets and thereby connecting these markets, and
- Derivatives can be used to utilize expectations on price movements.

OTC-derivatives are also used by end users (e.g. corporates) to hedge Foreign eXchange (FX), Interest Rates and equity risks. The base value of an OTC derivative compared to cash products and listed derivatives are that they can be tailor-made to specific hedge or risk purposes. In many cases an OTC derivative implies less financial burdens and less administratively cost for the end user (e.g. corporates).

E.g. in cases of hedging purposes the use of bespoke products to ensure elimination/significant reduction of risks is essential. As we will illustrate in chapter 4, forcing end users (e.g. corporates) to use standard products, expose end users (e.g. corporates) to unwanted risks which can imply (considerably) increased costs. The consequences for the end users (e.g. corporates) can be significant.

Although the financial crisis has brought more regulatory attention to the OTC-derivative markets and to the way in which credit risk has been transferred, the

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<sup>2</sup> For more information regarding the products in question, please see Appendix 1.

financial crisis is not caused by the OTC-derivative markets in general. One of the root causes of the crisis may be traced back to a fraction of the OTC-derivatives, namely structured credit derivatives. It is essential to understand that the trigger of the crisis was an overleveraged subprime housing market in the US. The bad loans was repacked and sold as structured credit derivatives. This process is called securitisation. The problem was not securitisation itself, but the way it was used. Many of the challenges related to securitisation and to the excessive risk transfer and risk mispricing have already been addressed by the recent review of the Capital Requirement Directive (CRD), and therefore extensive overregulation of the OTC-derivatives markets in general should be avoided.

That said it is also important to take into account that it takes time and resources to change the derivatives infrastructure built up over the last decades. Costs due to demands of fast changes to infrastructure are especially an issue for small and midsized – non-global – banks, and therefore timelines for any demands/measures to be fulfilled should be realistic.

Any changes must be well thought out and in close cooperation with the industry. Different OTC-derivative markets have different starting points and different needs for changes. Therefore, there cannot be a uniform “one size fits all” solution for all asset classes. Liquidity is a crucial aspect to take into account when discussing future regulation. The more liquid a market/asset class is, the more relevant it can be to discuss e.g. CCP-eligibility. And visa versa: Forcing less liquid products into e.g. CCP-clearing can have serious consequences for the market in question and to the end users (e.g. corporates).

Where possible industry initiatives should be applied instead of explicitly regulatory requirements and potential regulatory initiatives should build on and be complementary to the infrastructure that the industry has managed to develop itself (for instance DTCC, SwapClear (IRS) and MarkitWire).

And rather than focusing solely on the use of CCP as a risk-mitigating tool, we will highlight the initiatives above and a need to strength the legal security of bilateral credit risk reduction mechanism (basically close-out netting and col-

lateralization). We believe there is a need to improve the existing framework in the EU for close-out netting. We therefore urge the EC to go fast forward with a proposal that could make close-out netting safe in the EU.

Moreover, it is important with level playing field (EU vs. rest of the world) in order not to distort the competitiveness of Europe's financial markets and thereby deteriorating financial possibilities for European corporates.

Overregulation can lead to risk being transferred to and accumulated outside the regulated sector. While private contracts exist, so does the ability for risk to be transferred outside classical classes of financial instruments.

## 4. Reduced counterparty credit risk

One of the main issues in the EC Communication relates to standardisation. Standardisation can refer to:

- **Process standardisation/automation:** STP matching, confirmation, settlement, event handling, etc.
- **Legal standardisation:** legal relationships, e.g. ISDA Master Agreements, European Master Agreement, Local Master Agreements prepared by local securities dealers/bankers associations, etc. Legal standardisation sets the overall framework, but does also sometimes imply some extent of product standardisation.
- **Product standardisation:** standard valuation, payment structures, payment dates, etc.

Standardisation of processes and legal terms are valuable in order to mitigate operational risks in the system. Progress in these areas is continuously made by the industry itself.

Too much product standardisation in order to promote CCP-clearing or exchange trading can, however, be detrimental to the functioning of the financial markets, cf. below.

### 4.1. Mandating CCP-clearing

The EU aims for mandatory CCP-clearing of standardised derivatives. A central counterparty is a financial institution that acts as an intermediary between security market participants, becoming the buyer to every seller and the seller to every buyer. This reduces the amount of counterparty risk that market participants are exposed to directly. However, to enable the CCP to minimize own risk exposure and to cover losses in case of defaults the CCP will imply minimum standards of participants' size and profitability, use sophisticated risk management methods and require safety nets to cover potential losses such as a CCP's profits, parent guarantee, insurance and default fund (loss share). In short, a

CCP is not a “Miracle Cure” that removes risks. A CCP is in fact a vast concentration of systemic risk in itself.

The main advantages of CCP-clearing are to:

- Mitigate credit risks by multilateral netting of exposures
- Improve efficiency and processes and reduce operational risks both on a daily basis and in case of major defaults.

It appears from the EC-communication and discussion paper that OTC-derivatives are CCP-eligible if some degree of standardisation can be achieved.

However, we need to stress that CCP-eligibility is not synonymous with standardisation. Standardisation is a necessary but not a sufficient condition for a financial product to be clear-able.

The following criteria are relevant to CCP-eligibility, with liquidity being indispensable to the ability to manage counterparty risk:

- The trade and settlement flow should be sufficiently standardised to allow a CCP to step in after a trade is concluded
- There must be sufficient volume and liquidity in order to minimize failure of delivery and maximize the netting possibility
- Sufficient liquidity and standardisation is also needed in case of default situations to enable CCPs to close out contracts
- The price discovery venues need to be transparent and robust so as to facilitate risk valuation in e.g. mark-to-market processes
- Legal standardisation in order to secure the same legal framework
- Product standardisation of payment structures and dates, etc. in order
  - to make netting of contracts possible
  - to make it more simple for CCPs to calculate and handle cash-flows
  - to reduce the number of different types of contract and hence achieve the economic benefits of scale.

For some derivative product groups in the interbank-market, sufficient product standardisation for CCP-clearing exists already today. This includes CDS' which

are traded under standardised payments dates (IMM) and with standardised coupons, see table below<sup>3</sup>. It is notable that DTCC and Swapclear were founded before the crisis and proves the OTC self regulation capabilities.

However, for OTC-derivative products, which are tied up to hedging of specific contracts, e.g. corporate loans or other company-specific risks for instance related to foreign exchange risk or commodity exposures, product standardisation in terms of payment structures and dates is not possible without losing the possibility of hedging perfectly the specific risk, i.e. forced standardisation can lead to ineffective hedging and incomplete transfer of risk, leaving e.g. corporates with basis risks that they cannot manage effectively.

In short, the idea with the products will be eroded leaving the end users (e.g. corporates) with financial risks they should not have.

An illustration of the challenges with product standardisation is scheduled in an example below. Further examples can be found in Appendix 3. Please note that this is examples of the use of OTC-derivatives.

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<sup>3</sup> More information on the level on standardisation and clearing can be found in Appendix 2.

## Example 1. FX Swap

### FX Swap

In the FX Swap market the contracts are used in risk managing and for hedging end client (e.g. corporates)/banks' commercial cash flow.

### With bespoke products

A corporate wants to hedge inflow in USD on a certain future date (45 days from today). He sells USD and buys DKK on future date:

USD (mio.)	Period	Price	Spot	DKK (mio.)
100	1 month	0,34	500	500.340.000,-
100	45 days	0,44	500	500.440.000,-
100	2 month	0,6	500	500.600.000,-

The corporate knows today exactly what amount in DKK he will get in 45 days.

### With standardised products

The corporate must choose between 1 or 2 month products and will

1. risk to face another price for his product and
2. face the unwanted risk of changing spot price from the "FX Swap expiring date" to the date that he gets the USD.

Moreover, in general swaps are also used in liquidity management when, for instance, one moves from one currency into another on certain days, where the limitation due to standardisation will cause challenges for the handling of liquidity.

Hence, we do not support mandatory CCP-clearing since mandatory CCP-clearing requires standardisation which for many derivatives products, in particular those specifically tied up to individual contracts and individual risks, is not possible without compromising the possibilities for corporates to fully hedge their individual risk. In these circumstances bilateral, collateral agreements (CSAs) provide a good mechanism to control and mitigate risks. Use of CSAs between large corporations has increased significantly ever since the crisis began. Moreover, e.g. ISDA continuously improves various matters in connection with CSA-processes.

Moreover, forcing a CCP-eligible contract into CCP-clearing could unbalance the counterparty risk profile of a market participant's portfolio with a particular counterparty with whom other non-clearable transactions are also outstanding. Such a transfer could also increase the risk profile vis-à-vis the CCP. In other words, it is important to ensure that market participants are able to offset the "directionality" in their "non-clearing-eligible", bilaterally clearing positions with market counterparties.

In order to fully exploit the risk mitigation possibilities and not burden the industry excessively, there should only be a limited number of CCPs in each asset class. This is particularly important for midsized banks in a situation with no or limited interoperability between CCPs.

Due to the joint and several liabilities, the eligibility of OTC-derivative products to be cleared through a CCP should not be left to the CCP alone. Conditions for eligibility should be determined with CCPs and the industry without interference from the regulators.

CCPs should be regulated to ensure safe and sound risk governance of CCPs in order to reduce potential system risk implications as CCPs gain a more prominent role in the market. We support that the European Securities and Markets Authority (ESMA) – the successor to CESR in the future European supervisory set up – should give CCPs authorisation to operate in the EU and assist the Commission when considering requests for market access from third country CCP-providers.

#### **4.2. Increased collateralisation in bilateral clearing**

In case of bilateral clearing we support better bilateral, collateral management processes and the collateralisation of all interdealer OTC-derivative trades. However, it is important that potential initiatives build on existing markets' infrastructures and market forces.

At this point in time it is difficult to see how requirements on financial firms to post initial margins on bilaterally cleared contracts are to be implemented as transactions generally are executed at market value zero. Any demands on initial and variation margins should be on a level playing field in order not to distort competition across products and countries (especially US) or competition between large, global banks and regional banks.

Daily portfolio reconciliation and exchange of collateral should be the goal with respect to a bank's largest counterparties.

### **4.3. Increased capital charges on bilateral clearing**

We do not support punitive capital charges for contracts that are not CCP-cleared. Already with current rules in the CRD, there is a big incentive to move to CCP-clearing because of the zero risk weighting in regulatory capital calculations. Also, CCP-clearing has the important benefits of mitigating credit and operational risks for suitable products that are being eligible for standardisation.

It is important with a level playing field (EU vs. US) in order not to negatively affect the competitiveness of Europe's financial markets, including the possibilities for mitigating risks for corporates and institutions. We also note the ongoing work of the Basel Committee on capital incentives ("Strengthening the resilience of the banking sector") and we urge policymakers to ensure appropriate coordination.

We support zero risk weighting in the capital requirements calculations for indirect clearing participants in case of a set-up where the only counterparty risk for the indirect participant is that of the CCP.

## 5. Reducing operational risk

In general, we support standardisation of processes (e.g. electronic matching initiatives run by ISDA) and main legal parameters (i.e. Master agreements) to reduce operational risk.

As also described in chapter 4, initiatives that would attempt to standardise the terms of all OTC-contracts are counterproductive because these can lead to ineffective hedging and incomplete transfer of risk, leaving the end users with unwanted and unmanageable risks, i.e. a mismatch between the specific risks they face and non-specific, generic instruments that would be available in the market.

We support dialogue between the European Commission and the industry as a mean to promote standardisation of the legal terms and electronic processes rather than forcing any development by changing the operational risk approach in the CRD.

## 6. Transparency

### 6.1. Trade Repositories

We support the initiative of central trade repositories for all asset classes. A separate response to the recent CESR-proposal is made and can be found here: [http://www.cesr.eu/index.php?page=response\\_details&c\\_id=149&r\\_id=5066](http://www.cesr.eu/index.php?page=response_details&c_id=149&r_id=5066).

There should only be one trade repository for each asset class to avoid complexity and duplication of information and to achieve the benefits of scale. We support that trade repository requirements are being applied to both cleared and non-cleared trades, on a post trade basis, allowing consolidation of position data and regulatory reporting from a single source. This is also beneficial in terms of regulatory monitoring and accuracy.

Once data is reported to the repository, it should provide all relevant data to regulators, supervisors and central banks and related in order to avoid unnecessary, administrative burdens for the industry.

The primary purpose of the trade repository is to provide transparency to regulators on the market activity in each asset class. Access to trade repositories should be granted to all major financial regulatory bodies on the same terms.

We support that trade repositories are brought under a safe and sound transparency regulatory regime with appropriate data protection safeguards. Besides appropriate data protection safeguards, other important issues to be solved are access, location, governance and regulation. Any future policy must carefully treat these issues. We also support ESMA to be responsible for authorizing and supervising trade repositories in the EU and act as a gateway for disseminating information on derivatives to national financial services regulators. With regard to fee associated with trade repositories, it should derive solely from cost.

### 6.2 Increased trading on organised trading venues

In theory, all OTC-derivatives could – from a technical point of view – be traded on an exchange. However, in reality in order to achieve a sufficient level of liquid-

ity for exchange trading to make sense, the level of product standardisation necessarily has to be very high, including standardisation of maturity, amounts, counterparties, etc. As the price discovery process often is subject to negotiation and even involves, for some transaction types, product adjustment (which is complicated to replicate in an exchange format) makes it impossible to trade the end users (e.g. corporate) demand on an exchange. Hence, even CCP-eligibility does not per se imply eligibility for exchange trading.

Forcing OTC-products with low volumes (liquidity) onto exchanges would have an impact on their ability to trade these products. For example – the CDS-segment, in absence of participation of intermediaries and non-hedgers, are likely to cease being traded in a market and will become, as a result, extremely illiquid and costly, both to enter into a transaction and to terminate it. As a consequence, providers and end users (e.g. corporates) will be left with far more limited and more expensive alternatives for managing the credit risks arising from their lending and investment activities.

On the other hand, forcing a too extensive degree of standardisation of products in an attempt to create liquidity for exchange trading would lead corporates without the full possibility of hedging individual risk because standard exchange-traded contracts very rarely provide a perfect hedge for actual economic risk, cf. chapter 5.

Therefore, OTC and derivatives venues (i.e. derivatives exchanges or multilateral trading facilities) each have a separate, distinctive and logical reason to exist. We support trading of CCP-cleared OTC-derivatives on transparent and efficient trading channels, i.e. voice execution through brokers. Furthermore, we need to stress that market participants have valid reasons for choosing one trading channel over others and that trading based on competition between different venues is advantageous for market efficiency.

We do not, however, support mandatory product standardisation in an attempt to create liquidity in OTC-derivative products where sufficient liquidity is not possible to obtain due to an extensive use of and need for tailor-made products. If this is neglected, an obvious consequence is liquidity drying up and financial

markets will be impaired in their capacity to mitigate financial risks and deliver efficient risk management products to corporates and investors.

Finally, what matters and what should be the overall focus is the ability to serve the users' needs. If this is neglected an obvious consequence is drying up of the mentioned markets.

### **6.3 Pre- and post-trade transparency**

In general, we support higher transparency, but it is important to avoid unnecessary, administrative burdens on banks and respect industry competition.

The purpose of trade transparency is to assist the price discovery process in all financial markets. However, too much transparency is counterproductive.

Hence, we do not support MiFiD-type pre- and post-trade requirements as known in the equities markets. The OTC-markets vary substantially from the cash equities market where transactions are predominately small in size due to the presence of retail investors. By contrast, OTC-transactions are much larger by nature and are undertaken by professional end users (e.g. corporates, buy-side). The banking community has an essential role to play to transfer risk through their balance sheets. Therefore, post trade transparency becomes less relevant and the negative implications for liquidity are much greater.

Should pre-trade transparency, in spite of the above mentioned concerns, be prioritised, it should only be on high-liquidity contracts traded on exchanges and not on OTC-contracts as this is not compatible with products being tailor-made (i.e. individual credit charge element).

We support the disclosure to the public of appropriately aggregated information but not information on individual firms due to the harmful consequences of such dissemination on individual firms' future trading positions and therefore the market effectiveness.

## 7. Increased market integrity and oversight

We support enhanced market integrity in the derivatives markets.

One of the means will be extending the Market Abuse Directive (MAD) to OTC-derivatives. We support such an initiative, and a useful information tool could be the trade repositories. We do not, however, support an enhancement of the existing Transaction Report Exchange Mechanism amongst CESR members (i.e. regulators) to include OTC-derivative instruments. All relevant data should instead be available for regulators through trade repositories in order to avoid unnecessary, administrative burdens for the industry.

Moreover, the Commission intends to propose rules to give regulators the possibility to set position limits to counter disproportionate price movements or concentration of speculative positions (primarily for commodity markets).

We do not support this initiative. Who should judge when price movements are “disproportionate” and when do we see “concentration of speculative positions”? We do not believe that Authorities should take on such a role since this step de facto will imply a public inappropriate intervention in the market function which can be distorting. Also, we believe that banks’ position-taking already today is well regulated by overall capital requirements on risk-taking through the CRD.

## 8. Appendix

### Appendix 1 Description of products

Product	Description
<b>CDS</b>	A CDS is a contract between two counterparties under which the protection buyer will pay an annual fee (on a quarterly basis) to the protection seller until the maturity date of the contract or a credit event (typically bankruptcy, failure to pay, restructuring) occurs on the reference entity. In the latter case, the protection buyer must deliver bonds or loans of the reference entity for the amount of the protection (notional value of the contract) to the protection seller and receives the par value in return. A CDS protects against a credit event occurring on a single reference entity ("single name"), which can be a company or a sovereign, or on a portfolio of such entities, for example through an index. Such an index is constructed to reflect the performance of a segment of the credit market, for example large European companies with relatively good credit ratings.
<b>Interest Rate Swaps</b>	An interest rate swap is an agreement to exchange one set of cash flows (perceived as risky, as linked to e.g. a floating interest rate) against another set of cash flows (perceived as stable, as linked to e.g. a fixed interest rate).
<b>Cross Currency Swaps</b>	A cross-currency swap is an interest rate swap in which the cash flows are in different currencies. Upon initiation of a cross-currency swap, the counterparties make an initial exchange of notional principals in the two currencies. During the life of the swap, each party pays interest (in the currency of the principal received) to the other. And at the maturity of the swap, the parties make a final exchange of the initial principal amounts, reversing the initial exchange at the same spot rate. A cross-currency swap is sometimes confused with a traditional FX swap, which is simply a spot currency transaction that will be reversed at a predetermined date with an offsetting forward transaction; the two are arranged as a single transaction.
<b>FRAs</b>	A forward rate agreement is a forward contract on a short-term interest rate, in which cash flow obligations at maturity are calculated on a notional amount and based on the difference between a predetermined forward rate and the market rate prevailing on that date. The settlement date of a FRA is the date on which cash flow obligations are determined.

<p><b>Swap options (and other interest rates options)</b></p>	<p>In an interest rate option, the underlying asset is related to the change in an interest rate. In an interest rate cap, for example, the seller agrees to compensate the buyer for the amount by which an underlying short-term rate exceeds a specified rate on a series of dates during the life of the contract. In an interest rate floor, the seller agrees to compensate the buyer for a rate falling below the specified rate during the contract period. A collar is a combination of a long (short) cap and short (long) floor, struck at different rates. Finally, a swap option (swaption) gives the holder the right – but not the obligation – to enter an interest rate swap at an agreed upon fixed rate until or at some future date</p>
<p><b>FX-forward</b></p>	<p>Foreign exchange (FX) derivatives are closely intertwined with the underlying foreign exchange spot market (where the currencies are traded) The FX markets are large and mature. When moving from spot to the exotic part of the market, the less standardised and less subject to central infrastructure the market becomes.</p>
<p><b>Inflation swaps and options on those</b></p>	<p>The primary use of Inflation swaps is to transfer inflation risk. Therefore companies with an exposure to inflation often look to hedge that risk using inflation derivatives. An Inflation swap has one fixed side and one floating side based on an inflation index, such as UK RPI or Euro HICP ex tobacco. The Inflation Swap will be agreed over a set period, usually a number of years. In addition, the inflation swap will be based on a notional amount which represents the figure that inflation and the fixed rate payments will be paid out on.</p>
<p><b>Commodities swaps and options on those</b></p>	<p>The same types of contracts exist in commodities (futures, options, forwards and swaps). However, the underlying products are very diversified and the markets structure differs depending on segment, with some being more standardised and subject to CCP-clearing, with others being pure OTC.</p>
<p><b>Equities swaps and options on those</b></p>	<p>Options can be divided into Call (the right to buy) and Put (the right to sell)). In equity swap, counterparties make payments to each other with at least one set of payments being set by a share or an index return. The other payments can be fixed or floating rates, or the return of another share or index.</p>

## Appendix 2 Market characteristics

Product	Standardisation	Clearing	Trading/Trade confirmation	Transparency
<b>CDS</b>	<p>Contracts are on a continuous basis being changed by ISDA to improve standardisation. Recently ISDA has promoted contractual modifications, which entered into force in April 2009. Moreover, discussions regarding whether and how CDS' are traded with restructuring of credit events are ongoing. Finally, new conventions for standardisation of coupons has entered into force in North America respectively Europe.</p>	<p>CDS is a young market and clearing has so far been done on a bilateral basis. However, industry has this year accepted CCP-clearing. In US it is ICE Trust. In Europe it is BClear, Eurex Clearing, ICE Clear Europe and LCH Clearent SA.</p>	<p>Inter-dealer (electronic platform). Dealer to customer (by phone or through inter-dealer platforms). More than 90 pct. of the trades are confirmed electronically. DTCC Deriv/Serv, Market Wire and T-Zero are used.</p>	<p>Via e.g. Markit Wire (Markit RED database), CDS indices (iTraxx, CDX), daily quote report.</p>
<b>Interest Rate Swap</b>	<p>This market is very mature and the biggest market. Approximately 2/3 of the market is cleared through a CCP and are therefore highly standardised.</p>	<p>SwapClear</p>	<p>Trading is mostly done bilaterally (OTC) due to the bespoke nature of the market. However, inter-dealer trading (voice or electronic) and dealer to customer (voice or electronic platforms) trading is also seen. Since 2002 the majority of trading is confirmed via Markit Wire. Also Trade Express is used.</p>	<p>Composite price sources based on market makers' live indicative – or tradable pricing, e.g. Bloomberg.</p>

Product	Standardisation	Clearing	Trading/Trade confirmation	Transparency
<b>Cross Country Swaps</b>	As under the Interest Rate Swap	Swap-Clear	Bilaterally	n.a.
<b>FRAs</b>	Non standardised	n.a.	Bilaterally	n.a.
<b>FRAs</b>	IMM standardized in SEK	NAS-DAQ OMX		
<b>Swap Option</b>	Non standardised	n.a.	Bilaterally	n.a.
<b>FX-forward</b>	Large and mature market – highly standardised using ISDA MCA	N.a.	Bilateral.  Trade confirmation via SWIFT	
<b>Inflation Swaps and option on those</b>	Non standardised	n.a.	Bilaterally	n.a.
<b>Commodities Swaps and option on those</b>	Diversified market with a lot of segments whereas some of these are very standardised while others are truly bespoke. Used agreements are Master Confirmation Agreements (MCAs), e.g. ISDA Global, EFET, NBP.	n.a.	Bilateral.  Trade confirmation are increasingly done electronically.	n.a.
<b>Equities Swaps and options on those</b>	Not very standardised. Contracts can be concluded under ISDA or others but are often customized	n.a.	Interdealer network – e.g. ICAP, TFS and Tullet or internally.  Trade confirmation via Markit Wire and DTXX DerivNet	Limited

## Appendix 3 Further examples of the use of OTC-derivatives

### Example 1

#### Interest Rate Swap (IRS)/Currency Swaps (CCS)

IRS is used when swapping payment from floating to fixed rate or the other way around and CCS is furthermore used when swapping from one currency to another – e.g. mortgage loans, bank loans etc in order to secure future payments.

#### With bespoke products

The cash flow matches perfectly (on dates, fixing frequency, cash flow etc.) and thereby the customer gets exactly the wanted risk:

A customer expects interest rates to rise and wants his floating interest rate (fix every 6 months, p.t. 3,5 pct.) with fixing 30.12 and 30.06 (on his bank/mortgage loan) to be swapped into fixed rate to minimize unwanted risk; He prefers to face a (slightly) higher interest rate than to face the uncertainty not knowing what interest rate he will get.

He enters into an IRS where he is receiving floating rate (6 month, 3,5 pct.) and paying fixed rate (1 year, 4,0 pct.). The received 3,5 pct. matches the percentage he is paying on his loan (3,5 pct.) and the fixing frequency and dates <—> perfect match.

	17/12		30/12	
<b>DKK</b>	6 mdrs cibor	1 year	6 mdrs cibor	1 year
100 mio.	3,0 pct.	4,5 pct.	3,5 pct.	4,0 pct.

#### With standard products

The customer cannot get a swap where fixing is on the exact day where his loan is fixed (30.12), whereby he faces unwanted risks. The standard fixing date is e.g. 17.12. Therefore he pays the "fixed leg" 17.12 (4,5 pct.) and receives the "floating leg" (3,0 pct.) 17.12 on the swap. However he has to pay floating rate at 3,5 pct. 30.12 on his loan.

Moreover, the fixed, yearly rate is 4,5 pct. 17.12 compared to 4,0 pct. 30.12, and every fixing day in the future he'll have this difference between "fixing day" on his loan and "fixing day" on the swap – both on the floating and the fixed rate.

He thereby cannot hedge his loan perfectly.

## Example 2

### FRA

A forward rate agreement, where the buyer hedge risk against future interest rate rise. The buyer of a FRA hedges against future interest rise. The seller hedge against future interest rate fall:

### With bespoke products

A corporate wants to sell a DKK FRA because at 12 April he gets DKK and he wants to secure the future interest rate.

DKK	period	price	fixing day
500 mio.	14.04 - 14.07	1,56	12.04

### With standard products

The corporate has to choose a standard period (IMM date)

500 mio.	17.03 - 16.06	1,50	15.03
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- and cannot secure the rate from the exact day the corporate gets DKK and faces an unwanted risk.

## Example 3

### Commodity Swap (oil)

Industrial corporate and the shipping industry are using fuel swaps to hedge their physical contracts. To avoid any kind of basis risk, the energy swap market is a perfect fit for hedging. All physical underlying risk (physical negotiated contracts) are using the "Platts oil reference", which is a reference price created by the largest players in the market like Statoil, Shell etc, for determining the physical invoicing. Energy swaps has been used since the beginning of 1990 and hedging tools such as swaps are fully integrated in the oil industry, utility and shipping industry. In this context a swap is a fixed price transaction where the buyer is paid (or pays) the difference between the agreed price and the average value of an underlying benchmark price (here; Platts oil reference).

### With bespoke products

A shipping company which has exposure for rising oil prices in Europe would use the swap market to fix the price on oil. In this example, the company needs prices fixed for 1 quarter 2010.

The swap price for 1 quarter 2010 is today quoted at USD 437,-.

The corporate buys the swap today because he needs a perfect match for his physical contract.

- In January 2010 the oil price is settled at USD 450 and the corporate will get credited by USD 13 per tons. With a volume of 5,000 tons this implies USD 65,000
- In February the oil price is settled at USD 455 and the corporate will get credited by USD 18 per tons. With a volume of 5,000 tons this implies USD 90,000
- In March the oil price is settled at USD 460 and the corporate will get credited by USD 23 per tons. With a volume of 5,000 tons this implies USD 115,000

### With standardised products

If the swap market is standardised, the corporate cannot get a perfect match on his physical contract and thereby gets an unwanted risk because he cannot fix the price at the exact time it is needed and because of the inherent price risk due to the lack of bespoke products.

The swap market is "well industry regulated" by ISDA and Annex Commodity Definitions of 1992 and counterparty risk are reduced by Credit Support Annex (CSA). If this market (the products) is standardised, the corporate will face huge, unwanted risks.

Secretariat: Amaliegade 7 · DK-1256 Copenhagen K  
Phone +45 3370 1065 · [www.dbmf.dk](http://www.dbmf.dk) · [mail@dbmf.dk](mailto:mail@dbmf.dk)

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