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It's transparency, but not as we know it

By Per Sjoberg and Susan Hinko

There is a widely-held belief that the over-the-counter (OTC) derivatives market and the pricing of transactions is too opaque and not accessible to the general public.

Real time reporting and price transparency are viewed as the panacea to solve these problems. Achieving price and position transparency in the OTC derivatives market is an important goal of the new regulatory and legislative initiatives and rule-making currently underway.

Many believe that "real time" reporting of trades will accomplish that transparency while providing significant benefits to market participants. But that belief may be founded on knowledge of the highly liquid, standardised cash and futures markets rather than on the realities of the OTC derivatives market. This is the wrong comparison to be making because the volumes in the OTC markets are significantly smaller and more dispersed.

Not addressing the realities of the OTC markets could seriously undermine a market that plays a vital role in the global financial landscape.

In its capacity as the Interest Rate Trade Reporting Repository, TriOptima has been given access to data on interest rate OTC derivatives traded by the G-14* institutions which include the major global OTC derivative dealers. To test the belief that "real time" reporting will create meaningful, public transparency, TriOptima analysed the data submitted by the G-14 institutions in June 2010.

While the G-14 institutions do not represent the entire OTC derivatives market, they do represent the vast majority of trades.

The Bank of International Settlements, which gathers statistics from the central banks around the world, reported that there was $349,240bn in notional outstanding in interest rate swaps for the second half of 2009. In June 2010, the G-14 reported there were 3m interest rate swaps with a notional value of $332,200bn in the Interest Rate Trade Reporting Repository.

This sounds like a lot to someone not well-acquainted with the OTC markets. But it is important to realise that this is the total inventory of interest rate swaps globally across all currencies and all maturities. This inventory has grown over a long period of time and does not represent turnover or activity in trading.

There are many swaps that actually extend out to 50 years and sit in this inventory. Also, this includes all currencies in which an interest rate swap is traded, currently numbering 56 globally some with only one trade outstanding.

TriOptima analysed the interest rate swap data submitted for June 2010 and found that the average daily volume in interest rate swaps was 3,600 trades per day across all maturities and all currencies around the globe for the G-14 dealers.

For US dollar interest rate swaps, which is the most actively traded product, an average of 1,200 transactions a day were traded; euro interest rate swaps averaged just 830 trades per day.

To achieve price transparency, it is important to compare apples to apples. But when discussing interest rate swaps, 50 per cent of the daily volume were forward starting (meaning they take effect sometime in the future) or mature on an odd end date (reflecting the customised nature of OTC derivatives).

Only 50 per cent of the daily volume in dollar interest rate swaps was standardised with full year maturities, lending themselves to price comparison. This brings the standardised volume of interest rate swap transactions to a total of 600 per day in all maturities.

In the most liquid full year transaction type, 10-year dollar interest rate swaps, there were only 208 transactions per day in June last year. This means that about 17, 10-year dollar interest rate swap contracts were traded each hour in a 12-hour period. Most of the standardised swaps in other maturities and currencies trade less than 20 contracts per day making a meaningful price comparison between two transactions virtually impossible.

Why have the implications of price transparency for OTC derivatives been difficult to understand? Probably because the turnover data was not publicly available before and because the notional principal outstanding is significant. In the absence of actual data, the reference points for lawmakers and regulators were the cash and futures markets, all of which are high-frequency, standardised markets with a ticker recording trades every second, not hour.

In October, the Chicago Mercantile Exchange traded 34m eurodollar contracts, 22.9m futures contracts in 10-year notes, and 9.4m futures contracts in 5-year notes. Turnover on the New York Stock Exchange exceeds 1bn shares a day.

In these highly-liquid, standardised markets, real-time reporting and price transparency are meaningful concepts. When these concepts are applied to the OTC markets, adjustments should be made, especially given the fact that many of these low-frequency transactions have large notionals and need to be hedged discreetly to minimise hedging costs.

Also there are many non-G14 institutions that only trade a handful of new transactions per week or month; and real-time reporting would impose a cost which is disproportionate to the benefit to be achieved.

Certainly, there needs to be more transparency in the OTC markets and the current legislation and rule-making is moving the market in the right direction. However it is important for the new rules to reflect the realities of the market so regulators and the public have access to meaningful information. Intra-day reporting will place systems and cost burdens on institutions already restructuring to meet the demands of new legislation and regulation, and will not yield significant results to the public.

* The G-14 financial institutions include: Bank of America-Merrill Lynch, Barclays Capital, BNP Paribas, Citi, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, J.P. Morgan, Morgan Stanley, The Royal Bank of Scotland Group, Société Générale, UBS, Wells Fargo Bank.

Per Sjoberg is executive vice President and Susan Hinko global head of industry relations at TriOptima, provider of counterparty exposure management services

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