

Futurization of Swaps

A Clever Innovation Raises Novel Policy Issues for Regulators

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KEY TAKEAWAYS

- » The Dodd-Frank Act was designed to enhance safety of over-the-counter financial swaps markets. It directed the Commodities Future Trading Commission to require “standardized” swaps to be cleared through central clearinghouses. Some two and a half years after Dodd-Frank became law, the CFTC still has not implemented key swaps rules.
- » Meanwhile, rules governing futures transactions are less restrictive than current — and probably future — swaps rules.
- » Intercontinental Exchange, which announced plans to buy NYSE Euronext, and Goldman Sachs have circumvented swaps regulations by converting swaps contracts into futures. This futurization of swaps is likely to gather steam.
- » This regulatory arbitrage poses major policy challenges. It threatens the transparent trading of financial instruments, the free flow of pricing data, and the security of futures clearinghouses.
- » Policy makers could mitigate potential dangers by, among other measures, prohibiting common ownership of futures exchanges and clearinghouses as well as strengthening oversight of futures clearinghouses and increasing their capital requirements.

The revolution in securities trading advanced again last month with the announcement that the Intercontinental Exchange (ICE) had agreed to a friendly buyout of NYSE Euronext. In 2011, NYSE Euronext (a product of a cross-Atlantic merger involving the New York Stock Exchange) had tried and failed to merge with Germany’s largest exchange, Deutsche Boerse. The venerable Big Board, which has been around since the late 18th century, is now willing to turn over its keys to the Atlanta-based ICE, a relative upstart launched in 2000.

With the merger, ICE will enlarge its already dominant position in the trading of a broad array of financial instruments, including multiple futures contracts in the United States and Europe. That fact, however, should not pose sufficient antitrust concerns to nix the deal.

With some narrow exceptions, the two exchanges operate in different markets and don’t compete with each other: NYSE Euronext lists and hosts trading in stocks and certain European futures, while ICE is active primarily in U.S. futures markets and in European energy futures contracts. So this merger is likely to be approved, possibly with conditions, by the two antitrust agencies with jurisdiction, the Department of Justice in the United States and the Competition Directorate of the European Commission.

A far more interesting public policy issue relating to ICE, however, has so far escaped attention, and that’s the subject of this commentary. The issue grows out of ICE’s clever response to the sluggishness of the Commodities Futures Trading Commission, or CFTC, in developing rules under the Dodd-Frank Act for the trading and clearing of the roughly \$600 trillion annual market in financial “swaps,” some of which were at the center of the 2007-08 financial crisis.

Rather than wait for those rules to be finalized, ICE has converted its energy swaps operation to futures contracts. As more of this kind of regulatory arbitrage takes place -- an inevitable outcome unless policy makers slow it down or stop it -- more derivatives trading will move to the less protected and more monopolized world of futures trading, and away from swaps markets which are being regulated.

To understand the importance of this development, a brief refresher on swaps and what Dodd-Frank attempts to do about them may be helpful.

SWAPS PRIMER

Swaps come in many kinds and flavors, but, fundamentally, they are promises between two parties to exchange cash flows. They are derivatives because their value is derived from, or based on the value of, some other financial instrument, such as a loan or bond. Swaps are generally priced based on a notional value, which is the dollar value of a contract. For example, a \$1 billion credit default swap, or CDS, refers to the outstanding debt that’s insured, while the CDS’s actual market value, reflecting the likelihood of the seller actually having to make payment, is only a small fraction of the

notional amount.

Interest rate swaps, the most common type of swap at almost \$400 trillion in notional value, involve the exchange of payments on one type of loan (say, one made at a fixed interest rate) for payments on another type of loan (one whose interest rate generally fluctuates with a common benchmark, such as the controversial LIBOR).

A CDS is a contract under which the seller pays the buyer if the loan, or credit, defaults, and it's probably the most controversial swap arrangement. A CDS is the functional equivalent of default insurance on a loan, dressed up as a financial instrument that escapes insurance regulation.

That fact has led to a central criticism of CDS: Because buyers of the instrument need not actually own the loan and are hedging against its default by buying the CDS, these buyers lack an "insurable interest," which insurance regulators require property owners to have to keep from destroying their own homes simply to get the insurance money. Theoretically, any qualified buyer can purchase a CDS for speculative reasons, banking on default of the underlying loan, or at least on an increase in the market's perception of the likelihood of default, which pushes up the price of CDS protection.

Speculators have never been popular, but they provide important market functions. They often take the other side of trades that hedgers want and need. In addition, by providing additional liquidity to the market, speculators deepen the market for CDS, relative to the markets for the bonds they are protecting, which are often thinly traded. As a result, many investors and, in this author's view, regulators, can gain better real-time insight into the likelihood of a borrower's default by observing CDS prices than through any other method.

The central problem with CDS, at least before the financial crisis, is that the mechanisms for assuring that sellers of default protection had the financial means to pay up were inadequate. This was the root cause of AIG's near-failure and rescue by the Federal Reserve. The Fed's decision, no matter how necessary it may have been to save the financial system and the economy from disaster, has been one of the least popular decisions the central bank has ever made. It's the reason for much of the anti-Fed sentiment in Congress and among the general public since the crisis.

AIG's problems were two-fold. For one thing, the firm's CDS contracts were bilateral agreements between it and specific counter-parties, many of them large banking institutions, so that when AIG's solvency was threatened, federal policy makers feared its failure could have led, in domino-like fashion, to the collapse of other major financial firms. Second, because of AIG's size and its once-sterling AAA credit rating, its CDS buyers didn't insist that AIG offer sufficient collateral to back up its promises to pay in the event of default on the mortgage securities it was insuring. By the time those margin calls came, AIG didn't have the money to honor its commitments. The Fed felt it necessary to step in to save the financial system, which embodies the very essence of systemic risk.

TAKING OUT SYSTEMIC RISK

Dodd-Frank was enacted to prevent a reoccurrence of the events that led to the worst recession since the Great Depression. Given the many "causes" of that crisis, the act was complex and long. Title VII of the act, the portion aimed at curing the defects in the bilateral swaps markets, is one of its most important sections.

Among other things, Title VII required all "standardized" derivatives (those with standard terms and thus relatively easily traded) to be cleared through central clearinghouses, which would: set collateral (or margin) requirements, subject to regulatory oversight; bring trades more into the open through execution on "swaps execution facilities," or SEFs, akin to exchanges that handle equities and futures trades; and report prices of completed trades by trade repositories.

The central clearing mandate eliminated, at least for standard swaps, the types of bilateral arrangements that brought down AIG. That's because the clearinghouse would be the counter-party to the trades instead of the parties themselves (i.e., the buyer directly to every seller, and the seller to every buyer). Although mandated clearing concentrates risk in the clearinghouse, experiences with similar approaches in the banking, equities and futures arenas shows that, with the proper amounts of collateral, capital and loss-sharing provisions, clearinghouses can operate safely. The act implied, and regulators have since formalized, the designation of clearinghouses as "systemically important," which means that in a pinch the Fed would lend them money.

Before the financial crisis, all off-exchange, or over-

the-counter (OTC), derivatives trades were conducted by dealers on the telephone, with customers left in the dark about true current prices, liquidity and spreads (the difference between the best available offers to buy and sell). The SEF rules and the post-trade reporting provisions are supposed to turn much of the OTC derivatives market into a much more transparent marketplace that resembles equity markets.

Although simple to state, the primary derivatives provisions of Dodd-Frank have proven complicated to implement. While the law directed the CFTC and SEC to set common rules to move OTC derivatives out of the shadows, many of the most important rules still have not been issued, some two and a half years after the president signed Dodd-Frank into law. In particular, customers still don't know whether they have to register with regulators as "swaps dealers" or how onerous those requirements will be. In addition, market participants don't know precisely what will qualify as a swaps execution facility, and, in particular, whether SEFs will be permitted to accept trades by phone or must be electronic. Perhaps most critically, regulators haven't yet set the all-important margin requirements, especially for customized derivatives that aren't required to be traded on SEFs.

To complicate matters, U.S. regulators must take account of — and ideally try to harmonize with — swaps regulation in other countries, notably the United Kingdom, Germany, Japan, Hong Kong and Singapore. Otherwise, if U.S. swaps regulation is viewed by market participants as too onerous, swaps activity, along with the related systemic risks, may move offshore. Given the sluggishness of U.S. rulemaking, some swaps activities have moved to other markets.

Still, some progress toward central clearing of OTC derivatives trades has been made. LCH Clearnet operates a facility, SwapClear, which already claims on its website to clear more than half of all interest rate swaps.

Now let's get back to the International Clearinghouse. ICE operates ICE Clear Credit, the dominant CDS clearinghouse in the U.S. According to its website, the ICE clearinghouse has cleared more than \$20 trillion of CDS trades in notional value. The major CDS dealers are clearing members of ICE, which means they contribute to Clear Credit's guaranty fund, which is designed to honor obligations of members that default. The clearinghouse also has rules, like

bank clearinghouses, for unwinding trades of defaulting members if the guaranty fund proves insufficient.

REGULATORY ARBITRAGE AND SWAPS

One hallmark of financial regulation is its cat-and-mouse-like character. Because of rapid innovation and the creativity of financial actors and their attorneys -- not all of it in the public interest, of course, as the development of complex securities backed by subprime mortgages demonstrates -- regulators are constantly one step behind the market participants they are charged with regulating. This fact is especially true with respect to "regulatory arbitrage," or innovations prompted by efforts to shift financial transactions away from forms or venues subject to heavy regulation.

Until now, the two regulatory bodies overseeing the U.S. swaps markets, the SEC and the CFTC, have been worried only about geographic regulatory arbitrage, or the movement of swaps transactions out of the country. But in testimony in December before a subcommittee of the House Financial Services Committee, a number of market participants said a different and unexpected regulatory arbitrage was occurring. The leader of this new and entirely lawful development, which, if extended and replicated, would circumvent much of the regulatory apparatus envisioned for swaps by Dodd-Frank, is none other than ICE.

ICE's innovation lies in the recognition that a swap is largely the functional equivalent of a futures contract. A swap is a long-dated promise to exchange payments. Likewise, a futures contract implies an obligation to make a delivery or payment of a certain amount at a future date. So last October ICE converted its energy swaps to futures.

Several things could easily drive more swaps to be characterized as futures. Margin requirements on futures contracts are lower than those for swaps, which is reason enough to drive the switches. But other regulatory differences make it easier and less costly to conduct a trade as a futures contract. Among the most important are pending rules that will require traders with transactions above \$8 billion (notional value) to register as a swap dealer, giving them special reporting and compliance obligations that don't apply to futures traders. Current rules also require less frequent reporting of futures trades than swaps transactions.

Since ICE already dominates swaps clearing, and, as a result, is positioned to be a major swaps execution facility, as well, why would it be the first mover

to switch swaps to futures? Perhaps it's because once ICE executives realized how easy it was to accomplish the switch, they figured it would be better to get out in front of the parade, along with Goldman Sachs, which has announced similar plans, than to lag behind.

The same executives may also believe that the company can make more money by hosting futures transactions on their existing exchanges, which may be subject to less cumbersome regulation than the untested and undefined SEFs. In addition, given the potentially high capital requirements for operating swaps clearinghouses, ICE may believe it can earn more profit by directing swaps traffic to futures exchanges and earning its money from exchange fees, including charges for trade data.

This is especially true because in the futures markets, unlike the swaps market in which transactions executed on SEFs may be cleared on any clearinghouse, exchanges and clearinghouses tend to be commonly owned, much like a "walled garden." The Justice Department has criticized the vertical integration of trade execution and clearing, saying it hampers competition in exchange activity and raises barriers to entry for exchange services. The result, according to the department, discourages innovation in exchange activity and perpetuates high prices for exchange services.

The CFTC hasn't acted on this concern of common ownership of exchanges and clearinghouses. The possible tidal wave of swaps conversions into futures may give the commission strong reasons for reconsidering.

TURNING SWAPS INTO FUTURES

Some may argue that the migration of swaps onto futures exchanges either was intended by Congress all along in enacting Dodd-Frank or that, at the very least, this outcome is consistent with congressional intent and shouldn't raise red flags.

The broad claim — that Congress specifically wanted the futurization of swaps — is difficult to take seriously. If that were the case, why would Congress require the CFTC and SEC to write an elaborate set of rules only for swaps transactions? And why would Congress have wanted those rules to be so onerous and long-in-coming, giving participants in financial markets incentives to circumvent them? There is no evidence in the legislative history of the act that Congress intended either outcome.

There is some merit to the view that the futurization of swaps is consistent with Dodd-Frank's objectives, because futures transactions are conducted on exchanges and centrally cleared. But this outcome was not one that Congress anticipated. In addition, the futurization of swaps poses several policy problems that neither the CFTC nor the SEC have addressed.

First, margins on futures contracts are calculated differently from and are lower than those for swaps. This is a strong reason by itself for the migration from swaps to futures. But as this migration continues and volumes of transactions cleared on futures clearinghouses soar, the lower futures margins raise an all-important policy question: are these futures clearinghouses exposed to a greater risk of failure than the swaps clearinghouses they may displace? Neither the CFTC nor anyone else has answered this question.

This issue is of great importance because Congress enacted Title VII of Dodd-Frank specifically to reduce the systemic risk associated with swaps (or swaps-like) transactions. It's not satisfactory to say that the Fed can, as it has, designate large futures clearinghouses as "systemically important," implying they could be rescued in a future financial crisis. No one wants a system in which the likelihood of such rescues increases, both because of the moral hazard risks and the risks to taxpayers that future bailouts would entail.

Second, once the CFTC fully implements its rules on price reporting of swaps transactions, there will be less transparency if swaps move to futures exchanges. Swaps transactions are eventually supposed to be reported in real-time, but there's a 10-minute delay in futures price reporting. Ten minutes may not sound like a lot, but it's an eternity in the financial markets.

There's another difference in transparency between the two markets. Again, under rules to be finalized under Dodd-Frank, swaps prices are to be reported to publicly available data repositories, where investors (or anyone else) can get them for free. In contrast, at least up to now, futures exchanges claim to own the prices they report and charge for their release. ICE, for example, has been granted a license from Markit, the leading provider of CDS pricing information, to be the provider of CDS futures contracts that refer to indexes owned by Markit. ICE stands to profit from a potential explosion in trading of CDS futures and the revenue from the license to sell data about those prices.

In addition, unlike in swaps markets, futures ex-

changes control the size of “block trades” for futures contracts. Predictably, the exchanges have managed this detail to their advantage by making the sizes of block trades so low that almost every swap-like futures transaction is conducted outside the transparent exchange order book and over the phone. So instead of pre-trade transparency, which benefits the public and which Congress established as a goal of Dodd-Frank, the markets for swaps-like futures contracts will be left with the same opaque pricing and wider bid/ask spreads that were an impediment to price discovery during the financial crisis. Whether an instrument is called a swap or future will determine its price transparency and who can make money from that pricing information.

Dodd-Frank has created other regulatory differences between swaps and futures, with more user protections for swaps than futures. One area of attention involves segregation of customer funds, which has been inadequate in the futures arena, as demonstrated in the failure of MF Global. If credit default and interest rate swaps can be easily cross-dressed as futures, these other business-conduct protections (such as those applying to “special entities” such as schools and municipalities which in the past have been victimized by interest rate swaps that were ill-suited for these customers) will prove meaningless.

WHAT HAPPENS NEXT

In an ideal world, the CFTC would go back to the drawing board to ensure that each market is safe and has appropriate business-conduct rules. This would establish a more level playing field (nothing in finance can be perfectly level) and substantially reduce the incentives for regulatory arbitrage. Such an effort would ideally be coordinated with international regulations, much as the CFTC and SEC have been trying to do with swaps already. It’s also possible that Congress may get involved as part of a possible Dodd-Frank corrections act in 2013.

But all this will likely take so much time that much of the swaps market will migrate to futures before rules can be harmonized. One outcome is to live with whatever happens, and take consolation in the fact that at least standardized swaps-like instruments will be exchange-traded and cleared (on futures platforms, of course, rather than swaps platforms). More consolation may be gained from the fact that not all swaps

are likely to disappear, especially customized swaps for which standardized futures contracts will prove no substitute. In addition, jurisdictions where standardized swaps are not subject to heavy regulation, as in Europe and Asia, are likely to see swaps transactions migrate to those locations.

Another possibility, at least in principle, is for the CFTC to halt the trading of swaps dressed as futures for a sufficient period -- perhaps 6 to 12 months -- until the two regulatory regimes can be brought closer together. This idea, however, is antithetical to financial innovation and could be difficult to implement and enforce. (Clever lawyers will argue that new futures products are not really swaps.)

Likewise, it’s not clear that a satisfactory regulatory medium can be reached during a moratorium to give swaps and futures rough regulatory parity. Futures regulation would have to be toughened, while swaps regulation in the works would have to be relaxed. Who’s to say the result will be the right one? Again, if futures regulation is toughened here and not overseas, U.S. regulators will face their geographic regulatory arbitrage nightmare in the futures arena, not in swaps transactions.

A third outcome may prove the best: the CFTC could take seriously and implement the Justice Department’s idea of divorcing common ownership of exchanges and clearinghouses. This approach would remove barriers to entry in exchange markets, while enabling market participants to choose their clearing arrangements. Admittedly, clearing may tend toward monopoly, which some scholars argue is inevitable. But if this is case, then all the more reason not to permit exchanges to own clearinghouses, since the natural monopoly characteristics in clearing could end competition among exchanges.

Three supplements to this third outcome are worth considering. The CFTC could harmonize price reporting rules for the two markets, treating futures like swaps, so that all futures transaction data are reported to public repositories and made publicly available to consumers in real-time. This would ensure low-cost price transparency in both markets. In addition, the CFTC, or the new Financial Stability Oversight Council, could toughen their oversight and increase capital requirements for futures clearinghouses, which in a world of swaps-turned-into-futures will be more important sources of systemic risk.

Finally, the CFTC could require clearinghouses to treat futures contracts with identical terms that are listed and traded on different regulated futures exchanges as interchangeable for clearing purposes; in other words, futures contracts should be fungible as standardized swaps are. European financial policy is headed in this direction to reduce monopoly power and advance competition in the derivatives space. Adopting this concept in the U.S. seems reasonable, given that clearinghouses, such as those operated by ICE and the Chicago Mercantile Exchange, have been designated as “financial market utilities” by the FSOC, which underscores their public importance. If they are so important, shouldn’t customers that trade futures on

any futures exchange be able clear those futures at any clearinghouse that proudly holds the title of “financial market utility,” rather than being restricted to clearing their trades only at the exchange where their transactions are completed?

Ultimately, it may not possible, or even desirable, for financial regulators to fight the inevitable cat-and-mouse forces of innovation. That’s likely to be a losing battle. But regulators can -- and should -- set ground rules for regulatory arbitrage to limit its detrimental impacts on users of financial products and to contain the systemic risks that arbitrage may pose.

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Litan, who joined Bloomberg in August 2012 after serving as vice president for research and policy at the Kauffman Foundation and a senior fellow at the Brookings Institution, had previously been vice president and director of the institution’s Economic Studies Program. He is the author or co-author of more than 25 books and 200 articles about government and regulation, including the 2010 paper, “The Derivatives Dealers’ Club and Derivatives Markets Reform: A Guide for Policy Makers, Citizens and Other Interested Parties. That paper can be found at: http://www.brookings.edu/~-/media/research/files/papers/2010/4/07%20derivatives%20litan/0407_derivatives_litan.pdf

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