Going from strength to strength

Richard Metcalfe of ISDA looks at the forces driving the international derivatives markets and sees good reason for their continued growth in the coming year.

The millennium bug did not bite after all. In fact, the world managed to avoid catastrophe in the year 2000 – its bilaterally negotiated derivatives markets even took on new strength and energy. And, far from the computer's potential frailty holding the markets' attention, it was its challenge to traditional ways of doing business that caught the eye.

The headlines for the year went something like this:

- millennium bug crawls away;
- trading volumes bounce back;
- credit derivatives grow ever faster; and
- e-business comes to derivatives.

Each of these points is worth a story in its own right, as is the way the derivatives markets continue to play a major role in international finance. What this article will aim to do is to pull all these individual stories together and draw some general conclusions about where derivatives are heading as we approach 2001.

While for some of us the millennium bug seemed little more than a bad dream, from ISDA's perspective it was an important episode.

Any potential for disruption in derivatives markets is a serious matter, raising the prospect of deals (and even whole relationships) being terminated, as foreseen in the ISDA documentation. So the process of agreeing how to cope with such an eventuality – which may hold up derivatives-related payments for reasons other than true creditworthiness – is important.

For the majority of market participants, terminating deals and relationships is a last resort and is therefore to be avoided unless truly necessary. As the year 2000 rolled in, financial institutions could draw confidence from the fact that not only were their lifts and dealing screens still working – but from the knowledge that even indirect impact of the bug would not necessarily trigger immediate and drastic action in the dealer community over derivatives exposures.

Derivatives volumes, meanwhile, just keep growing. Volumes are published with some time lag, and the only confirmed figures at the time of writing stop at end-June 2000. But even these show a trend that has every reason to continue to the end of 2000 and beyond.

It is well known that 1998 and 1999 were overshadowed by events that tended to depress volumes: the aftermath of the Russian default of 1998; the introduction of the euro in 1999 (and the consequent disappearance of a number of important currency pairs); and the threat of millennium bug chaos in 2000. In the end, though, volumes in 1999 remained strong, with OTC notional outstandings hitting $88trn (representing gross market values of $2.8trn[1]). This was up 10% on the figures as of end 1998 ($80 trillion), with a further rise to $94trn by the end of June 2000.

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With nothing to hold the markets back in 2000, it is reasonable to expect continued solid growth. Derivatives have been the subject of intense regulatory and press scrutiny in recent years, but have emerged stronger than ever.

Accounting challenge

The truth is that in a world where economic uncertainty is part of daily life, derivatives are proving their usefulness in an ever growing number of situations. Now the challenge is to ensure they are afforded appropriate accounting treatment. ISDA continues to be concerned where accounting standards treat derivatives as though they are only designed to introduce risk – not, as it is more accurate to say, to manage it.

More positively, legal and regulatory advances to support the growth of bilaterally-negotiated derivatives are in prospect in various economies. In some, such as the US, derivatives have already been around for some time. While in others – notably in Eastern Europe – the advances will strengthen still developing markets.

A significant new area of usefulness for derivatives in recent years has been in relation to credit. The rise of credit derivatives was a key theme of an article by ISDA for *The Treasuser* this time last year – and we make no apologies for tipping this market again.

While the proportion of overall derivatives business attributable to credit derivatives remains modest (less than 10%), anecdotal evidence from market sources suggests that average deal size, peak deal size, average tenor and peak tenor have all increased in the last 12 months, as well as deal volumes. There is no reason why this growth should not continue.

Capital rules for banks

Contributing to this positive outlook is the trend in international capital rules for banks. The 1988 Basel Capital Accord gave only limited recognition to the use of collateral and acknowledged only a limited range of assets that would be eligible as such. Proposals published last year by both the Basel committee and the European Commission promise improvements on both fronts – the range of eligible assets and the degree to which any of them will be recognised when used as collateral.

This in turn is part of a broader move to recognise the effects of a number of credit risk mitigation techniques, including on-balance sheet netting, guarantees and credit derivatives.

The underlying point is not widely appreciated, but it is of increasing significance to the bilaterally negotiated derivatives markets. The ability to manage credit risk dynamically allows intermediaries to offer easier access to these and other markets. Credit derivatives are a good example of this principle at work. Similarly, the ability to post and receive collateral in a legally secure environment – and with due recognition in capital terms of the credit risk reduction achieved – can have a huge benefit for the effectiveness of capital markets, including derivatives.

For this reason, ISDA is particularly heartened by the prospect of a European directive on collateral law reform. For those wishing to learn more about this, the crucial importance of credit risk mitigation, particularly in the form of collateral, is highlighted in a survey published by the Association in March 2000 – the 'ISDA 2000 Collateral Survey'[2].

One of the remarkable things about smaller sub-sets of derivatives markets, including credit derivatives, is that they are attracting electronic trading initiatives just as much as the higher-volume sections such as interest rate swaps. At a recent ISDA member update held in London, over a dozen initiatives covering front, back and middle offices in all distinct product areas and customer groups were represented.

A word of caution though. Electronic trading has yet to prove itself in the derivatives markets, and the coming year is more likely to be one of assessment and experimentation – not necessarily the revolution often believed to be taking place in e-business.

As outlined above, initiatives are going on at various levels. And some of them involve the development and promotion of new internet-oriented language as much as the creation of networks and trading platforms. This may have as much impact on operations – an increasingly important area for ISDA members – as on trading.

Moreover, much of this development is happening within industry groupings, rather than through commercial ventures. This would suggest that the internet will complement existing business models – not rewrite them.

A similar point could be made about the impact of the internet on documentation. ISDA has already moved to make some forms of documentation available electronically.

It has been actively investigating the implications of the web for its various forms of deal documentation over the past year, the results of which will be published soon. Again, progress here is likely to be through evolution rather than revolution.

This article has focused on some headline issues. I have not addressed the constant and significant activity that ISDA supports in documentation, market practice and regional development across a range of derivatives markets. (ISDA now has offices in Singapore and Tokyo, to complement London and New York.)

Issues such as the accession of the Greek drachma to the euro, for instance, and the ruling in the Peregrine case have been part of the ISDA case load in the past year. But the fundamental moral is the same – whichever individual stories you examine: derivatives are an established part of the global economy, and in maturity they promise even more than in their youth. ■

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Rules and regulations

An important dimension of the rise of e-business has been the regulatory supervision of what are being called 'alternative trading systems' or 'electronic communication networks'. On behalf of its members, ISDA takes a close interest in regulatory treatment of derivatives and has identified significant issues that require careful handling in order not to jeopardise the health of the OTC markets.

There is a misguided perception that because electronic trading is on the increase in 'organised' markets, then all electronic trading constitutes an 'organised' market. This is clearly false logic, but its application poses a serious threat to the health and flexibility of the bilaterally-negotiated derivatives markets. These involve counterparties who either are aware of the risks they are incurring or are covered by investor protection rules.

To impose an extra layer of regulatory supervision is to impose costs (when the whole point of electronic business is to reduce these) and – just as important in the context of the broader economy – to introduce constraints of time and manoeuvrability on these markets, just when they have demonstrated that their greatest strength is their responsiveness to individual requirements.

Whatever the future of electronic activity in the derivatives markets – a subject covered in more detail in the main article – it seems clear to ISDA that the mechanism is not the relevant factor, but the economic service delivered. The reality, though, is that this point may have to be made strongly over the next year and, more, to preserve the efficiency of the derivatives markets for all its participants. ■

Notes

1 This figure translates to a gross credit exposure – that is, gross market values after taking into account legally enforceable bilateral netting agreements – of just over $1trn. All figures are from the Bank for International Settlements.

2 Copies of this survey are available at www.isda.org. Also on the ISDA website are *ISDA Guidelines for Collateral Practitioners* and the *ISDA 1999 Collateral Review*. ■