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November 17: Market Risk - New 'Warehouse' for Derivatives

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A group of investment banks and fund managers have joined forces with America's dominant settlements platform to launch an institution that can record, monitor and help process trades in the credit derivatives market.

It is the first time that a centralized "warehouse" of this type has been created in the "over-the-counter" derivatives sector.

The scheme, which is being run by the Depository Trust & Clearing Corporation should significantly strengthen the infrastructure of the credit derivatives market, which is attracting growing involvement not just from hedge funds and banks, but pension funds and other mainstream investors.

However, it could also reduce the incentive to move this lucrative derivatives business onto an exchange in the future.

Although derivatives businesses have often "migrated" onto exchanges as they have matured in the past, the creation of a centralized warehouse in the OTC market will now offer many of the attractions that exchanges have traditionally provided. "This [project] is a just-in-time technological solution necessary to support our vibrant OTC market," said Robert Diamond, president of Barclays.

The move comes after a year in which investment banks have come under severe pressure from regulators to improve the infrastructure of the credit derivatives world. In particular, regulators have become increasingly concerned that sloppy trading practices in this sector could pose a risk to the financial system, since investment banks were keeping lax records of deals.

The industry has exploded in size over the past year, with gross outstanding contracts now believed to total \$26,000 billion.

In the past year, banks have tried to improve trading practices by cutting their backlogs of unprocessed deals and turning to electronic trading systems. The new system will take this further by offering a centralized platform for confirming and processing trades, as well as a means of recording all trades over a five-year period, and tracking any legal changes to these deals.

This should make it easier for banks to value trades in a standardized manner and for regulators to track the market.

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