



# ICFR roundtable The future of international OTC derivatives regulation

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International Centre for  
Financial Regulation

## The objectives of the session:

1. Understand the issues within the OTC derivatives market that have led to calls for greater regulation, centralised clearing and exchange-trading
2. Determine potential effects of, and problems with, outstanding and forthcoming regulatory proposals
3. Discuss alternatives

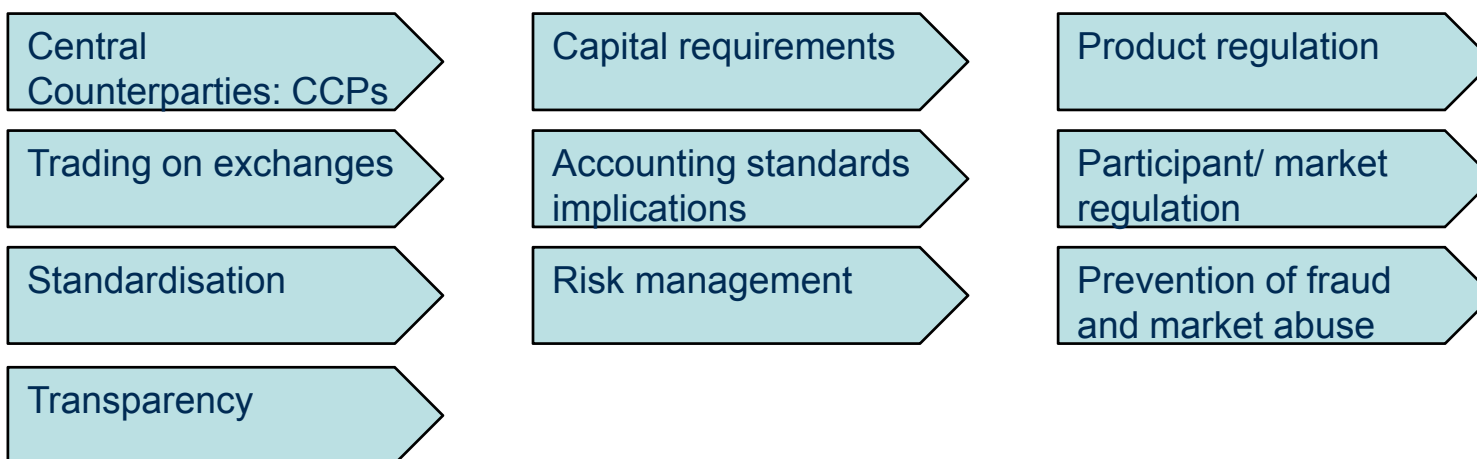
# Contents

- Key questions for the debate
- Introduction to derivatives
- Regulatory landscape
- Current regulatory proposals

# Key questions for the debate

- Why do legislators see a need for OTC derivatives specific regulation?
- Where do EU and US proposals differ?
- The corporate response
- Clearing
- Trade reporting and data warehousing
- Exchange trading

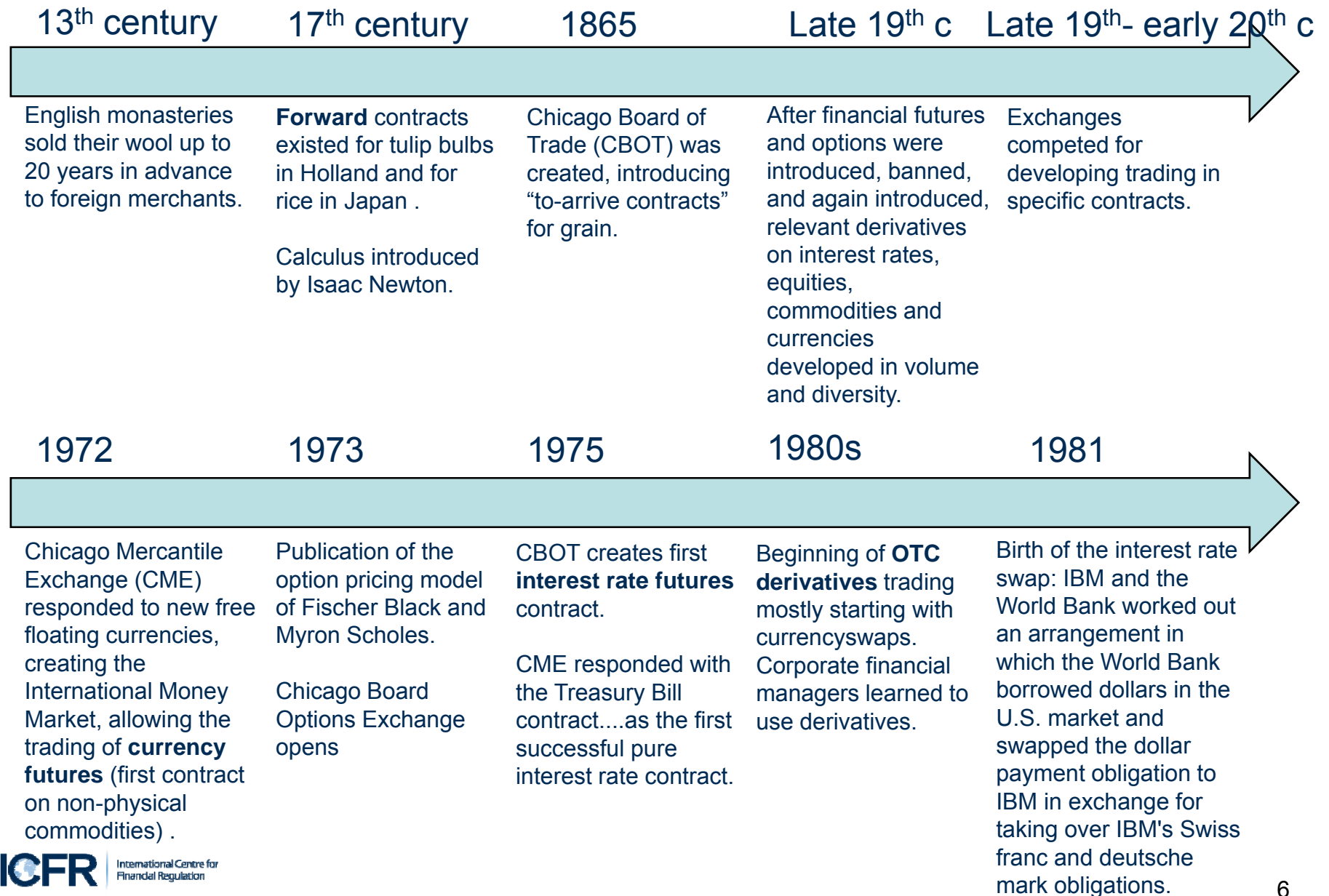
## Underlying key aspects of the topic



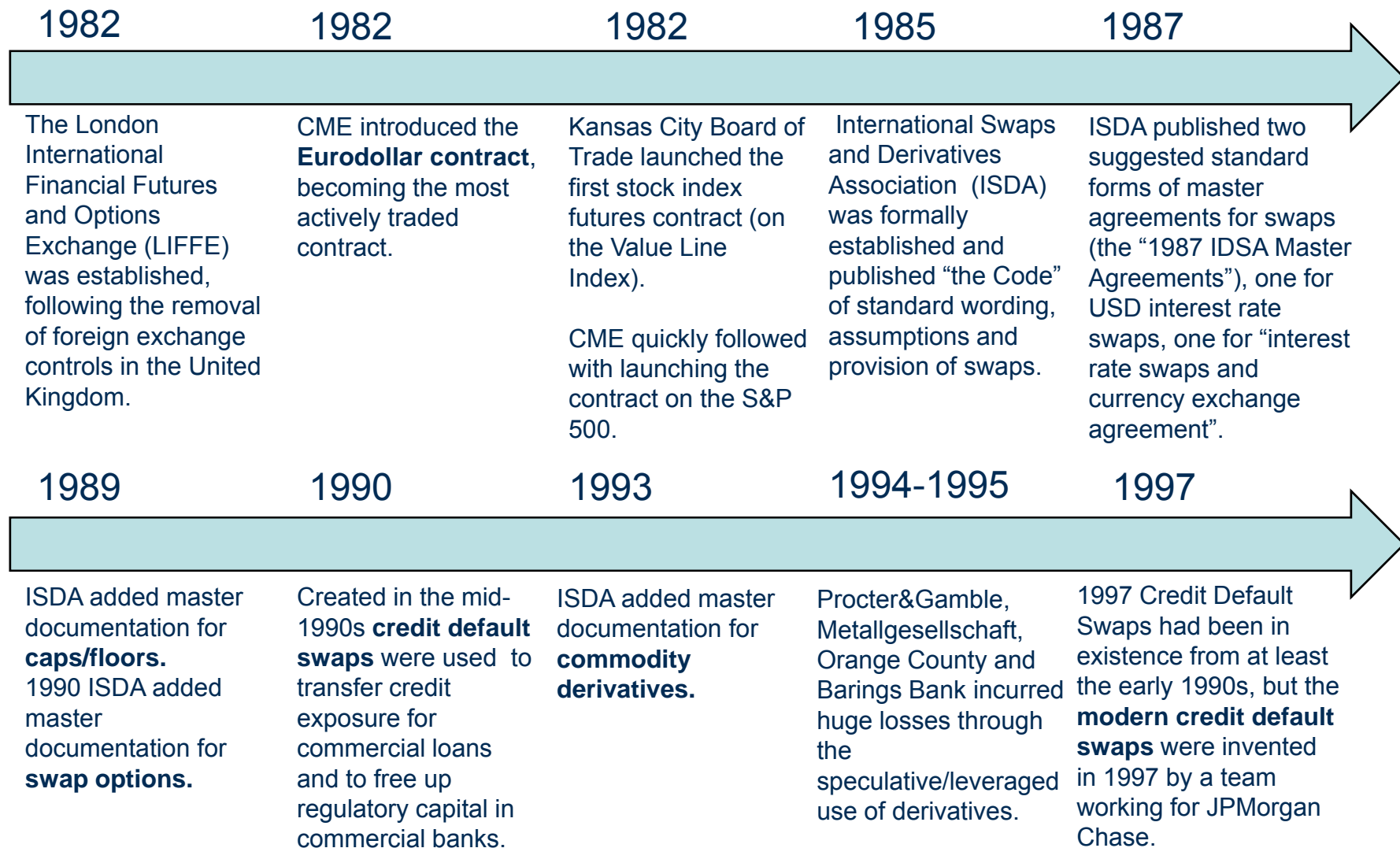
# Introduction to derivatives

- Derivatives are financial instruments whose value is derived from the value of an underlying asset
- Two types:
  - Traded on exchanges
  - Privately negotiated between two parties - the over-the-counter (OTC) derivatives
- OTC derivatives are not standardised but rather tailored to meet a specific need

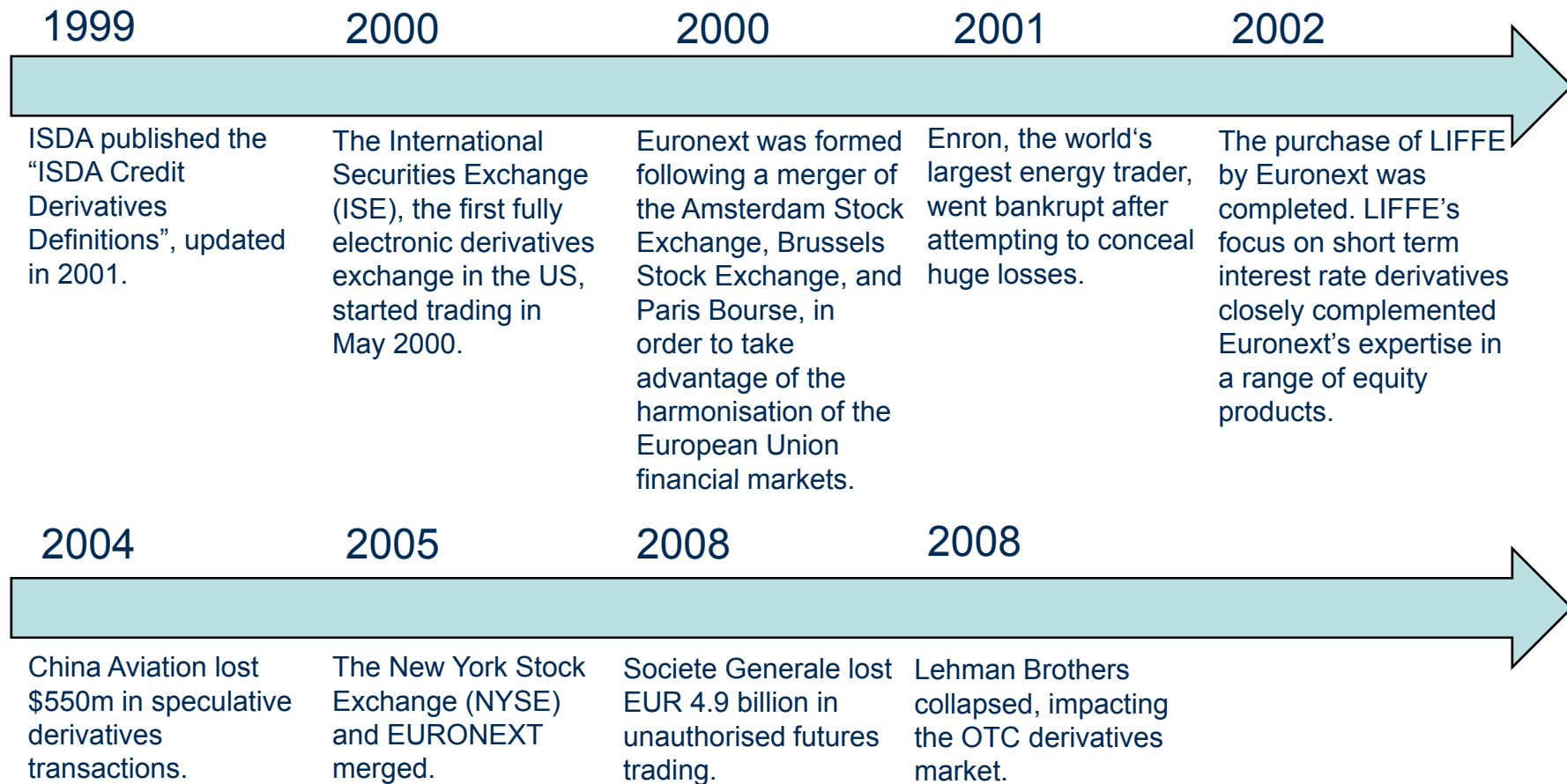
# A brief history of OTC derivatives



# A brief history of OTC derivatives - 2



# A brief history of OTC derivatives - 3



# Why are derivatives at issue?

The unintended consequences of derivatives use are at issue rather than the instruments themselves:

1. Lack of centralized reporting on OTC derivatives made it difficult for counterparties to know each others' full positions causing mistrust and further eroding market confidence.
2. Derivatives permitted the build up of position risks with a lower level of capital than required when transacting in the underlying, effectively leveraging their positions.
3. Risks build up in good times and materialise in bad times.
4. Inter-bank business came to substitute for client business, particularly among financial institutions in search of yield (Landesbanks, for example).

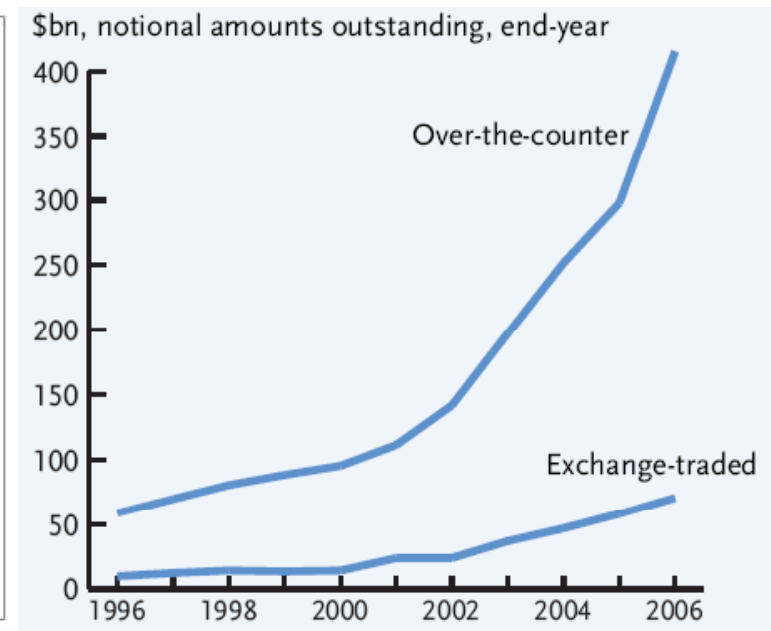
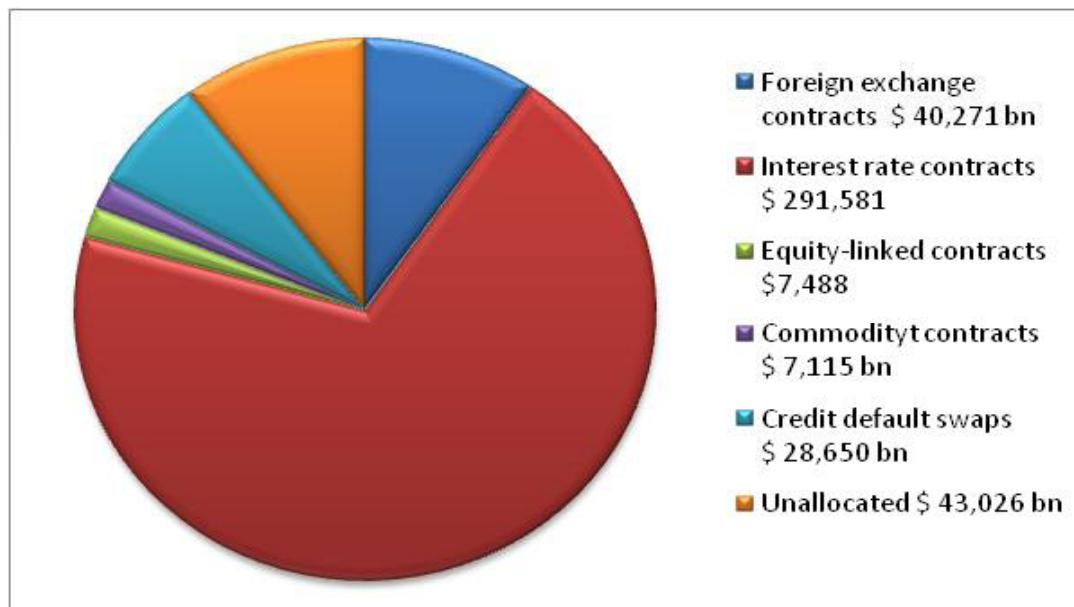
# Introduction to derivatives

- How to encourage innovation while maintaining some control
- How to encourage diversity and liquidity
- How to monitor (and control if necessary) systemic risks and pro-cyclical feedback effects
- How to restore trust in the system:
  - Transparency
  - Supervisory understanding
  - Counterparty risk management
  - Market risks management
  - Timely/efficient derivatives processing and documentation.
- The use of incentives vs, rules
- Equilibrium between risk control and economically viable derivatives prices.

# The international OTC derivatives market before the crisis

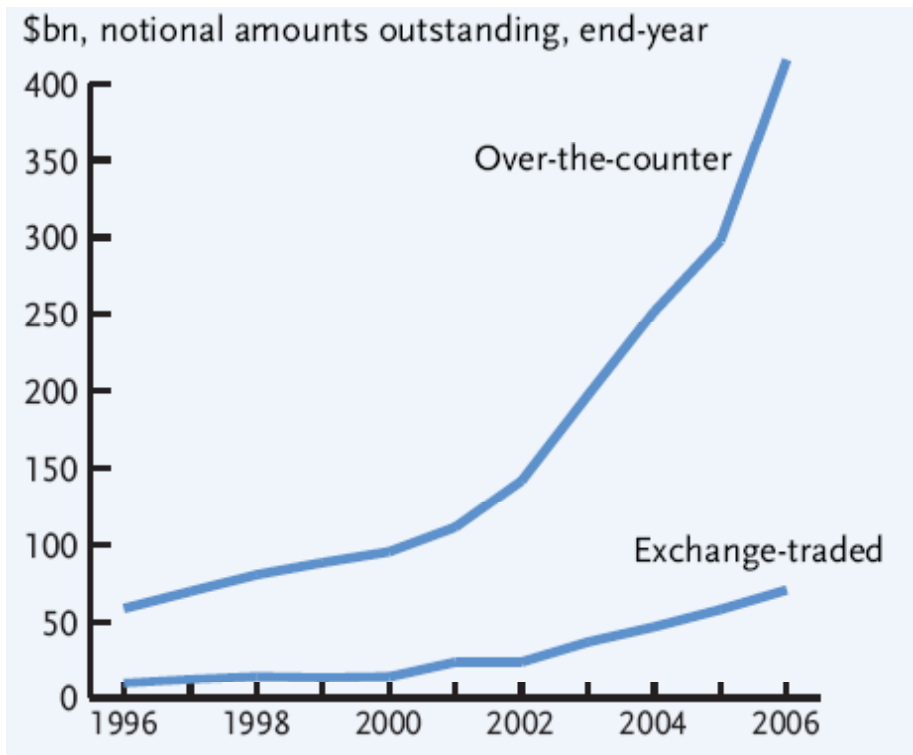
In terms of notional value, the OTC market was about 10 times bigger than the exchange traded market.

December 2006



Total OTC derivatives notional principal outstanding: \$ 418,131 bn

# Impact of the crisis on the derivatives market



# Impact of the crisis on the derivatives market

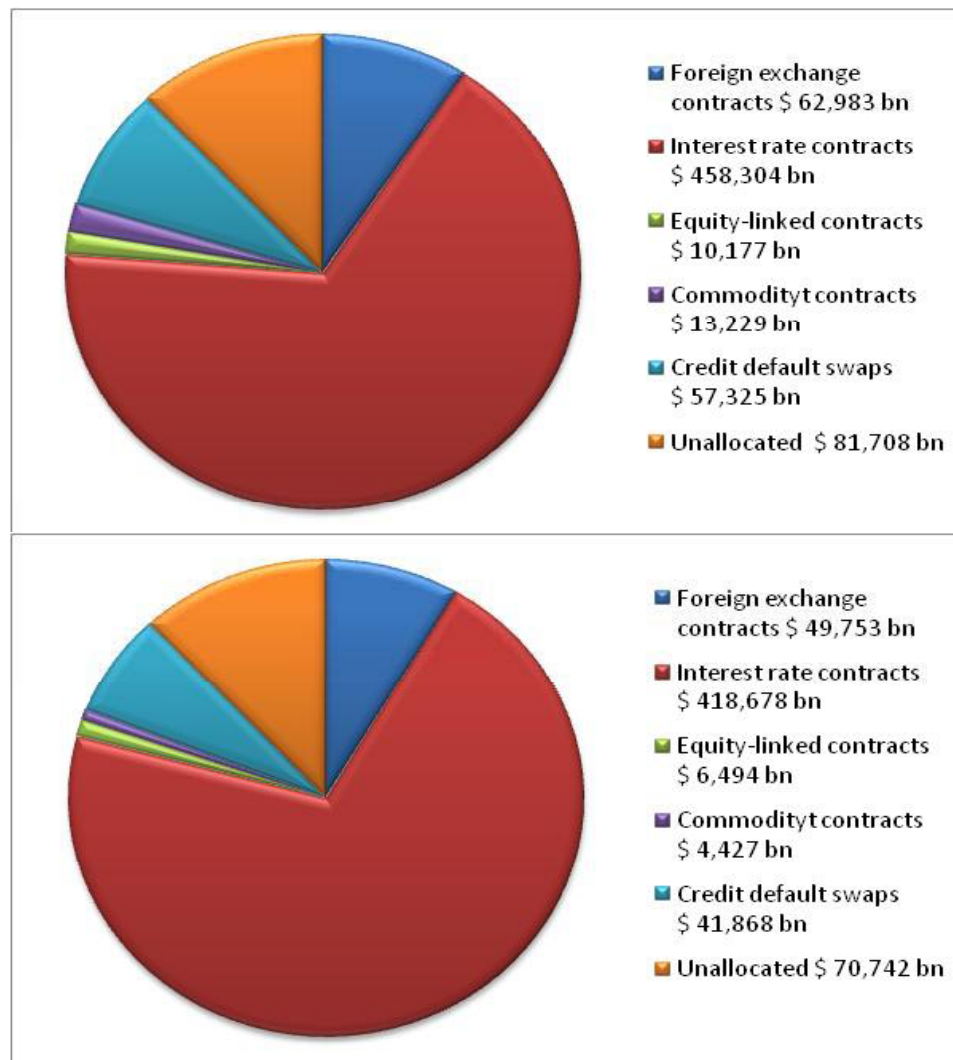
June 2008

Total OTC derivatives notional principal outstanding : \$683,726 bn

CDS trade volumes dipping at the end of 2007 while overall OTC derivatives trading decline started in the middle of 2008.

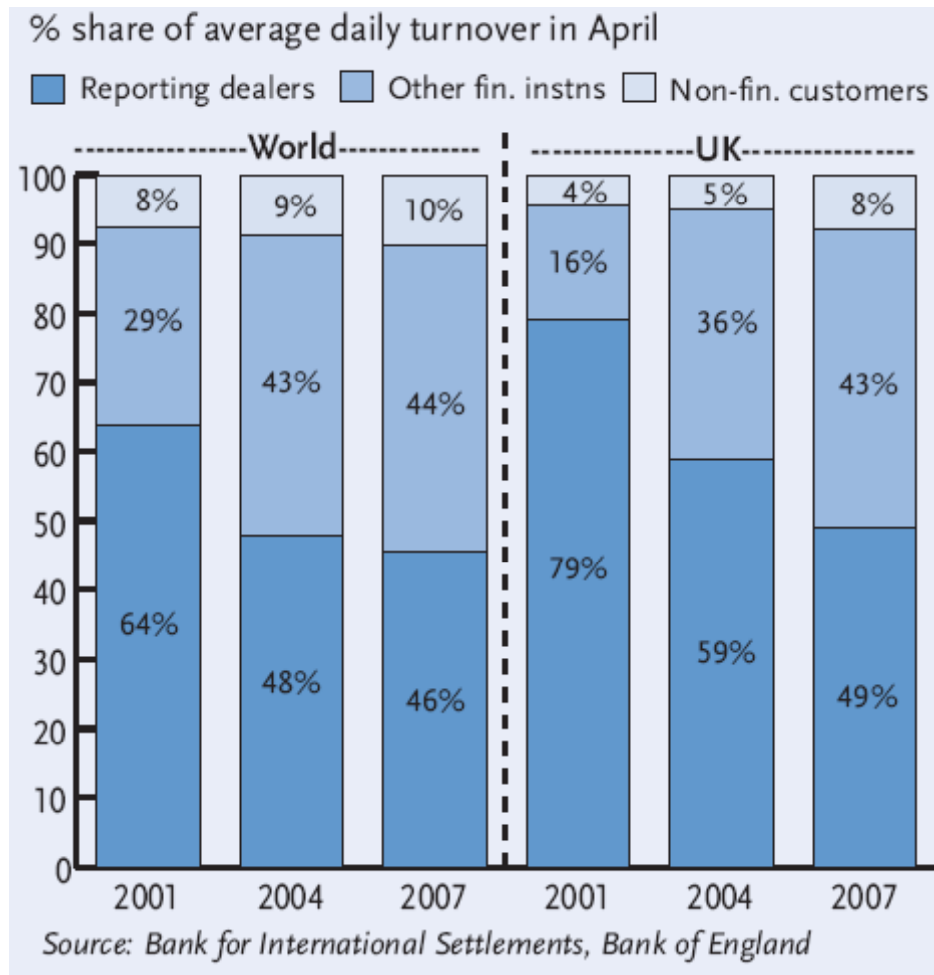
December 2008

Total OTC derivatives notional principal outstanding: \$591,963 bn



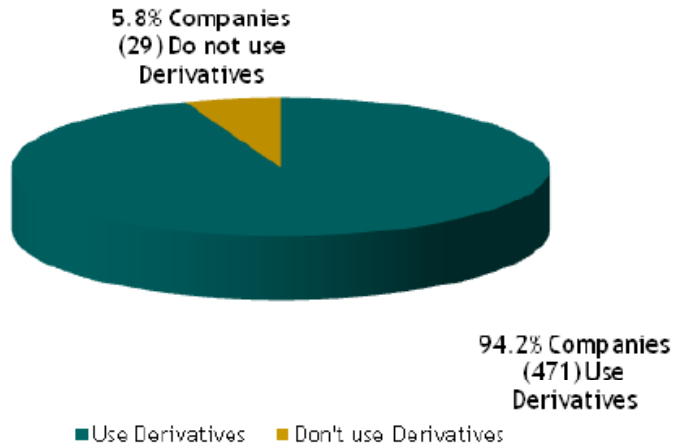
# Key stakeholders in the debate

## Counterparties in OTC derivatives markets in the world and the UK



The major feature of the global counterparty breakdown was a further rise in the share of other financial institutions to 44%, close to the 46% share of reporting dealers. The global share of non-financial customers also edged up to 10%. Distribution of trading by counterparty in the UK was more closely aligned with global shares in 2007 than previously.

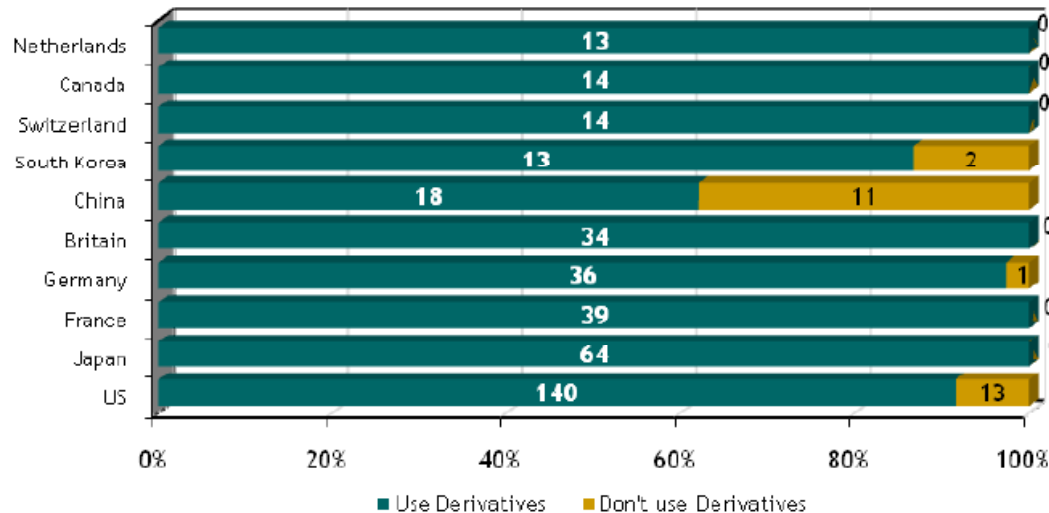
# Corporate users of derivatives



Usage by Sector

Sector Name	Total	% Using Derivatives	% Using Interest Rate	% Using Forex	% Using Commodity	% Using Credit	% Using Equity
Basic materials	86	97%	70%	85%	79%	0%	6%
Consumer goods	88	91%	81%	84%	39%	1%	9%
Financial	123	98%	94%	96%	63%	76%	80%
Health care	25	92%	80%	72%	8%	4%	20%
Industrial goods	49	92%	86%	86%	37%	2%	20%
Services	40	88%	75%	85%	35%	3%	13%
Technology	65	95%	86%	92%	15%	6%	15%
Utilities	24	92%	92%	88%	83%	0%	8%
Total	500	94%	83%	88%	49%	20%	29%

Top 10 Countries: Highest Reported Use of Derivatives



Source: ISDA survey report 23 April 2009: Derivatives use by the world's 500 largest companies

# The Regulatory Landscape

- History of Regulation
- Key Regulators involved
- Timeline on Consultations

# Existing regulation with implications for derivatives

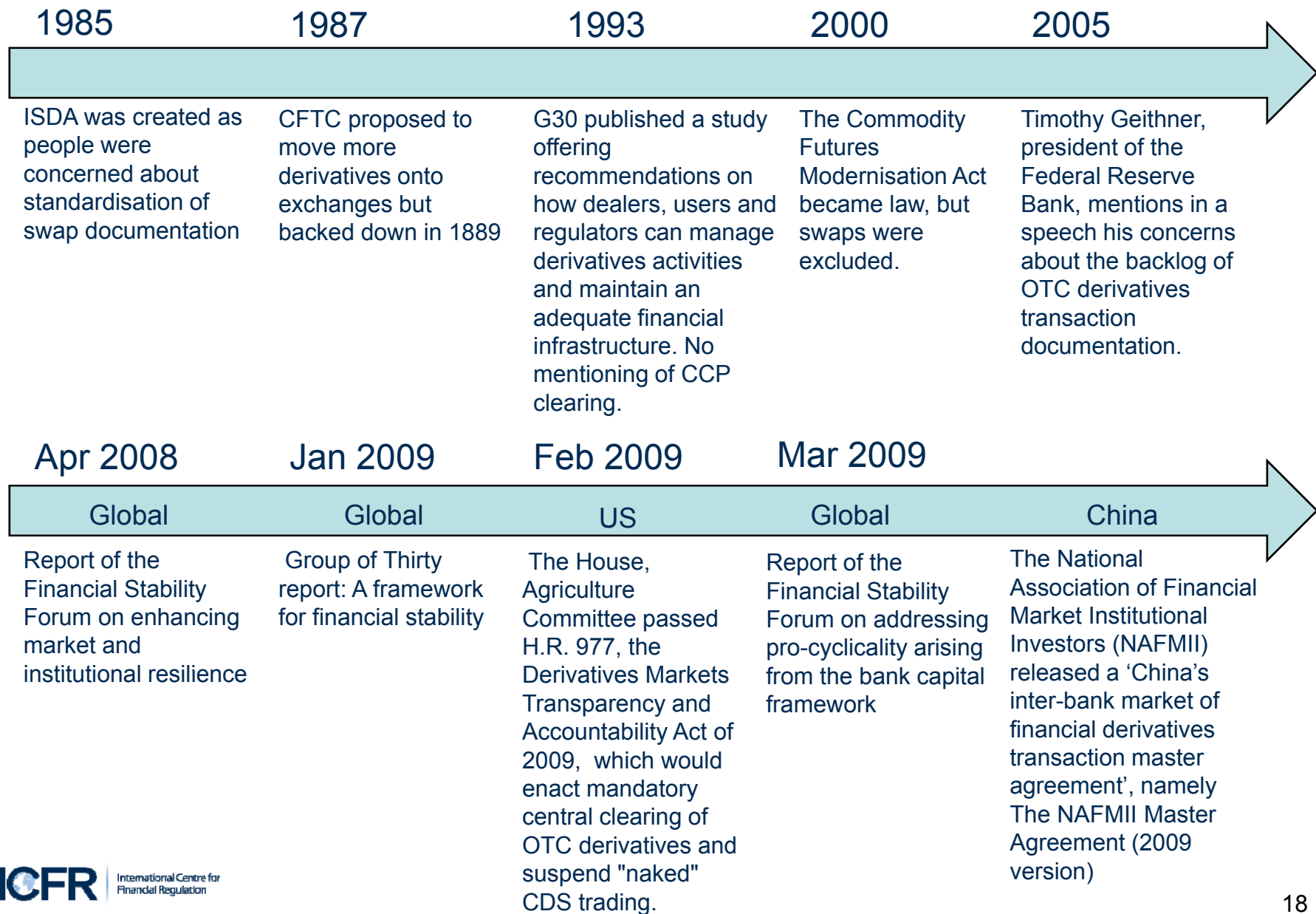
	Legislation	Rules and regulations
Global		ISDA rules on documentation IOSCO Principles and Multilateral Memorandum of Understanding IFRS: International Financial reporting Standards vs. US GAAP
Europe	Markets in Financial Instruments Directive (MiFID) Market Abuse Directive (MAD) Capital Adequacy Directive (CAD) 2009	De Larosiere report
US	Commodity Exchange Act Commodity Futures Modernization Act of 2002 Securities Act of 1933 Securities Exchange Act of 1934 The Code of Federal Regulation	CFTC Regulations SEC Rules Securities Credit Rules Government Securities Act Regulations Exchanges manuals and internal rules
UK	Banking Act 2009 Financial Services Act 1986 - Repealed Financial Services and Markets Act 2000 Investment Exchanges and Clearing Houses Act 2006 Regulation of Financial Services Act 2005	FSA Handbook
China		SFC regulations NAFMII *** "China's inter-bank market of financial derivatives transaction master agreement" (2009 version)

\* Directorate-General for Economic and Financial Affairs (DG ECFIN) and The Internal Market and Services Directorate General (DG MARKET)

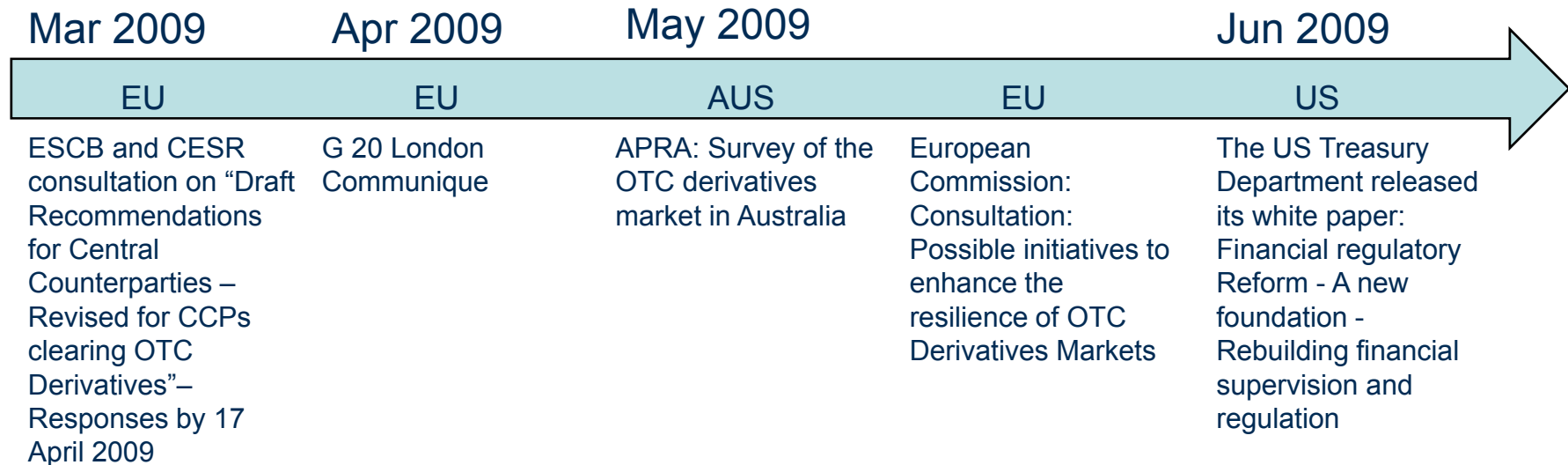
\*\* ECON = Committee on Economic and Monetary Affairs and CRIS = Special Committee to tackle the Financial Crisis

\*\*\* National Association of Financial Market Institutional Investors

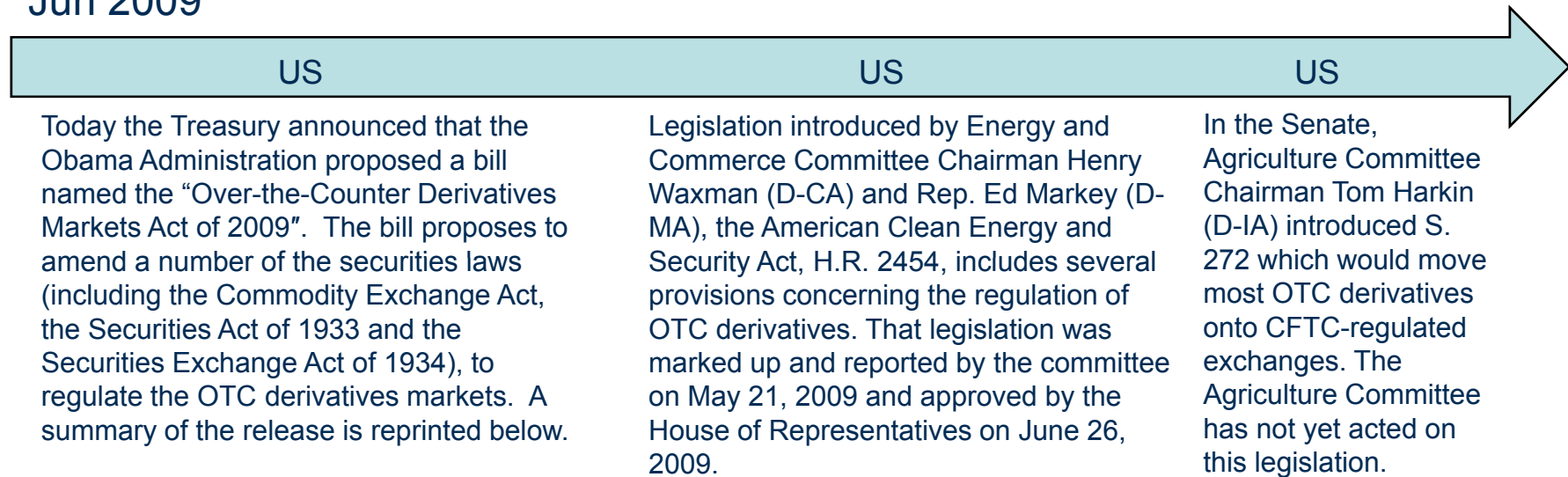
# Documentation with potential OTC implications



# Documentation with potential OTC implications-2



## Jun 2009



# Documentation with potential OTC implications-3

Jul 2009

Global	EU	EU	EU	Global
<p>Basel Committee: Enhancements to the Basel II framework and guidelines for computing capital for incremental risks in the trading book</p>	<p>CESR consultation on MiFID complex and non-complex financial instruments for the purposes of the Directive's appropriateness requirements: CLOSED 17 July 2009</p>	<p>CESR consultation paper: Classification and identification of OTC derivative instruments for the purpose of the exchange of transaction reports amongst CESR members</p>	<p>CESR-ESCB recommendations for securities settlement systems and recommendations for central counterparties in the European Union</p>	<p>Report of the Financial Crisis Advisory Group to advise the IASB and the US Accounting Standards Board about the standard-setting implications of the financial crisis and potential changes in the global regulatory environment.</p>

Aug 2009

US	UK	US	UK
<p>Today the Treasury announced that the Obama Administration proposed a bill named the "Over-the-Counter Derivatives Markets Act of 2009". The bill proposes to amend a number of the securities laws (including the Commodity Exchange Act, the Securities Act of 1933 and the Securities Exchange Act of 1934), to regulate the OTC derivatives markets. A summary of the release is reprinted below.</p>	<p>The FSA has published version 2 of its Transaction Reporting User Pack (TRUP). The TRUP is a consolidated point of reference to transaction reporting obligations. The revised TRUP was effective from 21 Sep 2009 and includes OTC derivatives.</p>	<p>The House Agriculture committee held hearings to review proposed legislation by the U.S. Department of Treasury regarding the regulation of OTC derivatives markets. Testimony by CFTC and by SEC</p>	<p>Joint UK Financial Services Authority and HMT Treasury response to the EU consultation document: Possible initiatives to enhance the resilience of OTC derivatives markets.</p>

# Documentation with potential OTC implications-4

Oct 2009

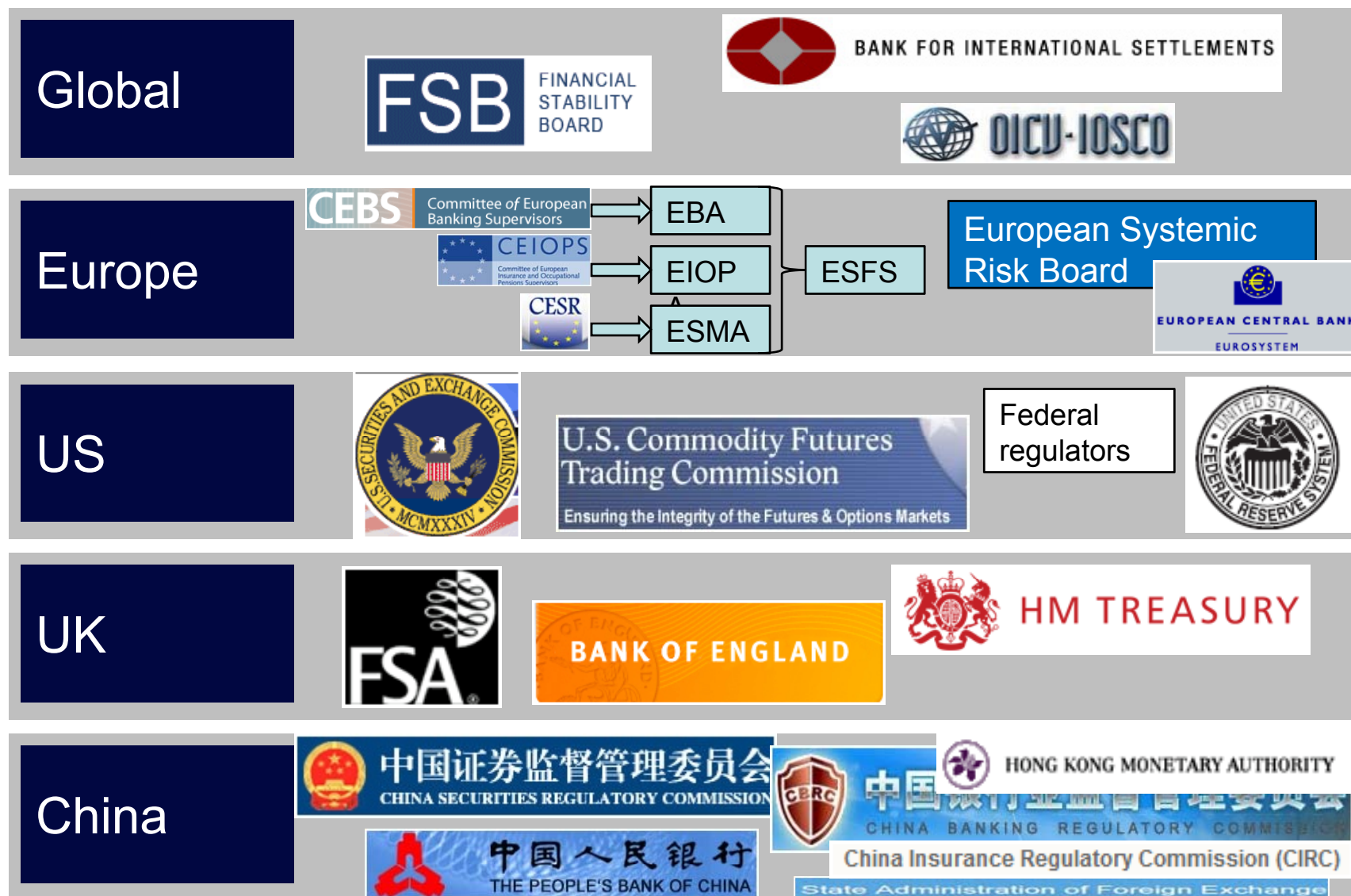
Global	Global	EU	EU	US
Improving financial regulation - Financial Stability Board: Report to the G20 Leaders	G20 Pittsburgh communique - leaders statement	CESR consultation on "Trade Repositories in the European Union": DEADLINE 6 November 2009	CESR consultation on classification and identification of OTC derivative instruments for the purpose of the exchange of transaction reports amongst CESR Members : CLOSED 1 October 2009	Rep. Barney Frank (D-MA), Chairman of the House Financial Services Committee, released a discussion draft of legislation to regulate OTC derivatives.

Oct 2009

Nov 2009

US	EU	EU	EU	US
Over-the-counter derivatives markets act of 2009; House Agriculture Committee Chairman Collin Peterson (D-MN) released discussion draft legislation to regulate the market for OTC derivatives.	European Commission: Ensuring efficient, safe and sound derivatives markets: Future policy actions	CESR statement - Application of Disclosure requirements related to Financial Instruments in the 2008 Financial Statements	CESR: Waivers from Pre-Trade Transparency Obligations under the Markets in Financial Instruments Directive (MiFID) - Update	National Conference of Insurance Legislators (NCOIL) is drafting model legislation that would subject credit default swaps to regulation as insurance and prohibit such transactions that are not undertaken for hedging purposes.

# Overview of the key regulators involved



# Timeline of consultations

Issue date	Authority	Legislation/regulation	Submission deadline
April 2010	European Commission	Draft legislation available for consultation	
9 October 2009	House Agriculture Committee Chairman Collin Peterson	Over-the-counter derivatives markets act of 2009	Closed
29 September 2009	CESR	CESR consultation on "Trade Repositories in the European Union":	Closed 6 November 2009
23 September 2009	IOSCO	IOSCO consultation on transparency of structured finance products	Closed 13 November 2009
25 September 2009	European Commission	Public consultation: Derivatives in Crisis: Safeguarding financial stability	25 September 2009
	CESR	Consultation on classification and identification of OTC derivative instruments for the purpose of the exchange of transaction reports amongst CESR Members	Closed 1 October 2009
22 July 2009	CESR	CESR consultation paper: Classification and identification of OTC derivative instruments for the purpose of the exchange of transaction reports amongst CESR members	
	CESR	Consultation on MiFID complex and non-complex financial instruments for the purposes of the Directive's appropriateness requirements	Closed 17 July 2009
3 July 2009	Commission of the European Communities	Consultation document: Possible initiatives to enhance the resilience of OTC Derivatives Markets	
	ESCB and CESR	ESCB and CESR consultation on "Draft Recommendations for Central Counterparties – Revised for CCPs clearing OTC Derivatives	Closed 17 April 2009

# G20 targets for OTC derivatives regulation

Leaders' statement, the Pittsburgh summit, 25 September 2009

1. All standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the least.
2. OTC derivatives contracts should be reported to trade repositories.
3. Non-centrally cleared contracts should be subject to higher capital requirements.
4. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.

# What are the key items addressed by the current regulatory proposals? US vs. Europe

EU and US proposals to tighten regulation of the OTC derivatives markets are consistent at a high policy level.

1. Closer supervision and regulation of OTC derivative markets
2. Greater standardisation of contracts
3. A much greater degree of multilateral clearing of contracts through central counterparties
4. Enhanced transparency and information collection
5. Comprehensive reporting of all OTC derivative transactions to the authorities
6. Overall two complementary regulatory regimes will be required: One for the dealers and one for the markets themselves (exchanges, clearing houses, trading systems)

# What are the key items addressed by the current regulatory proposals? US vs. Europe

Clearing and exchanges

## Europe

Main tool to manage counterparty risk: European Commission wants to see the broadest possible use of CCP clearing houses considering incentives for using CCPs or making use mandatory for standardised contracts. Commission to analyse further the impact of moving derivatives trading onto organised trading venues onto ability of some market participants to hedge risks effectively.

## US

All standardised derivatives contracts to be cleared through well-regulated central counterparties  
All executed either on a regulated exchange or regulated electronic trading platform . Regulated financial institutions will be encouraged to make greater use of regulated exchange - traded derivatives.

Standardisation

More standardisation:  
1) Contract specifications  
2) EC focus on legal terms of the contract (while allowing flexibility in the specifications)

Standardised OTC derivatives will be pre-defined and the definitions will be updated to match evolving markets.

Product regulation

Regulators will monitor product developments for customisation with the sole purpose of avoiding central clearing and exchange trading

# What are the key items addressed by the current regulatory proposals? US vs. Europe

	Europe	US
Participant/ market regulation	Reduce counterparty risk by (i) proposing legislation to establish common safety, regulatory and operational standards for central counterparties (CCPs), (ii) improving collateralisation of bilaterally-cleared contracts, (iii) substantially raising capital charges for bilaterally-cleared as compared with CCP-cleared transactions, and on top of this (iv) mandate CCP-clearing for standardised contracts; Assessing operational risk approach in the CRD to prompt standardisation of contracts and electronic processing	All OTC derivatives dealers and all other major OTC derivatives markets participants will be constrained by regulation, supervision, a capital regime, margin requirements and business conduct rules and tightening of standards of who may participate in those derivatives markets
Capital regime		
Transparency	Widening the use of central data repositories (already in use for CDS) on number of transactions and outstanding positions	Transparency of OTC derivatives markets enhanced through record keeping and reporting requirements

# What are the key items addressed by the current regulatory proposals? US vs. Europe

	Europe	US
Prevention of fraud and market manipulation	Enhance market integrity and oversight by clarifying and extending the scope of market manipulation as set out in the Market Abuse Directive (MAD) to derivatives and by giving regulators the possibility to set position limits.	Regulators will have clear authority to act against fraud, market manipulation and other abuses.
Global standards and regulation	European Commission will continue to work closely with the US to ensure global consistency of policy approaches and to avoid any risk of regulatory arbitrage.	Tim Geithner: US administration will work with its international partners to ensure that its strict regulatory regime for OTC derivatives is matched by a similarly effective regime in other countries.
Local standards and regulation	In Europe the definition of the roles of CESR and its local counterparties regarding OTC derivatives regulation and supervision still needs to be finalised.	The idea of merging the two regulatory agencies overseeing derivatives markets (SEC and CFTC) has been shelved due to powerful vested interests opposing the merger.



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