

**ICFR roundtable about the future of OTC derivatives regulation
24 November 2009, London
Draft Summary**

Objectives:

The ICFR held a roundtable discussing the different proposals for future OTC derivatives regulation on Tuesday 24 November 2009. The objectives of the meeting were:

- To understand what the European and US regulatory proposals are trying to achieve as well as the key differences between them,
- To highlight potential consequences for market participants, and
- To consider alternative solutions.

The international participants comprised regulators, exchanges, clearing houses, data repositories, banks, insurance companies and representatives of the legal and accounting professions, and representatives of the industry generally and corporate derivatives users specifically.

Issues on which there was consensus:

1. Participants recognized the need for understanding and mitigation of systemic risk. To achieve this, regulators need:

- Access to relevant information, and
- A means to incentivize effective risk-management practices and infrastructure among market participants.

2. They agreed that data repositories provide a useful service for both the market and regulators.

3. Participants stressed the linkages between exchanges and OTC markets. Market participants were wary of forcing OTC products to exchanges, as it forces standardisation of products. Rather, there was consensus that there is a natural flow of product development from OTC to exchanges as volumes develop and products standardize, and this should be encouraged.

4. Participants agreed that the industry is a cross-border one. All felt it was critical to have consistent regulation across jurisdictions on OTC derivatives, if the sector was to be able to operate efficiently, and so as not to provide opportunities for regulatory arbitrage. An expert minority highlighted its concern that outside the EU there is no formal mechanism for harmonising laws amongst major financial centres, and within the EU regulatory authority remains ultimately vested in national governments and regulators. This leaves considerable scope for divergence between national regulators both in policy formation and in enforcement and arbitrage will necessarily arise unless national authorities are strongly committed to co-ordinated policymaking and enforcement.

5. Efforts are clearly being made to coordinate between the EU and the US regulators. Market participants made special mention of the strong collaborative and open process the EU has led to date.

International Centre for Financial Regulation 5th Floor, 41 Moorgate, London EC2R 6PP United Kingdom
Telephone: + 44 (0)20 7374 5560 www.icfr.org

The International Centre for Financial Regulation is incorporated as a company limited by guarantee in England and Wales
Company Number 6625422 Registered Office 5th Floor, 41 Moorgate, London EC2R 6PP, United Kingdom

6. Market participants agreed that it was essential that regulators remained focussed on the issues that they are seeking to address with new regulation.

Outstanding issues and avenues for cooperation:

1. Standardisation:

Definition of the term “standardised” is critical. It was suggested to focus on the clearable deals and to consider solutions for the not readily clearable transactions once the first task has been completed and proven successful. Some participants argued that \$250 trillion of notional outstanding in derivatives are relatively easy to clear and that the 80/20 rule would be a practical way of aiding systemic stability without creating problems by forcing clearing upon all derivatives, which might actually create credit problems for the clearers. Any definition would have to allow for thresholds to permit the inclusion of new products as they develop.

2. Data Repositories:

Despite strong consensus on the utility of data repositories, the degree and purpose of regulatory access, as well as problems with conflicting domestic data protection legislation across jurisdictions, make this issue more problematic than it appears, particularly with regard to single customer data as opposed to aggregated data. In order to maintain confidence in the market clients must be assured that data will be safe and that regulators rights for information are clearly defined and articulated.

3. Incentives:

It was unclear to participants whether ‘carrots’ or ‘sticks’ would best be used to incentivise market participants to clear OTC derivatives. It was not clear if there would be incremental capital charges for transactions not centrally cleared vs. capital relief for transactions that were centrally cleared.

In the same vein, many participants felt that previous threats of regulation (ex: transactions tickets and the NY Fed, CDS clearing with ICE) had been extremely effective in mobilising industry action. On many fronts it was felt that a panel of market participants together with a regulator and a facilitator could make more effective progress on outstanding issues than any party on its own.

4. Specific issues with proposed legislation:

How will international financial institutions engage in OTC derivatives with US counterparties or trade with other international counterparties in US products under proposed legislation?

The reasons for and necessity of a 20% ownership cap for ownership of swap execution facilities caused concern for many participants.

5. Corporate users of derivatives:

Most corporates use derivatives for their day to day hedging. While comfortable with managing counterparty credit risk deriving from OTC transactions, corporates face considerable difficulty in managing the liquidity risk which would result from the margining imposed by central clearing. This is because of the risk’s open-ended nature. Some corporate might elect to leave positions unhedged – thereby leaving their business exposed to the underlying risk – rather than accepting the liquidity risk associated with collateralizing positions

6. Central counterparty clearing:

Central clearing of portfolio swaps could have significant counterparty risk implications for counterparty risk management and cross-product netting.

Required clearing with a small number of clearing houses could undermine CCP credit quality as competition for market share leads CCPs to reduce standards and increase risks.

7. Collateralisation/margins and capital:

Single name CDS are very difficult to margin for clearing houses due to the 'jump to default' effect, unless there are so many single names that they effectively create a portfolio effect within the CCP.