



# Proposed regulatory reforms and related risk management considerations

*February 2010*

*Nicole Hergarten*



International Centre for  
Financial Regulation

# Agenda

Introduction

1. Key stakeholders in the debate

2. Reasons and aims of OTC regulation reform

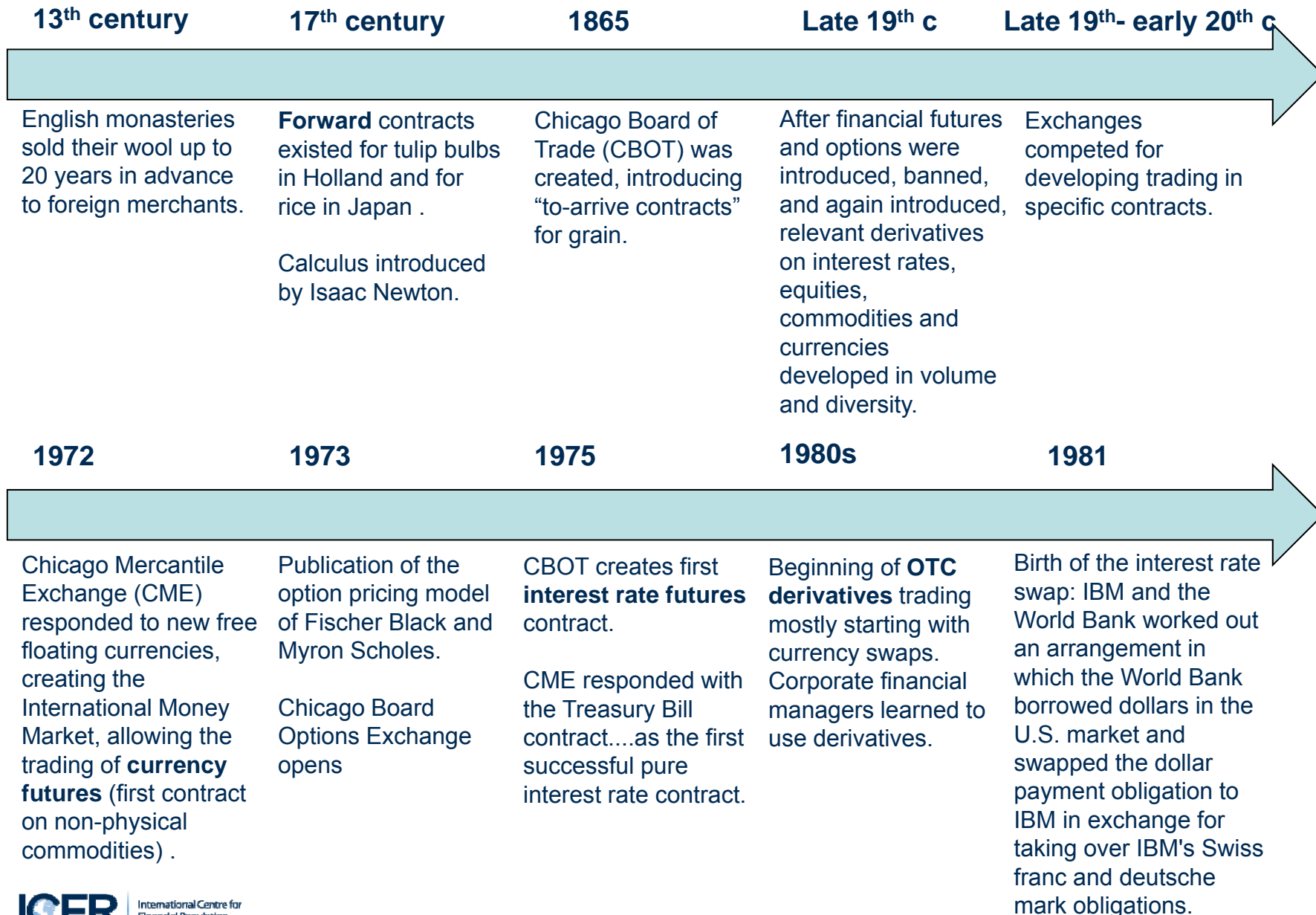
3. US, European and worldwide initiatives

4. Ongoing debate

# 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

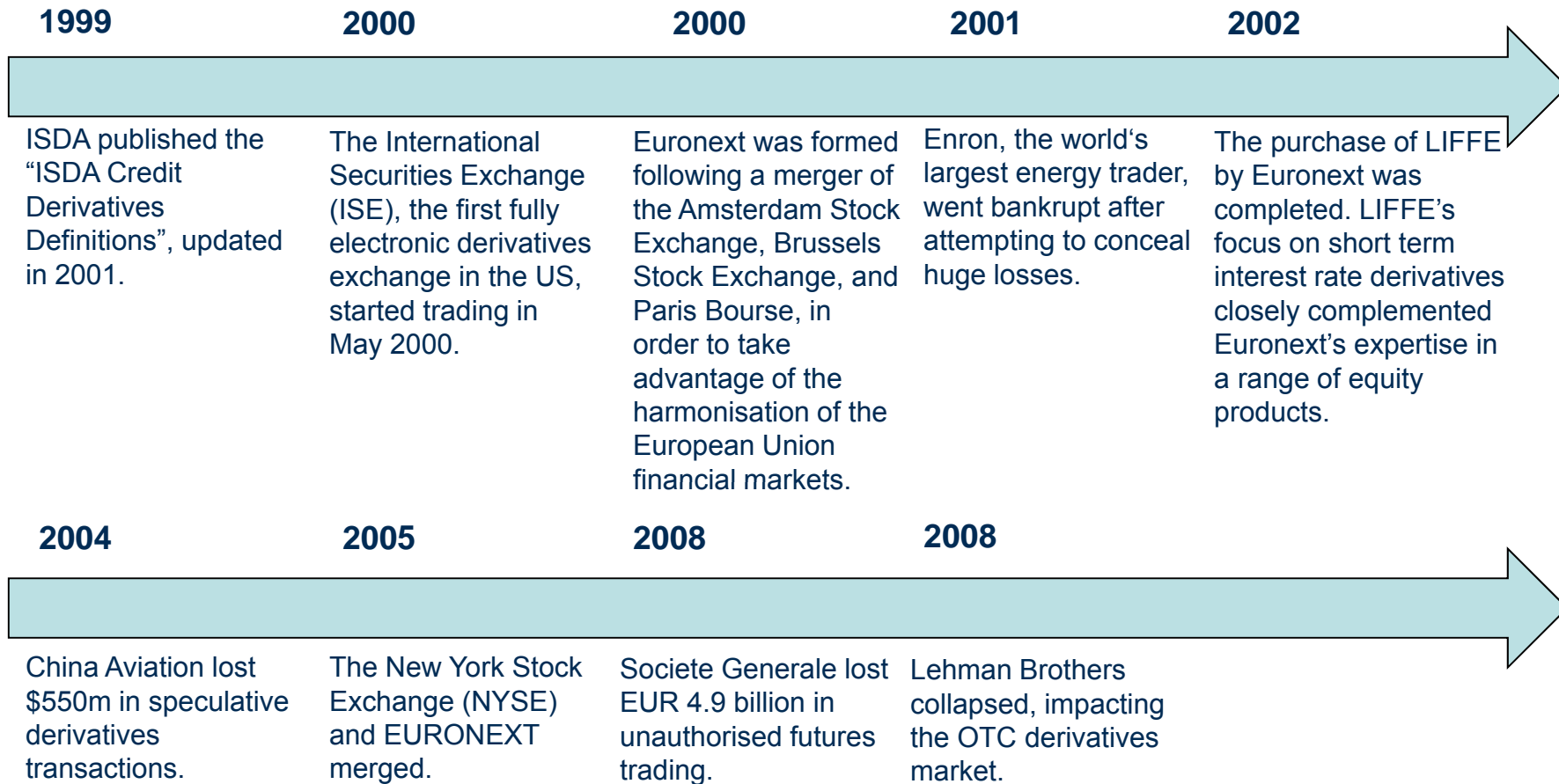
# A brief history of OTC derivatives (I/III)



# A brief history of OTC derivatives (II/III)

1982	1982	1982	1985	1987
<p>The London International Financial Futures and Options Exchange (LIFFE) was established, following the removal of foreign exchange controls in the United Kingdom.</p>	<p>CME introduced the <b>Eurodollar contract</b>, becoming the most actively traded contract.</p>	<p>Kansas City Board of Trade launched the first stock index futures contract (on the Value Line Index).</p> <p>CME quickly followed with launching the contract on the S&amp;P 500.</p>	<p>International Swaps and Derivatives Association (ISDA) was formally established and published “the Code” of standard wording, assumptions and provision of swaps.</p>	<p>ISDA published two suggested standard forms of master agreements for swaps (the “1987 IDSA Master Agreements”), one for USD interest rate swaps, one for “interest rate swaps and currency exchange agreement”.</p>
1989	1990	1993	1994-1995	1997
<p>ISDA added master documentation for <b>caps/floors</b>. 1990 ISDA added master documentation for <b>swap options</b>.</p>	<p>Created in the mid-1990s <b>credit default swaps</b> were used to transfer credit exposure for commercial loans and to free up regulatory capital in commercial banks.</p>	<p>ISDA added master documentation for <b>commodity derivatives</b>.</p>	<p>Procter&amp;Gamble, Metallgesellschaft, Orange County and Barings Bank incurred huge losses through the speculative/leveraged use of derivatives.</p>	<p>1997 Credit Default Swaps had been in existence from at least the early 1990s, but the <b>modern credit default swaps</b> were invented in 1997 by a team working for JPMorgan Chase.</p>

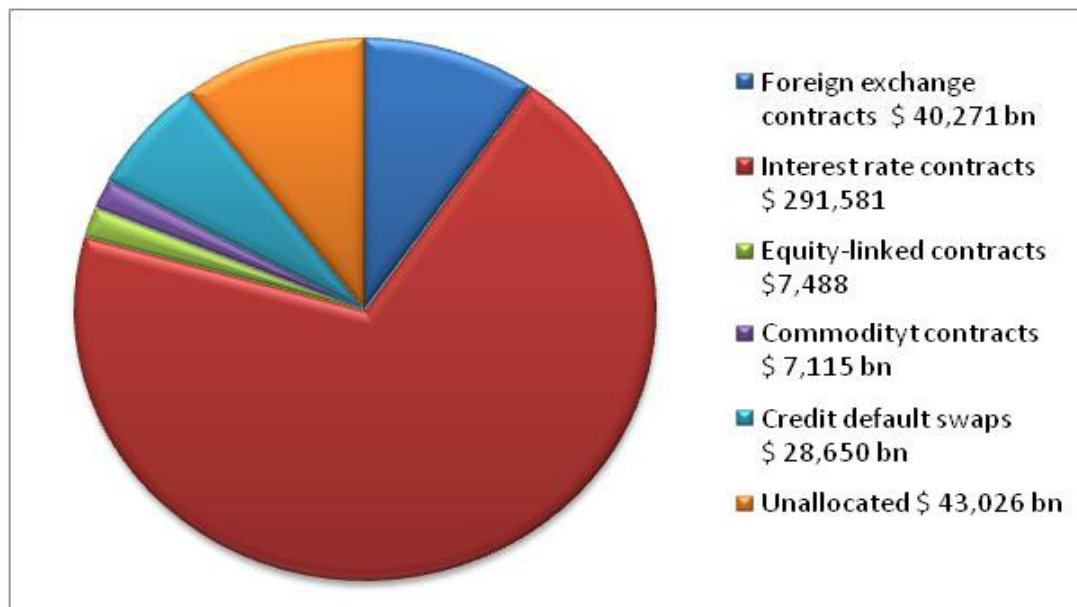
# A brief history of OTC derivatives (III/III)



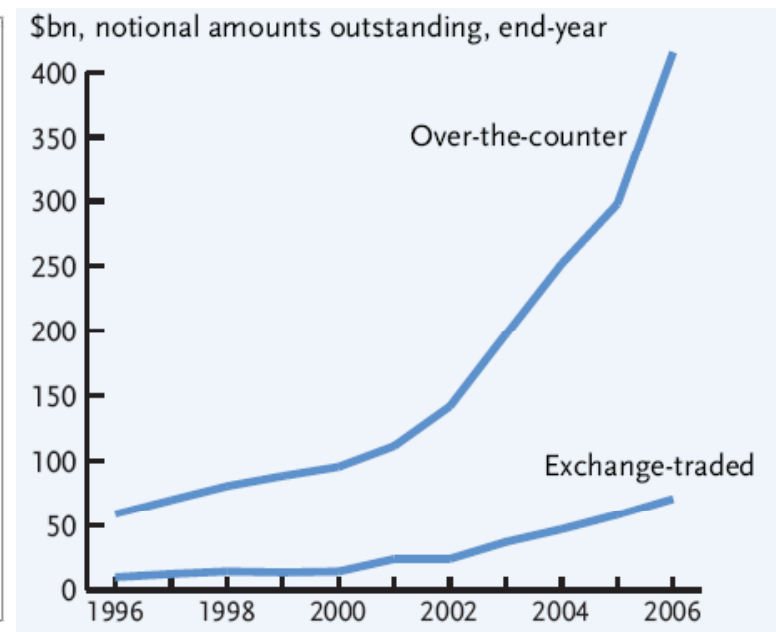
# The international OTC derivatives market before the crisis

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

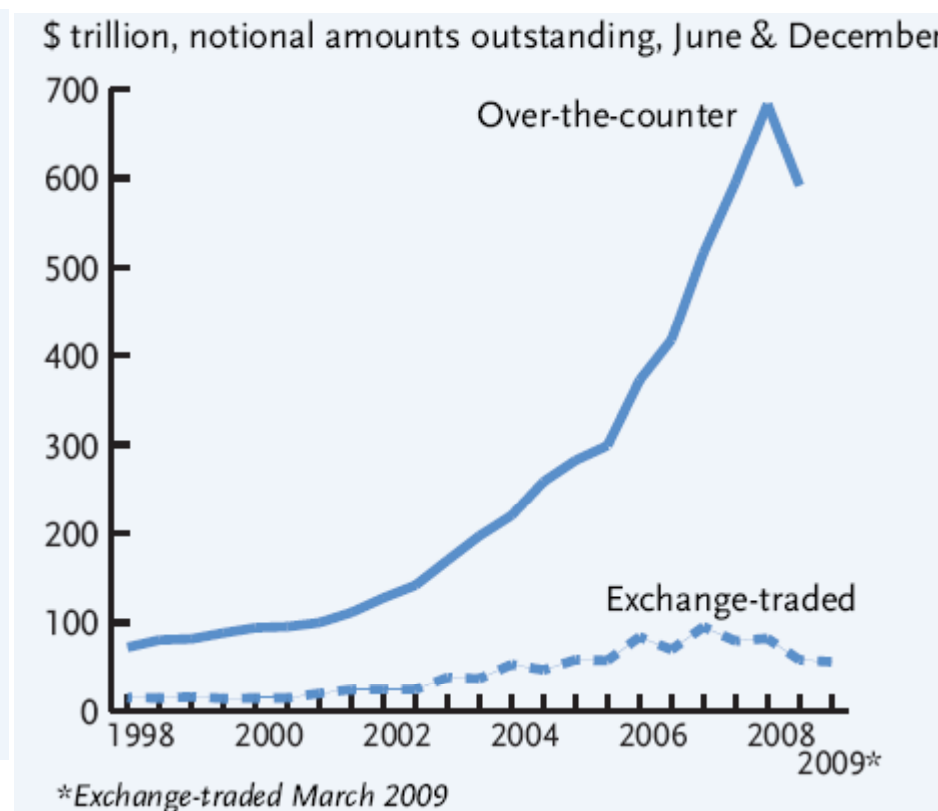
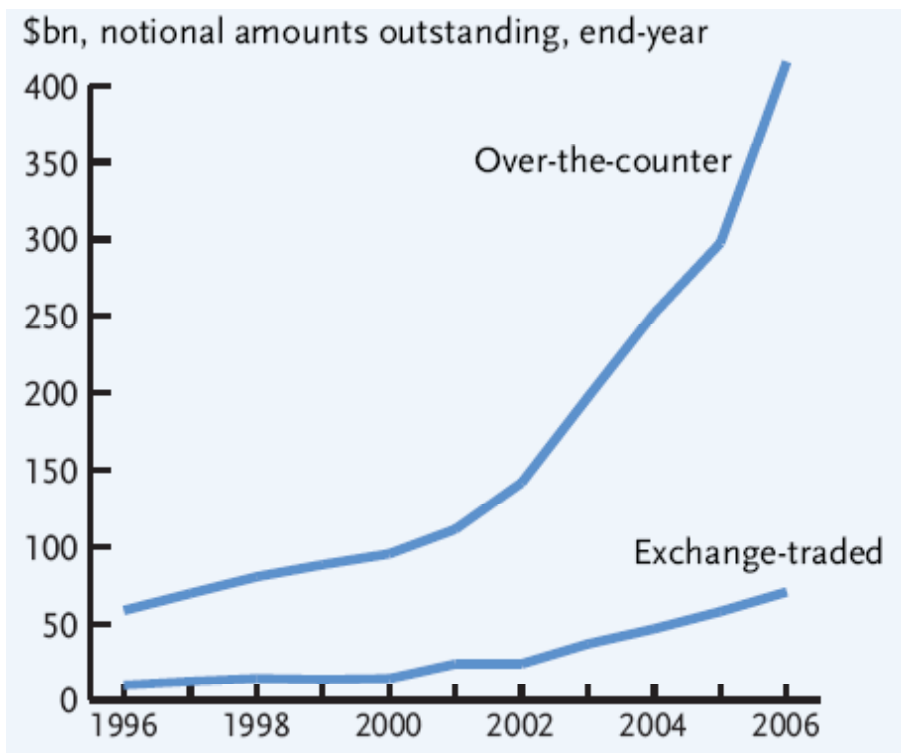
December 2006



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

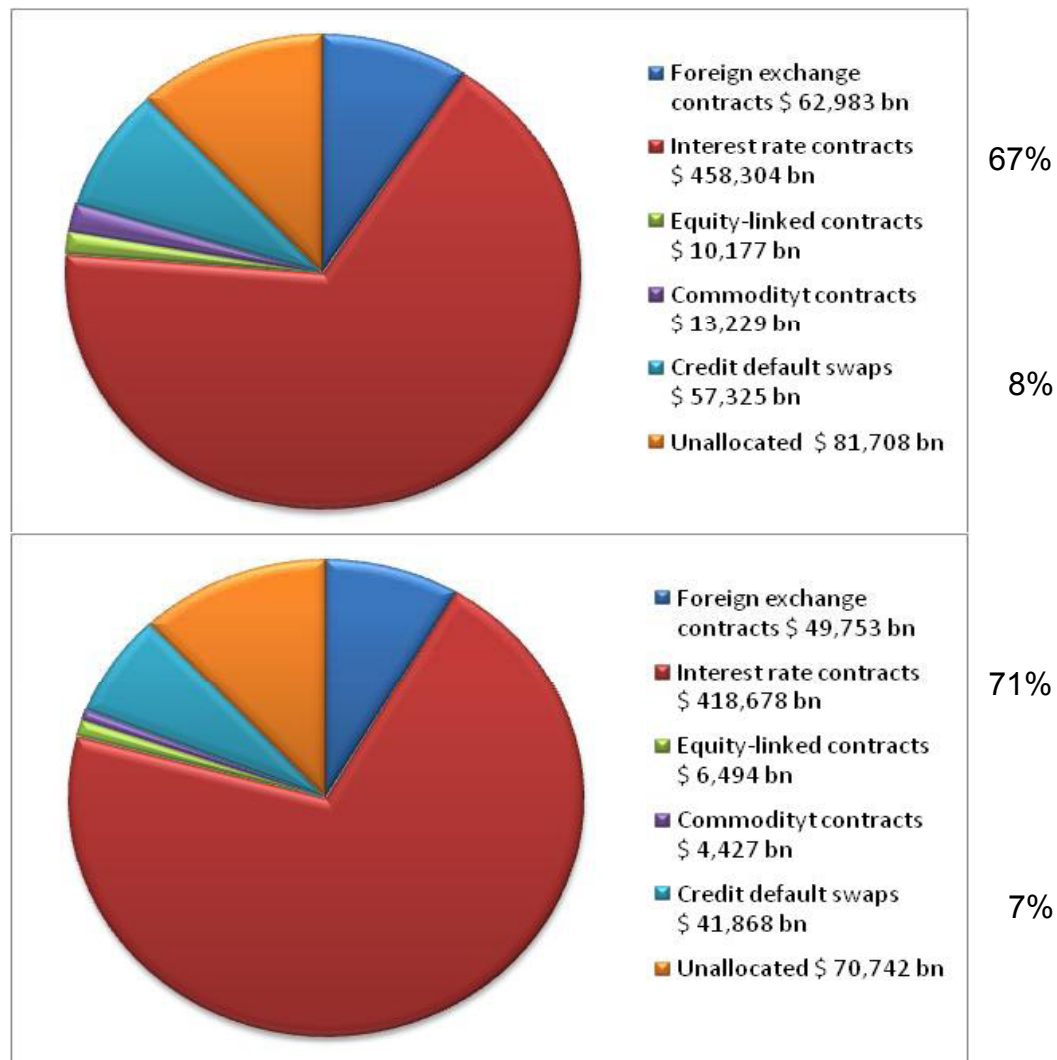
June 2008

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 (-13%)



# Considerations regarding the notional value of OTC derivatives

**The "notional value" isn't usually a very good representation of what a contract might really be worth to the parties involved, or how much risk exposure is created.**

- Notional value is not easily compared with other measures of financial wealth
  - Owning the right to buy \$5,000 worth of oil isn't the same as actually owning \$5,000 of oil.
  
- Within that \$591 trillion are derivatives that effectively relate to the same assets.
  
- Moreover, in many instances, the "notional amount" is just a benchmark that never even changes hands.
  - As in the case of an interest-rate swap, by far the most common type of derivative.
  
- Also, many contracts in the system essentially cancel one another out. (Take account of netting, compressing of derivatives exposures).

# Agenda

Introduction

1. Key stakeholders in the debate

2. Reasons and aims of OTC regulation reform

3. US, European and worldwide initiatives

4. Ongoing debate

# An overview over proposed future regulation Who are the key stakeholders of the debate?

Regulators

Dealers and exchanges

Legislators

Investors and corporate users

Lawyers

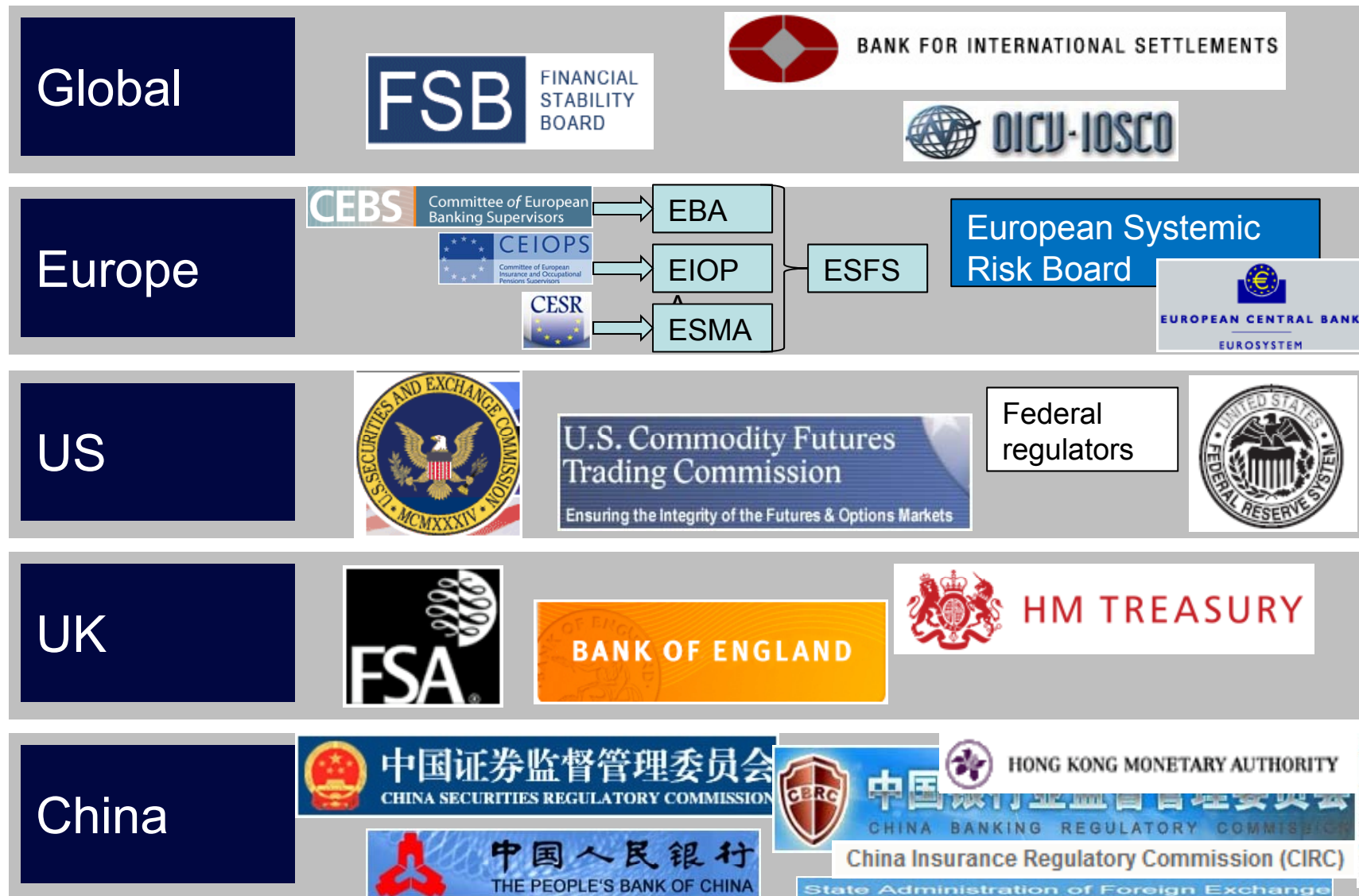
Clearinghouses

Accountants

Trading data repositories

# Key stakeholders in the debate

## Regulators



# Key stakeholders in the debate



House Committee on Agriculture  
Chair: Collin Peterson



House Committee on Financial Services  
Chair: Barney Frank

## US Commodity Futures Trading Commission (CFTC)



Chairman Gary Gensler

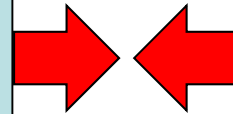
- Congress created the Commodity Futures Trading Commission (CFTC) in 1974 as an independent agency
- with the mandate to regulate commodity and financial futures markets in the United States.
- The agency's mandate has been renewed and expanded several times since then, most recently by the Commodity Futures Modernization Act of 2000.
- Oversees market intermediaries, including derivatives clearing organizations, foreign market access by intermediaries,



## US Securities Exchange Commission (SEC)

Chairman Mary Schapiro

- Independent agency of the United States government
- Primary responsibility for enforcing the federal securities laws and regulating the securities industry (stock and options exchanges, and other electronic securities markets.)
- Created by the Securities Exchange Act of 1934
- Enforces the Securities Act of 1933, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Sarbanes-Oxley Act of 2002 and other statutes.



# Key stakeholders in the debate

## Regulators



Joint report of the SEC and the CFTC  
on Harmonization of Regulation  
(October 16, 2009)



Product listing and approval

Exchange/ clearinghouse rule changes

Risk based portfolio margining

Bankruptcy/ insolvency regimes

Linked national market and common clearing  
Vs  
Separate markets and exchange-directed clearing

Price manipulation and insider trading

Customer protection standards for financial advisors

Regulatory compliance by dual registrants

Cross-border regulatory matters

# Key stakeholders in the debate

## Regulators: The European regime changes

**23 September 2009:** The European Commission has adopted a package of draft legislation. The aim of these enhanced cooperative arrangements is to sustainably reinforce financial stability throughout the EU; to ensure that the same basic technical rules are applied and enforced consistently.



**European Systemic Risk Council (ESRC)**

**European System of Financial Supervisors (ESFS)**

With three new supervisory authorities:

**CEBS**



**European Banking Authority (EBA)**

**CESR**



**European Securities and Markets Authority (ESMA)**

**CEIOPS**

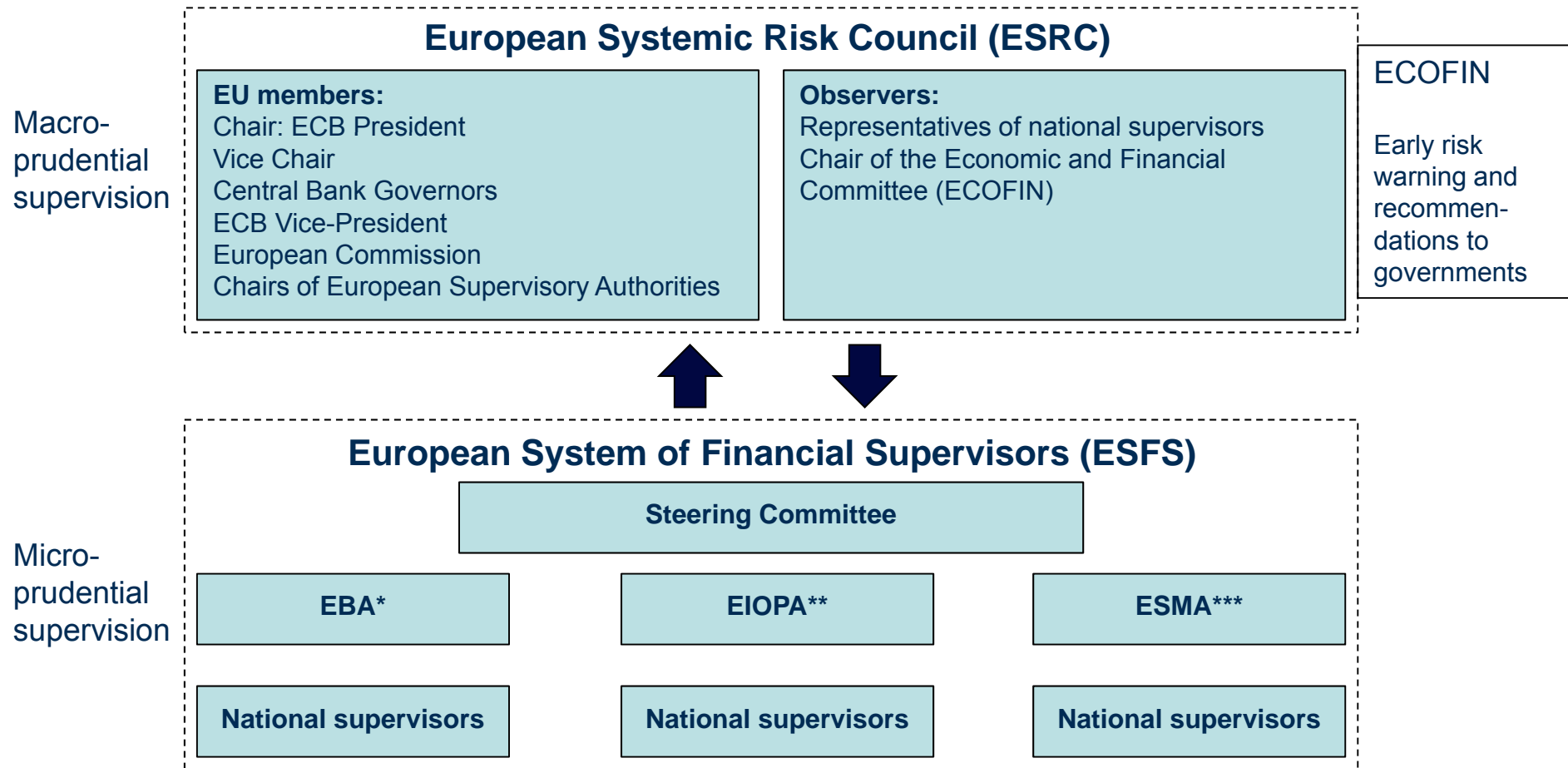


**European Insurance and Occupational Pensions  
Authority (EIOPA)**

**26 October 2009** A further European Commission proposal complements and reinforces the supervision package of 23 September and provides more details about precisely what powers are proposed for the new European Supervisory Authorities and in what areas.

# Key stakeholders in the debate

## Regulators



**While the current European regulatory committees are issuing recommendations for the local regulators and supervisors, the new supervisory authorities will be able to deliver binding regulatory guidelines.**

\* European Banking Authority (EBA)

\*\* European Insurance and Occupational Pensions Authority (EIOPA)

\*\*\* European Securities and Markets Authority (ESMA)

# Key stakeholders in the debate

## Legislators

	Legislators	Others
Global	G 20	The Futures and Options Association Securities Industry and Financial Markets Association SIFMA International Swaps and Derivatives Association ISDA The Global Association of Central Counterparties CCP 12
Europe	Council of the European Union European Commission (DG ECFIN, DG MARKT)* European Parliament (ECON, CRIS)**	Data repositories, banks, insurers, asset managers, corporate users of derivatives European Federation of Energy Traders The European Association of Central Counterparty Clearing Houses (EACH)
US	Congress { House of Representatives 1) Committee on Agriculture (Peterson) 2) Committee on Financial Services (Frank) Senate (banking committee (Shelby) Joint committee                      President	Exchanges, Clearing houses, data repositories, banks, insurers, asset managers, corporate users of derivatives
UK	Prime Minister UK Treasury (Darling) House of Commons } Parliament House of Lords	LIBA                      City of London                      BBA Exchanges, Clearing houses, data repositories, banks, insurers, asset managers, corporate users of derivatives
China	Chinese Communist Party (Politburo, Secretariat) National People's Congress and its Standing Committee (NPC) President State Council (Premier) + Local governments	Commercial banks State-owned Assets Supervision and Administration Commission

# Key stakeholders in the debate Exchanges

## Largest derivatives exchange groups

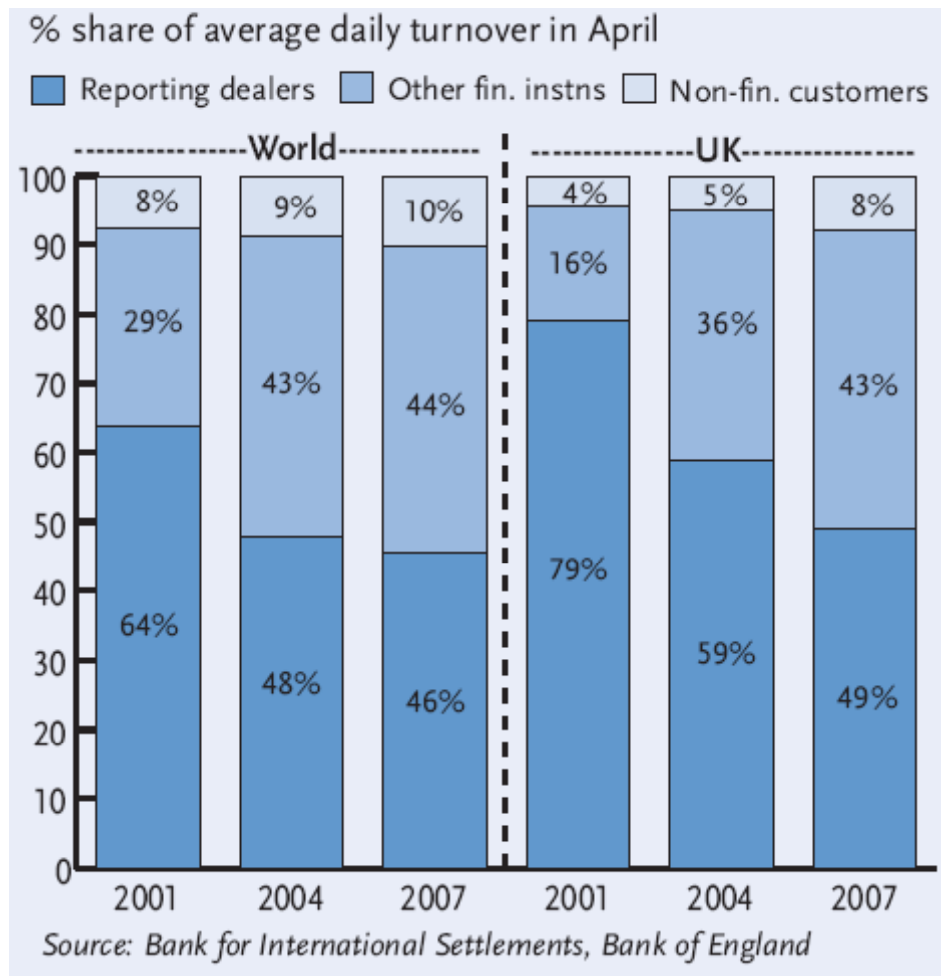
Annual number of contracts traded, millions

Exchange	2005	2006	2007	2008
1 CME Group	1940	2443	3158	3278
2 Eurex	1697	2119	2704	3173
3 Korea Futures Exchange	2593	2475	2777	2865
4 NYSE Euronext <sup>1</sup>	1106	1124	1525	1674
5 CBOE Holdings	468	675	946	1195
6 BM & F Bovespa	466	571	794	742
7 Nasdaq OMX Group	266	396	551	722
8 National Stock Exchange of India	132	194	380	590
9 SAFEX Securities Exchange	51	105	330	514
10 Dalian Commodity Exchange	198	120	186	313
11 Russian Trading Systems Stock Exch.	53	80	144	238
12 Intercontinental Exchange <sup>2</sup>	82	140	196	237
13 Zhengzhou Commodity Exchange	28	46	93	223
14 Boston Options Exchange	78	94	130	179
21 London Metal Exchange	79	87	93	113

<sup>1</sup>Includes NYSE Liffe markets in London, Amsterdam, Paris, Brussels & Lisbon  
<sup>2</sup>Includes ICE Europe based in London  
Source: Futures Industry Association

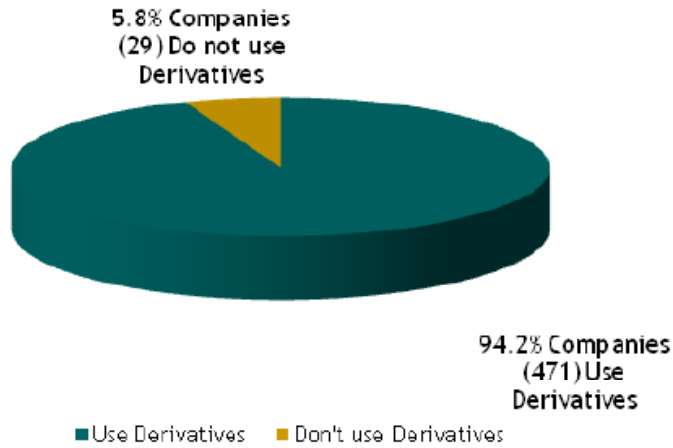
# Key stakeholders in the debate

## 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.

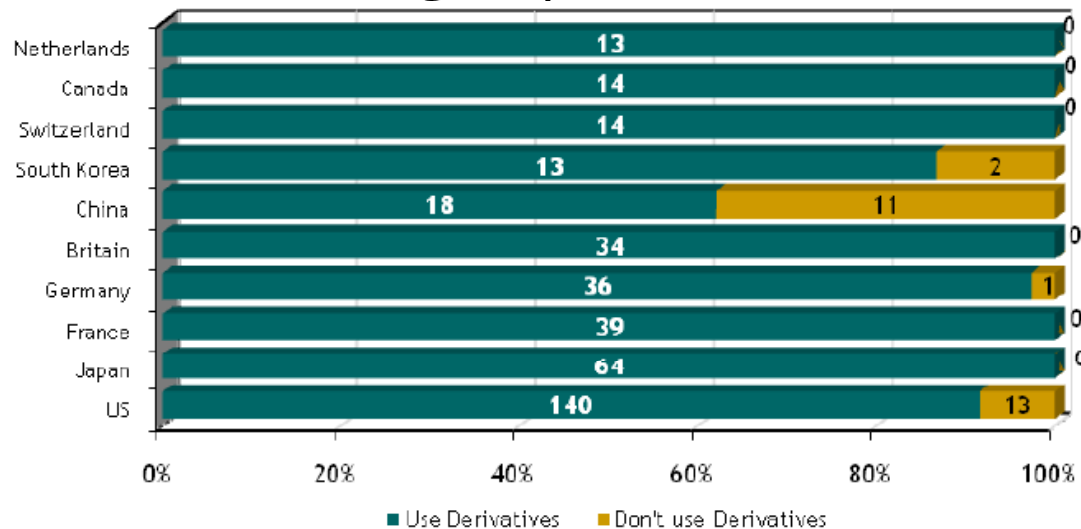
# Corporate users of derivatives



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%
<b>Total</b>	<b>500</b>	<b>94%</b>	<b>83%</b>	<b>88%</b>	<b>49%</b>	<b>20%</b>	<b>29%</b>

**Top 10 Countries: Highest Reported Use of Derivatives**



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

# Agenda

Introduction

1. Key stakeholders in the debate

2. Reasons and aims of OTC regulation reform

3. US, European and worldwide initiatives

4. Ongoing debate

# Why are derivatives at issue?

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

1. Lack of transparency: 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. (Plus wrong-way risk effects)
4. Inter-bank business came to substitute for client business, particularly among financial institutions in search of yield (Landesbank examples).
5. The crisis highlighted insufficient management of counterparty risk, operational risk, liquidity risk.

# Key considerations regarding OTC derivatives regulation

- 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
  - Operational risk management: Timely/efficient derivatives processing and documentation.
  - Clearing houses and exchanges
- How to strike the balance between use of INCENTIVES vs. RULES and
- equilibrium between risk control and economically viable derivatives prices?
- How to cater for the global nature of the OTC derivatives market?
- How to cater for the corporate end users of OTC derivatives?

# What are the key items addressed by the current regulatory proposals?

Central Counterparties: CCPs	A well capitalised company should act as an intermediary for OTC transactions. The two sides of the transaction to trade with the CCP rather than directly with each other.
Standardisation Trading on exchanges	Features and documentation of OTC derivatives to become standardised so that they can be traded on exchanges and centrally cleared? How will standardised be defined?
Capital requirements	Basel II proposals were issued which determine the amount of capital banks have to put aside for OTC derivatives exposure and capital treatment of trading book and banking book.
Product regulation	Are regulators going to approve new financial products and to classify products that should be standardised and traded on an exchange, which ones should be CCP cleared
Participant/ market regulation	Stricter oversight for exchanges, central counterparties and electronic trading platforms to be based on a clear supervision and enforcement regime. Also rating agencies have now to be registered in Europe.
Transparency	Trades should be reported to a qualified trade repository and data recorded in trade information warehouses: to report on, among other things, open positions, fair values, total exposure by counterparty, notional volumes, and any new margin or capital requirements
Risk management	Incentives and supervision to be introduced for strengthening risk management especially for non-centrally cleared instruments
Accounting standards implications	Ongoing debate about harmonisation of accounting standards with regulatory reporting.
Prevention of fraud and market abuse	Addressing fraud through inclusion of derivatives into existing fraud regulation and addressing manipulation via position limits.

# Agenda

Introduction

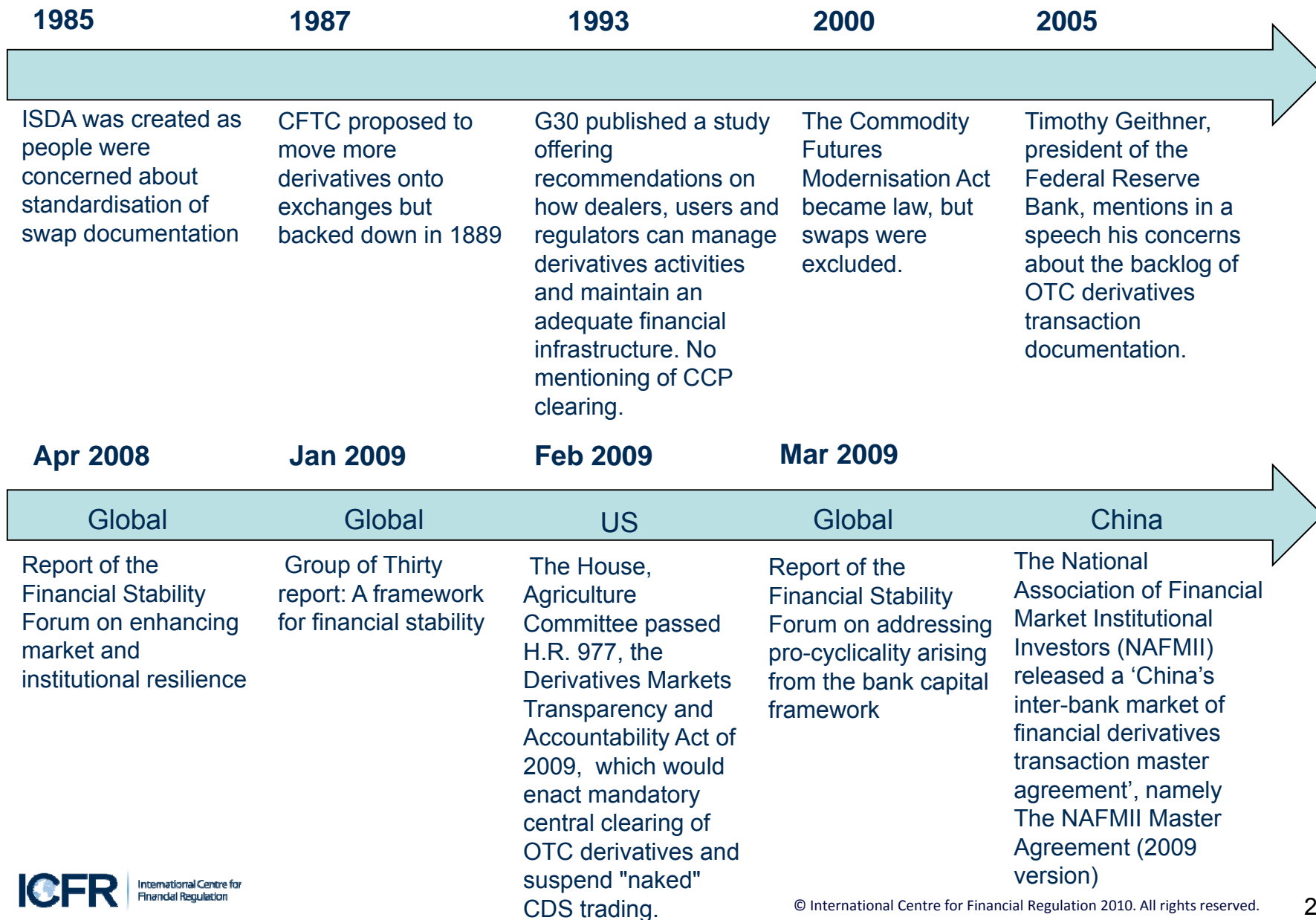
1. Key stakeholders in the debate

2. Reasons and aims of OTC regulation reform

3. US, European and worldwide initiatives

4. Ongoing debate

# Documentation with potential OTC implications



# Documentation with potential OTC implications-2

Mar 2009	Apr 2009	May 2009	Jun 2009
EU	EU	AUS	EU
ESCB and CESR consultation on “Draft Recommendations for Central Counterparties – Revised for CCPs clearing OTC Derivatives” – Responses by 17 April 2009	G 20 London Communique	APRA: Survey of the OTC derivatives market in Australia	European Commission: Consultation: Possible initiatives to enhance the resilience of OTC Derivatives Markets
			US
			The US Treasury Department released its white paper: Financial regulatory Reform - A new foundation - Rebuilding financial supervision and regulation

Jun 2009	Jun 2009	Jun 2009	Jul 2009
US	US	US	Global
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.	Legislation introduced by Energy and Commerce Committee Chairman Henry Waxman (D-CA) and Rep. Ed Markey (D-MA), the American Clean Energy and Security Act, H.R. 2454, includes several provisions concerning the regulation of OTC derivatives. Marked up and reported by the committee on May 21, 2009 and approved by the House of Representatives on June 26, 2009.	In the Senate, Agriculture Committee Chairman Tom Harkin (D-IA) introduced S. 272 which would move most OTC derivatives onto CFTC-regulated exchanges. The Agriculture Committee has not yet acted on this legislation.	Basel Committee: Enhancements to the Basel II framework and guidelines for computing capital for incremental risks in the trading book ➤ Taking effect in December 2010

# Documentation with potential OTC implications-3

## Jul 2009

China	EU	EU	EU	Global
<p>CBRC issues Notice on Further Strengthening the Risk Management of Derivative Product Transactions between Banking Financial Institutions and Institutional Implementation reports due 31 Oct 09</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.

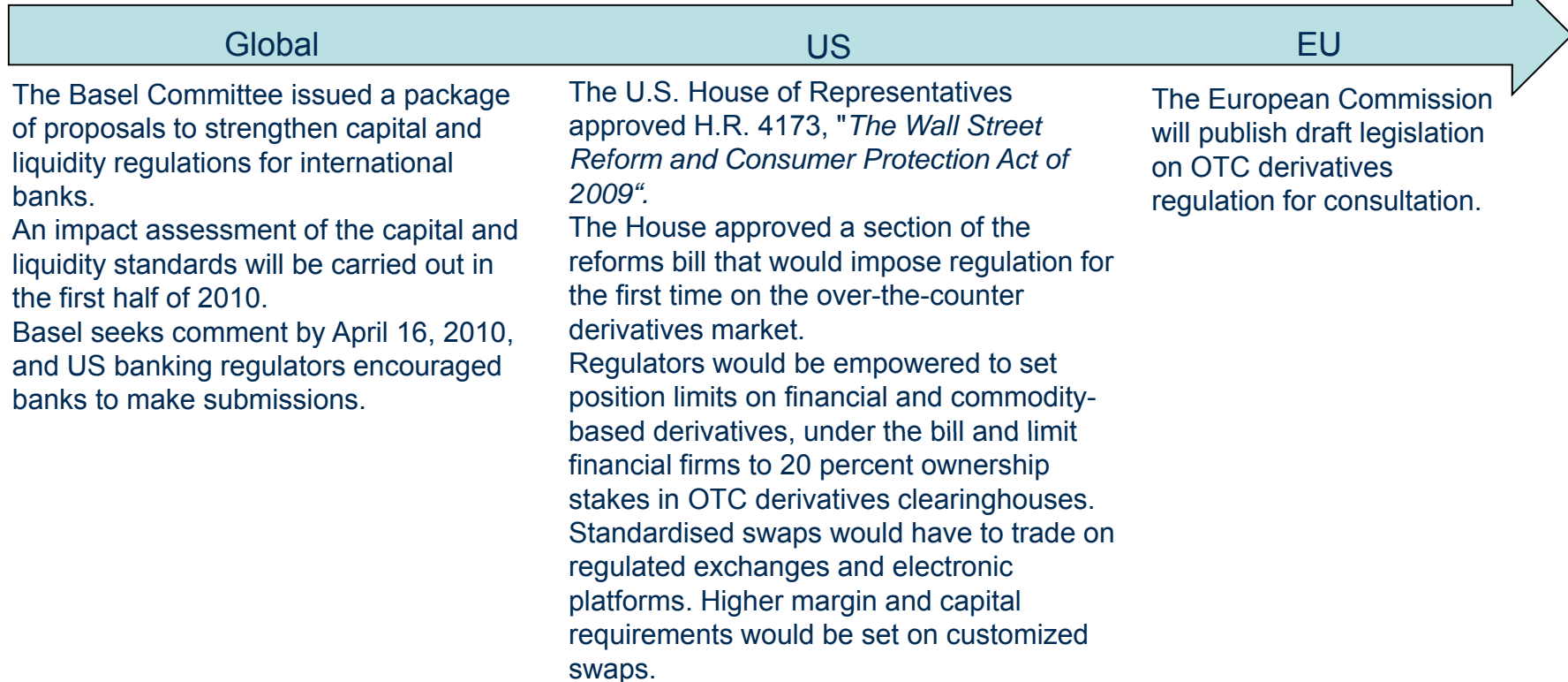
**Oct 2009**

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.

# Documentation with potential OTC implications-5

**Dec 2009**

**April 2010**



# 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.

# Actions by the European Commission (I/II)



Communication from the European Commission to the European Parliament, the Council, the European Central Bank...

“Ensuring efficient, safe and sound derivatives markets”:

## Future policy actions

Objective	Proposed actions	Time line
1. Reduce counterparty credit risk – strengthening clearing	Legislation on CCP* requirements safety requirements (conduct, governance..) authorisation and supervision mandating CCP* clearing of standardised derivatives	Mid 2010
	Amend CRD** mandate financial firms supplying initial and variation margin substantially differentiate capital charges between CCP-cleared and non CCP-cleared contracts	End 2010
2. Reduce operational risk standardisation	Assess operational risk approach in the CRD** to prompt standardisation of contracts and electronic processing	End 2010
	Work with industry to increase standardisation of legal regimes and processes	Ongoing

# Actions by the European Commission (II/II)



Communication from the European Commission ...  
 “Ensuring efficient, safe and sound derivatives markets:  
**Future policy actions**

Objective	Proposed actions	Time line
<b>3. Increase transparency – trade repositories</b>	Legislation on trade repositories regulate trade repositories mandate reporting of OTC derivatives transactions to trade repositories	Mid 2010
<b>4. Increase transparency - trading</b>	Amend MiFID*** to require transaction and position reporting to be developed in conjunction with CCPs and repositories Ensure trading of standardised contracts on organised trading venues under MiFID*** Enhanced trade/price transparency across venues and OTC markets, as appropriate, in MiFID Conclude review of exemptions from MiFID	End 2010
<b>5. Improve market integrity</b>	Extend MAD**** to OTC derivatives Give regulators the power to set position limits in MiFID	End 2010

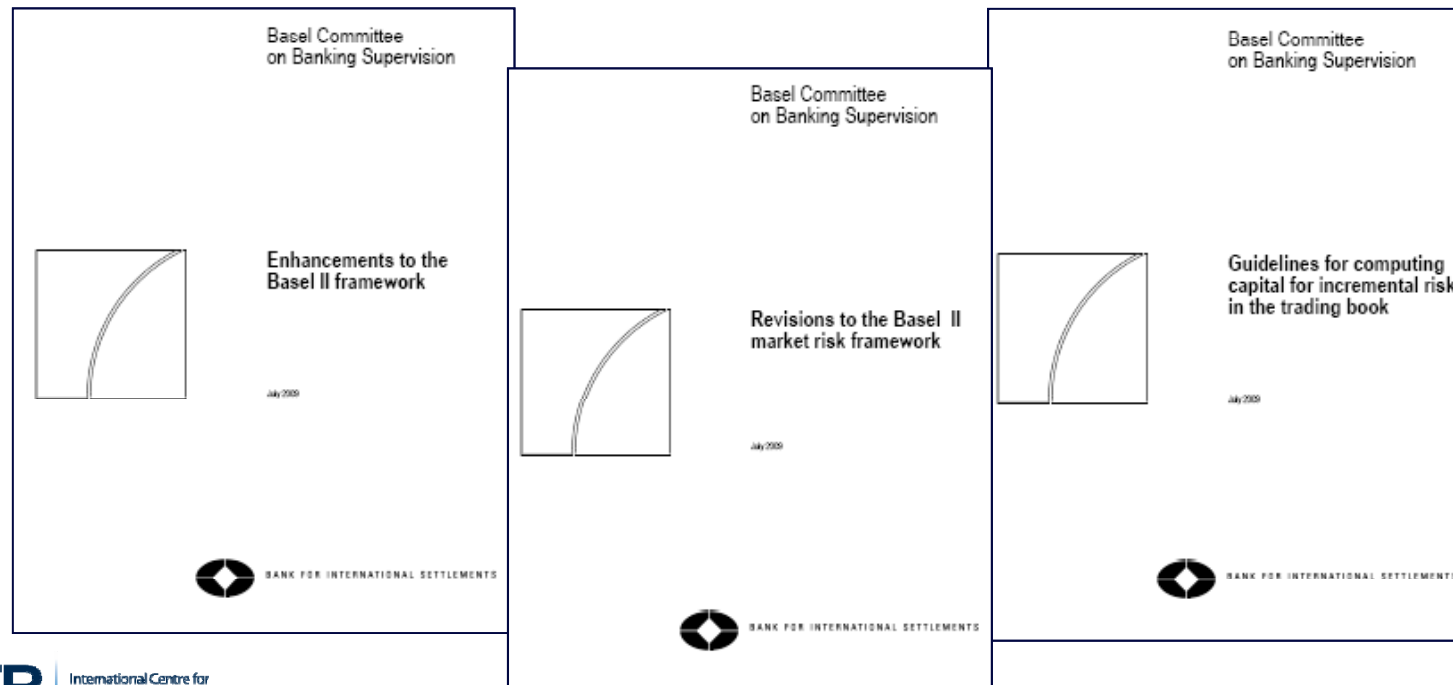
\* Central Counterparty  
 \*\* Capital Requirements Directive  
 \*\*\* Markets in Financial Instruments Directive  
 \*\*\*\* Market Abuse Directive

# Basel Committee on Banking Supervision (BCBS) capital proposals

July  
2009

The BCBS completed a number of reforms to the Basel II framework:

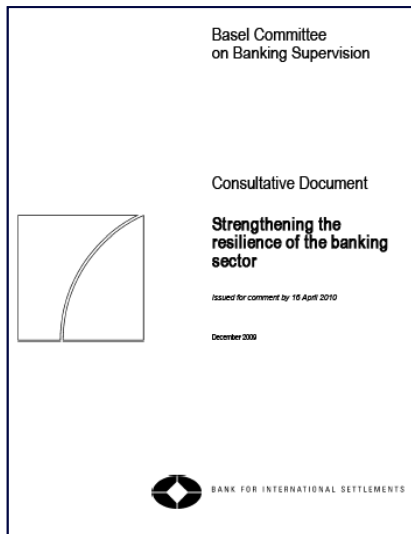
- Raising the capital requirements for trading book and complex securities
- Introducing a stressed VaR capital requirement
- Increasing the capital requirements for resecuritisations (banking and trading book)
- Raising the standards of the Pillar 2 supervisory review process
- Strengthening Pillar 3 disclosures



# BCBS capital proposals

22 December 2009: **Strengthening the resilience of the banking sector**

The Basel Committee issued a package of proposals to strengthen capital and liquidity regulations for international banks. They seek to address deficiencies in bank regulation and risk management that were identified by the recent credit crisis. These measures had been requested by the G20 leaders including the US at the Pittsburgh Summit and are being overseen by the Financial Stability Board. US bank regulators, who are members of the Basel Committee, encouraged submissions on the proposals.



1. The quality, consistency and transparency of capital base will be raised
- 2. The risk coverage of the capital framework will be strengthened.**
3. BCBS will introduce a leverage ratio as a supplementary measure to the Basel II risk-based framework
4. The Committee is introducing a series of measures to promote the build up of capital buffers in good times
5. BCBS is introducing a global minimum liquidity standard
6. The Committee is reviewing the need for additional capital, liquidity or other supervisory measures regarding systemically important institutions

# BCBS capital proposals – key changes (I/II)

## BCBS December 2009: Strengthening the resilience of the banking sector

### 2. The risk coverage of the capital framework will be strengthened.

- Banks must determine their capital requirement for counterparty credit risk using stressed input
- Banks will be subject to a capital charge for mark-to-market losses (credit valuation adjustment (CVA) – capturing risk deterioration)
- Standards for collateral management and initial margining will be strengthened
  - a) Banks with large and illiquid derivatives exposures to a counterparty has to apply stricter capital requirements
  - b) Additional standards are being proposed to strengthen collateral risk management
- Banks' collateral and mark-to-market exposures to central counterparties will qualify for a zero percent risk weight if the relevant central counterparty meets strict criteria currently being developed by the Committee on Payments and Settlement Systems
- Banks must ensure that sufficient resources are devoted to the orderly operation of margin agreements for OTC derivative counterparties and
- That appropriate collateral management policies are in place to control, monitor and report risks arising from margin agreements

# BCBS capital proposals – key changes (II/II)

## BCBS December 2009: Strengthening the resilience of the banking sector

### 2. The risk coverage of the capital framework will be strengthened.

- BCBS will reinforce the incentive for banks to use CCPs for OTC derivatives, increasing capital requirements against exposures if completed on a bilateral basis (rather than through a CCP).
- BCBS proposes to raise the risk weights on exposures to financial institutions relative to the corporate sector
- The Committee is raising risk management standards especially in the area of “wrong way risk” where exposure increases in times when the counterparty credit quality deteriorates.
- Additional guidance for sound backtesting of counterparty credit exposures will be issued.

# BCBS capital proposals: Implementation (I/II)

## Considerations

- Avoid cutting bank lending
- Avoid the risk of slowing the economic recovery
- Ensure that implementation is consistent with financial market stability and sustainable economic growth

## Next steps and timing:

An **impact assessment** of the capital and liquidity standards will be carried **out in the first half of 2010**.

**Fully calibrated standards** will be developed by the **end of 2010** to be phased in as financial conditions improve, with the aim of **implementation by end-2012**.

The Committee will allow **phase-in measures and grandfathering** for a sufficiently long period to ensure a smooth transition to the new standards.

**Basel seeks comment by April 16, 2010**

# BCBS capital proposals: Implementation (II/II)

US

- US banking regulators issued a notice encouraging interested persons to make submissions
- Large US banks are still in the process of implementing parallel runs on the existing version of Basel II.
- Only then can they move to a three-year transition period before adopting the Basel advanced approach.
- US regulators can be expected to issue further guidance on how the new Basel rules, when finalized, will need to be implemented.

# FSA and UK Treasury

## December 2009: Reforming OTC Derivative Markets

- Greater standardisation of OTC derivatives contracts: Enhancing efficiency of transaction processing, increasing use of Central Counterparties (CCP) clearing and trading on exchanges, facilitating comparable trade reporting
- More robust counterparty risk management: CCP clearing and robust collateralisation and capitalisation of not CCP clearable transactions
- Consistent and high global standards for Central Counterparties:
  - a) Regulated to a high standard
  - b) Standards applied consistently in major jurisdictions
- International agreement as to which products are 'clearing eligible': Requiring assessment and decision by CCPs and regulators
- Registration of all relevant OTC derivative trades in a trade repository: Calibrated to a minimum scope and engaging existing reporting channels where appropriate to minimise costs.
- On-exchange trading: At this stage, observing whether there was a need of mandatory exchange trading of standardised derivatives.  
Regulatory objectives can be achieved by the means outlined above.  
Mandatory exchange trading would imply regulatory imposition of trading structure.

# Comparison of selected key proposals in the US (I/III)

**11 August 2009: Obama administration proposes draft reform legislation**

**11 November 2009: US Senate Banking Committee chairman Christopher Dodd proposals**

**11 Dec 2009: US House of Representatives approved “The Wall Street Reform and Consumer Protection Act of 2009”, including OTC Derivatives legislation still to be voted on by the US Senate**

## Clearing requirements

All standardised OTC trades are to be cleared through a clearing organisation regulated by the CFTC or a securities clearing organisation regulated by the SEC.  
A transaction accepted for clearing by a registered clearing house is regarded as standardised.  
CFTC and SEC jointly define “standardised” transactions.

CFTC/SEC can define particular transactions as clearable.  
Clearing houses can seek product approval from CFTC/SEC regarding clearing eligibility.  
CFTC/SEC may put clearing requirements on hold while reviewing terms of clearing arrangements.

Under the House Legislation, a swap must be cleared if a Derivatives Clearing Organization (“DCO”) will accept the swap for clearing, and the CFTC has determined that the swap is required to be cleared.

## Exchange trading requirements

All standardised OTC transactions are to be traded on a regulated exchange or alternative swap execution facility.

Transactions eligible for clearing also need to be executed on a regulated exchange or alternative swap execution facility.

All swaps required to be cleared must be traded on a regulated exchange or swap execution facility (“SEF”), which includes electronic trade execution and voice brokerage facilities. If no exchange or SEF will list the contract, it does not have to be executed and transaction reporting rules apply.

## Trade reporting requirements

Both counterparties of a non-cleared OTC transaction must report the trade to a trade repository or to CFTC/SEC if not accepted by trade repository.

Transactions that are not cleared and executed to be reported to a trade repository and are subject to margin requirements.  
All swaps that are not accepted for clearing must be reported either to a swap repository or the CFTC, if no swap repository will accept the swap.

# Comparison of selected key proposals in the US (II/III)

**11 August 2009: Obama administration proposes draft reform legislation**

**11 November 2009: US Senate Banking Committee chairman Christopher Dodd proposals**

**11 Dec 2009: US House of Representatives approved “The Wall Street Reform and Consumer Protection Act of 2009”, including OTC Derivatives legislation still to be voted on by the US Senate**

## Market participants

Any company that deals in OTC derivatives or takes large positions in OTC products needs to register with CFTC and/or SEC, being regulated and supervised. Some market participants are being classified as “dealers” or “major swap participants” and subject to specific regulation and registration requirements.

Capital, margin and conduct rules will apply.

While all other proposals define major swap participants as a person holding “substantial net positions” in swap transactions, Dodd defines this category as a person whose outstanding swap exposure (currently and potentially in the future) could cause significant credit losses to other market parties.

Swaps primarily held for hedge purposes are not excluded from the major swap participant definition.

Swap repositories, swap dealers, major swap participants, and swap execution facilities to register with the CFTC. Amends the Commodity Exchange Act to require joint regulation of swap markets by CFTC and SEC. (Major swap participant definition excludes swaps primarily held for hedging) Legislation gives regulatory authority to several Prudential Regulators to monitor bank swap dealers and major swap participants. The CFTC and the SEC are required to consult with each other and the Prudential Regulators before promulgating new rules.

Swap dealers and major swap participants subject to clearing and execution requirements, capital and margin, and business conduct rules. CFTC can exempt a person from being designated a swap dealer.

## Position limits

SEC and CFTC may impose position limits on transactions imposing significant price discovery functions. Any market participant can be subjected to position limits and CFTC/SEC may exempt any person or transaction from position limits.

Legislation expands the CFTC's authority to establish position limits (now limited to agricultural commodities) by directing the CFTC to set position limits for spot month, each month, and aggregate positions for all physically deliverable commodities, other than excluded commodities as defined by the CFTC.

# Comparison of selected key proposals in the US (III/III)

**11 August 2009: Obama administration proposes draft reform legislation**

**11 November 2009: US Senate Banking Committee chairman Christopher Dodd proposals**

**11 Dec 2009: US House of Representatives approved “The Wall Street Reform and Consumer Protection Act of 2009”, including OTC Derivatives legislation still to be voted on by the US Senate**

## Capital and margin requirements

Swap dealers and major swap participants will be subject to

1. Capital requirements for OTC transactions with higher capital charges for non-cleared trades.
2. Minimum initial and variation margins will be set by SEC/CFTC for non-banks and by federal banking agencies for banks.

Dodd’s proposals require margining rules for all but makes allowances for the regulators to exempt market participants (non-financial business) or market transactions (for hedge purposes) .

The regulators must impose capital and margin requirements, including both initial and variation margin, on regulated swap dealers and major swap participants, to ensure “the safety and soundness of the swap dealer or major swap participant.”

## Exemptions

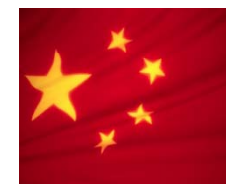
The OTC Clearing and exchange trading rules do not apply in the cases of:

1. Transaction not being accepted for clearing by a clearing house
2. One of the counterparties is neither a “swap dealer” nor a “major swap participant” under the definitions and does not meet clearers’ eligibility criteria

Legislation carves out foreign exchange forwards and swaps , unless the CFTC makes a determination, with the agreement of the Treasury Secretary, that foreign exchange swaps or foreign exchange forwards or both should be regulated as swaps. All forward exchange swaps and forwards must be reported to a trade repository or the CFTC.

Legislation exempts “any sale of a nonfinancial commodity or security for deferred shipment or delivery, if transaction is intended to be physically settled”. These transactions may still be subject to the regulatory regime if they do not result in actual delivery, and the counterparties are unable to demonstrate they intended to physically settle the transaction.

# Regulatory actions in China



## China Banking Regulation Commission: Development and Regulation of Derivatives in China

### OTC derivatives in China

- Interbank trading in RMB-FX forwards, RMB bond forwards, RMB interest rate swaps
- Trading with offshore counterparties in a range of instruments on FX, interest rates, credit, stock indices, commodities (mostly forwards, swaps, options)



Subject to the unified regulation and administration of the PBOC\*

### Regulating and developing derivatives trading

- Is crucial to financial reforms
- Is the necessary path for Chinas banks and their customers to participate in global competition

### Focus on

- Increase all market participants' expertise and understanding
- Strengthen their ability to utilise and risk-manage derivatives

# Agenda

Introduction

1. Key stakeholders in the debate

2. Reasons and aims of OTC regulation reform

3. US, European and worldwide initiatives

4. Ongoing debate

## Ongoing debate (I/II)

1. Market participants wary of **forcing OTC products onto exchanges**:
  - A natural flow of product development from OTC to exchanges as volumes develop and products standardize should be encouraged.
  - Forcing on exchange might clash with MiFID requirements of choice of execution.
2. All felt it was critical to have **consistent regulation across jurisdictions**, if the sector was to be able to operate efficiently, and so as not to provide opportunities for regulatory arbitrage.
3. 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 .
4. Market participants agreed that it was essential that regulators remained focussed on the issues that they are seeking to address with new regulation while **not loosing sight of the big picture** and overall goals of future regulation.

## Ongoing debate (II/II)

5. Strong consensus on the utility of **data repositories** but concerns about:
  - The degree and purpose of regulatory access
  - Problems with conflicting domestic data protection legislation across jurisdictions, particularly with regard to single customer data
  - Confidence in the market: Clients must be assured that data will be safe and that regulators rights for information are clearly defined and articulated.

Market participants highlighted:

6. **Ownership of clearing houses** and how non-member transactions will be catered for needs to be carefully considered.
7. Central clearing could have significant **counterparty portfolio risk** implications for counterparty risk management and cross-product netting.
8. Single name CDS are very difficult to margin for clearing houses due to the 'jump to default' effect.



This publication is produced by the ICFR and is intended for general guidance only.

***The ICFR grants permission to:***

- Download, display or print material for personal use or use within an individual organisation and for non-commercial use only.
- Create weblinks to these pages.
- Reproduce extracts provided the source is stated as being the “International Centre for Financial Regulation ([www.icfr.org](http://www.icfr.org))”.



International Centre for  
Financial Regulation

## ABOUT THE ICFR

The ICFR is a global collaboration between key players in the private and public sector with backing from major international financial institutions and professional services companies, as well as the UK Government and the City of London Corporation. Its mission is to address the critical issue of international financial regulation by creating new thought leadership, research, scholarship and training for the financial industry. While based in the City of London the ICFR serves a global constituency.

Further information may be found at: [www.icffr.org](http://www.icffr.org).

**The International Centre for Financial Regulation is incorporated as a company limited by guarantee in England and Wales**

**Company Number 6625422**

**Registered Office 5<sup>th</sup> Floor, 41 Moorgate, London EC2R 6PP, United Kingdom**



International Centre for  
Financial Regulation