

# OTC Derivatives Forum – 4 March 2010

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## Draft for Participants' Comments

The ICFR held its second forum on OTC derivatives regulation on 4 March 2010 to discuss specific areas of proposed legislation.

The areas highlighted for discussion at the roundtable were

- Clearing and settlement of OTC derivatives
- Regulation of central counterparties (CCPs)
- Data repositories
- Position limits
- Use of exchanges

The participants comprised representatives from

- Regulators
- Clearing houses and data repositories
- Banks
- Asset managers and corporate derivative users
- The legal and accounting professions

The discussion started with participants listing their key concerns. Many of these focussed upon definitional issues and what proposed regulation was trying to achieve. In particular, definitions of eligibility and standardization, transparency, and what is 'capable of clearing' remain open for interpretation and discussion. Many participants agreed that it would be useful to draw attention to examples of effective collaboration between industry and regulators to address problems. They also considered at length the interests market participants have in good risk management, and how to motivate market participants toward better risk management.

### Proposed Regulation

The participants agreed that there was a need for regulation based upon evidence of need for reform. It was widely considered that there was a risk associated with prescribing a solution before full discussion of how such proposals may work in practice. There was an understanding that the likelihood of getting international consensus was small, despite the need for global standards to avoid regulatory arbitrage. Furthermore, the participants understood that legislators may be more receptive to arguments of end-users than those from the industry. There was concern that, as legislators are not specialists in these markets, they will consider securities and derivative markets to be analogous, and thus will create regulation that is inappropriate for derivative markets, affecting both sell- and buy-side firms. There was concern over measures that may make legitimate corporate hedging impossible, such as banning naked CDS, and also that potential changes to collateral requirements, from a default basis to a credit quality migration basis, may increase the cost of such transactions dramatically. The number of consultation (and other) papers coming from various regulatory bodies, with very little detail about how the proposals would work in practice, makes it extremely difficult to quantify the impact, particularly in light of differing views emanating from European bodies, and the pending CPSS/IOSCO review, which is being carried out independently of any new regulation. Instead of regulation, however, persuasion through the series of commitment letters sent to various regulators by a group of major dealers has served to show a willingness to be

pro-active on the part of the industry, as well as a gauge of what is practically possible in the time scales laid out.

### CCPs: Governance and Use

It was argued that up until the present point, CCPs had worked extremely well, particularly being able to withstand the failure of clearing members. However, it cannot be said that it is possible to make a one-off policy decision as to whether it is best to have a single CCP or multiple CCPs. Should there be a single CCP, questions regarding ownership would need to be carefully considered; with multiple CCPs competition may engender a race to the bottom in order to attract business which may serve to undermine proposals on margin requirements, for example. Similarly, the potential for a race to the bottom in business carried out with non-CCP members was discussed, particularly in relation to credit quality, margining and collateralisation. Whilst the participants agreed that, in principle, they did not believe that the current systems of bilateral agreements and counterparty exposure needed to be regulated against in its entirety, any increase in the cost of doing business with non-CCP members may cause financial sector firms to exit these businesses and may possibly precipitate a movement towards unregulated participants. It was noted that the vast majority of the market value of OTC derivatives is actually collateralised, as it is among inter-dealer brokers, all of which have Credit Support Agreements (CSAs) in place.

Instability may come from CCPs trying to clear products that they are not capable of clearing, due to the difficulty of determining appropriate margining and pricing; such clearing may also lead to the destruction of liquidity in any particular security. Furthermore, there was discussion about the variability of liquidity based upon market activity, term and credit quality: a contract that is clearable today may not be clearable in a year's time. For this reason, any static definitions of "clearable" or measures to clear a derivative based on the liquidity of the product would not work over an extended period of time.

### Data Repositories and Transparency

The participants were keen to point out that the interest rates repository that has been set up in Sweden seems to work well, and that a central repository, correctly carried out, could also work. The rates repository, however, does not publish information to anyone who wants it – those undertaking transactions have to agree to the regulators that can view that data. All participants agreed that this was an elegant solution that upheld the requirements of international data privacy laws. As it currently stands, the proposals for any repository for OTC derivatives are more intrusive. More work will need to be done on data privacy issues across borders, although creating a similar regime of giving regulators permission to view data where disclosure is required would be a strong start. Whilst there was agreement that post-trade transparency was a good thing to achieve, the major question was around who will need the information collected at these repositories, and what will be done with it? At best, this information could be used by regulators to see general trends in the market. The need for a measured approach to define what information would be required was highlighted, and concern noted over the best way of going about this: particularly whether all regulators would want – or need – the same information.

Whilst data repositories by product seem the most straightforward way to proceed, and the interest rates repository is an excellent success story, product repositories only tell a part of the story as they do not show a good picture of counterparty risk, especially where cross-product netting is in place. Cross-product netting is also a problem for counterparty risk exposure where required clearing through a CCP is involved.

### Risk Management:

The considerations detailed above lead to recognition that it is critical to align incentives for risk management by market participants with financial stability objectives. Currently, there are significant inconsistencies in accounting, regulatory and derivatives regulation which send divergent messages on netting, hedging and clearing of derivatives risk. Clear, consistent explanation of the trade-offs to regulators involved in all of these issues is important. The creation of the Co-operative Global OTC Derivatives Regulatory Group was mentioned. It might be worth directing considerations in this area to this group.

### Success Stories

When asked for examples of successful efforts to improve risk management and transparency, the participants highlighted four different areas:

- Netting and close-out netting after a default or bankruptcy. The major success story in this area was the speed and relative ease with which contracts were closed out after the bankruptcy of Lehman Brothers.
- Commitment letters have served as a means of engaging with regulators and proposing reforms that are attainable and that should effect a positive move towards the aims of transparency and risk management that legislators appear to be aiming for.
- ISDA master agreements and CSAs have served as a market-driven means of standardising the terms of business in the market; any new regulation should look to the substance of the agreements already in place to ensure that it does not reinvent the wheel.
- The interest rates repository was discussed as a project that was completed in a timely and successful manner. This was largely down to a consensus-based approach, which had clear objectives set out between the interested parties (regulators and industry), coupled with the quality and knowledge of key people involved. There was agreement, however, that this was perhaps made easier by the fact the repository was not driven by commercial profit, may not be true for any repository built in response to the proposed legislation.

### Next Steps

- The participants discussed a means of quantifying the costs of new regulation, and who is best positioned to carry out such a task. There was concern that such figures, as presented by the industry, may be viewed sceptically by legislators, and that perhaps it would make more sense to work together with end-users to produce such information. The interaction between derivatives legislation, Basel II and its revisions and IFRS also need to be considered.
- Publishing a list of success stories as examples of how to make the market work better and how to encourage successful interaction between the market and regulators was encouraged.
- It was agreed that it would be useful to find a way to educate regulators on certain specific aspects of the derivatives markets as well as on the success stories.