Derivatives Regulation: A New World Order?

This article focuses on some of the key developments in the area of derivatives and trading regulation through 2009, and likely moves towards concrete regulation and policing of these markets on a cross-border basis through 2010 and beyond.

By Prajakt Samant

ENHANCING MARKET INTEGRITY and oversight, reducing operational risk in trading, reducing counterparty risk in trading and increasing transparency are now key action items for regulators of derivatives markets and trading on both sides of the Atlantic and elsewhere. "We must lower risk, promote greater market integrity and improve market transparency" in the words of Gary Gensler, Chairman of the Commodity Futures Trading Commission (CFTC). These words continue to resonate following the conference held by the European Commission in Brussels on 25th September 2009.

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The near-collapse of Bear Stearns, the Lehman bankruptcy and the bail-out of AIG (among others) have, for some, illustrated the damaging impact derivatives can have on the global economy. As a consequence, market commentators began to focus on why everyone knew so little about these key financial instruments, which apparently underpinned much of the international financial system. Whilst the focus was not commodity derivatives *per se*, the result has been commodity derivatives being grouped with the offenders, resulting in the general perception of 'derivatives' as a dirty word – "... financial weapons of mass destruction," as described by Warren Buffett back in 2003.

The EC has set a goal to safeguard financial stability by improving the way in which the derivatives markets function. It is argued that the lack of transparency in OTC derivatives enabled certain market players to keep hidden from others the true extent of their exposures to counterparties, thereby creating uncertainty and loss of liquidity, not to mention the timely discovery of the systemic risks which had built up.

Risk Mitigation

Counterparty risks can be alleviated by the way trade and post-trade functions are structured. It is argued that risks are mitigated through clearing, which can occur either bilaterally between two counterparties or at a central market level via a Central Counterparty (CCP). CCPs almost exclusively perform the clearing for on-exchange derivatives, whereas bilateral clearing is the dominant method for off-exchange derivatives. Whilst bilateral clearing is often more cost-efficient, and may give the bigger OTC players in the market an information advantage, its many disadvantages include reliance on each counterparty's internal risk assessment methodology, (in) frequency of valuation and subsequent exchange of collateral, and the failure to take into account the cost of replacing a defaulted contract in the market. It has also been demonstrated that the credit rating agencies, responsible for assessing the quality of a counterparty's credit, can have a detrimental impact on a counterparty when it is downgraded, resulting in a considerable increase in the collateral to be posted into the market.

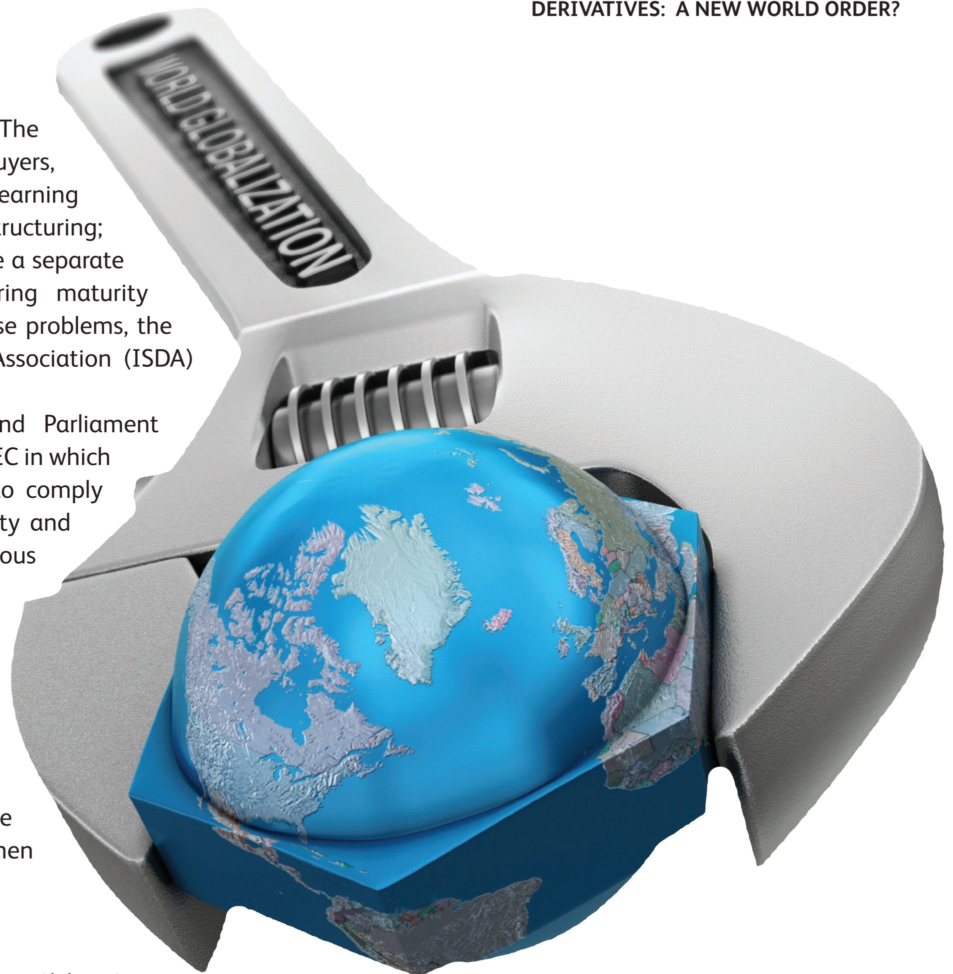
October 2008 – July 2009

In October 2008, the Commission requested a systematic study into the derivatives markets, following the lessons learned from the financial crisis, and the development of solid proposals on how to mitigate the risks surrounding credit derivatives, which has resulted in several regulatory developments.

In the short-term, ten major dealers consented to put their credit default swaps (CDS) on European indices and the single names to one or more central counterparties regulated in the EU by the end of July 2009. July 2009 saw two CCPs (ICE Clear Europe and Eurex) providing clearing with a third CCP (LCH.Clearnet SA) anticipated to be providing clearing of European index CDS by the end of this year and single-name CDS in 2010.

Drafting standard legal terms in the contracts that include European specificities was another hurdle as it concerned the 'restructuring' credit event. Restructuring in the US is generally conducted via Chapter 11 and, as such, North American contracts (with the exception of the majority of North American single-name CDS) will trade without restructuring.

However, in Europe the removal of restructuring in these contracts is not feasible, and has failed as buyers want protection against the particular credit event that will trigger the restructuring process.



This posed two problems for CCPs. The first was selective triggering whereby buyers, hoping that the seller defaults and so earning more, may decide not to trigger restructuring; and the second being the need to make a separate auction for each different restructuring maturity limitation date. In order to resolve these problems, the International Swaps and Derivatives Association (ISDA) published the *Small Bang Protocol*.

In April 2009, the EU Council and Parliament approved a regulation proposed by the EC in which credit rating agencies will now have to comply with strict standards of integrity, quality and transparency and be under continuous supervision.

July 2009 Onwards

Through a series of Commission *Staff Working Papers* in July 2009, the EC highlighted a number of tools to be applied by each market depending on its level of maturity in order to increase transparency of trades and strengthen counterparty credit risk mitigation:

1. Promoting Standardisation

Earlier this year, over 2,000 market participants accepted ISDA's 'Big Bang' protocol relating to the establishment of the determination committees, hardwiring the auction process so that physical settlement outside the auction is no longer possible ,and rolling the effective date thereby ensuring that trades on the same reference entities and same notional but different dates could be perfectly offset. Amendments were made to the credit definitions at a global level for both existing and new transactions in an attempt to improve market standardisation. Five regional determination committees (Americas, Japan, Asia ex-Japan, EMEA (Europe, Middle East and Africa) and Australia-New Zealand) were established to form a binding judgment on whether credit and succession events had occurred and when, thus heading off at the pass circumstances where conflict arises between counterparties in a credit default swap contract as to whether a credit default event has in fact occurred.

The disadvantage of standardisation is that its costs correlate with the level of standardisation required and the risk mitigation tools utilised. Equity and commodity derivatives, although often documented on standard industry agreements, are (in relative terms) quite non-standardised. These master agreements are topped and tailed to customise the contracting parties' needs e.g. dividends and corporate events with regard to equity derivatives, whilst commodity derivatives are controlled by product considerations in relation to physical delivery of the underlying. By comparison the foreign exchange market is readily definable and the contract specifications are standardised with large institutions usually trading out of London, thereby converging their OTC foreign exchange business on one type of contract under English law.

2. Strengthening Bilateral Collateral Management for Non-CCP Eligible Contracts

Not all OTC derivatives can be cleared via a CCP. The numerous liquidity and standardisation requirements that must be fulfilled prior to utilising a CCP may be a stumbling block that cannot always be overcome. Taking these circumstances into account, the EC resolved to strengthen counterparty risk management in bilateral trades. Risk is mitigated in bilateral contracts via the injection of collateral which is only a successful indemnity against credit exposure if collateral is frequently calculated, is comprehensive to cover the overall potential counterparty credit exposure, and is successfully exchanged in a timely manner. The Commission has posited that daily valuations, increased collateral coverage, reinforcement of the collateral management process and

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reduction of outstanding derivative positions (through mechanisms such as multilateral netting of positions) would need to be employed in order to further mitigate risk.

3. Enhancing The Use of Central Data Repositories

In order for regulators to have accurate and meaningful oversight of potential systemic and financial risks, they must possess the fullest possible purview of the derivatives markets. Central data repositories are vital sources of information and, as such, contribute considerably to improving market transparency. These repositories collect data such as the number of transactions, the size of the outstanding positions as well as assisting payment and settlement instructions. A repository currently exists for CDS which could be utilised for other derivatives. CESR is conducting a study into whether such a data repository would be possible in the EU and how its compatibility with current infrastructures could be ensured.

Such encouragement to use central data repositories raises two public policy questions. Firstly, how would market participants be encouraged to use central data repositories; and, secondly, who should have access to the information that the repositories collect. It has been suggested that the first issue could be overcome either by incentives or mandating the use of data repositories, whilst the second issue could be resolved by granting the regulators full and unrestricted access to central data repositories while the public would be granted aggregate market information. Currently, a group of numerous national regulators are creating standard templates of information that should be disclosed to the public and to the relevant regulators.

4. Clearing of Standardised OTC Derivatives Move to CCPs

Clearing OTC derivatives via one or more CCPs enables counterparties to post collateral to a central party which has the benefit of netting exposures multilaterally (each party posts its collateral against the CCP), not to mention the availability of a larger pool of collateral should a counterparty default. CCPs 'double' their insurance against counterparty default by requiring an upfront payment ('default fund') which provides additional protection to counterparties.

Unlike bilateral clearing, where a change in exposure may go unnoticed for a period of time, CCPs by their nature are capable of making swift adjustments when a risk position in the market changes.

There are strong advantages to using a CCP. Risk is mitigated through the use of multilateral netting and by vigorous margining procedures. Despite strong opposition (particularly from so-called 'pure hedgers' in the market) that moving to a CCP may imply higher margins (as a CCP applies margin multilaterally, per product range cleared, whereas margins are applied to the portfolio of all products with a specific counterparty in bilateral clearing), the consequent reduction in systemic risk may be seen to far outweigh the added cost.

If a sufficient number of asset classes are cleared, as a result of multilateral netting, payment netting and cross-margining arrangements, CCP clearing may reduce the collateral required and actually enhance market liquidity.

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Utilising a CCP reduces mistrust in the market as there is no benefit to the CCP to withhold information for its own profits and for not allocating losses. Given that it is responsible for deducing margin and collateral requirements, mark-to-market contracts and payment transfer, this model may lead to greater operational efficiency at a lower risk and cost.

5. Increasing Transparency of Prices, Transactions & Positions

Greater efficiency, diligence and a more accurate assessment of risk are the main reasons given for the clarion call for more transparency. The Commission has formulated its stance on transparency in the form of trade repositories, regulation of these repositories, moving standardised derivatives on exchange and other public trading venues and addressing an increasing pre- and post-trade transparency in the next review of the Markets in Financial Instruments Directive (MiFID). MiFID stands at the forefront of encouraging the development of a harmonised infrastructure for trading in financial instruments. Under Article 25 of MiFID, investment firms must report all transactions in any financial instrument admitted to trading on a regulated market to the competent authority. OTC derivatives not admitted to trading on a regulated market are exempt from these MiFID requirements.

6. Moving Trading to Public Trading Venues

During the G20 meeting in September 2009, it was agreed that "all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate". The Commission considered this to also be the logical addition to standardised derivatives that were being cleared by CCP. A public trading venue would display prices, volumes, open interest and other trade-related information which would facilitate market access.

Public trading venues would require a stringent set of transparency provisions in order to ensure that all derivatives were covered, and

that no readily exploitable loophole existed. Such venues would encourage competition amongst themselves, which would increase market efficiency and guarantee fair competition.

US Regulatory Developments

Speaking at the recent meeting in Brussels, convened by the Commission's DG Internal Market and Services, on 25th September 2009, Gensler addressed the fact that the interconnectedness and symbiotic nature of the global financial markets meant that every nation must work together to ensure that the financial regulatory system does not fail again. The solution could not come from just the US, as it was now abundantly clear that institutions such as AIG had two-thirds of its approximately US$45 bn net notional value of credit default swaps written to support major banks primarily in Europe.

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During the summer, the CFTC held three days of hearings and heard from over 20 witnesses. There were mixed reviews as to whether position limits should be applied across the various commodity markets. However, there was a general consensus that should such limits be set, it should be the CFTC's responsibility and not the exchanges' to police.

Gensler has identified five key components that would need to be considered in order for risk to be lowered and market transparency and integrity to increase:

(1) Regulatory development should be applied to all products/entities, and not just those that suffered as a result of the financial crisis, which would include interest rate swap, CDS, currency swaps and "all derivative products that may be developed in the future". Regulation across the board would reduce the opacity currently present in the OTC derivatives market.

(2) Any regulation implemented must be sufficient to cover not only the derivatives markets but also monitor the dealers.

(3) Standardised OTC derivatives should be moved to regulated exchanges or regulated trade execution facilities, thereby encouraging pre- and post-trade transparency and market efficiency.

(4) The relevant regulators must possess information on all OTC trades.

(5) Central clearing should be obligatory for all standardised OTC derivatives. Gensler believes that incentives by themselves will not be sufficient to encourage market participants to move to utilising a clearinghouse. Clearing houses will be governed to ensure that they have open access to promote competition, open membership, including to the non-dealer community that meet risk management standards and open governance to ensure proper management, and maintain public interest at the forefront.

Impact of Regulatory Proposals on Non-financial Sector

Industrial players have long utilised OTC derivatives to manage anything from the unpredictability of currencies and fluctuations in price of commodities such as oil to even employee pension fund liabilities. It appears that non-financial companies are the most vociferous dissenters of the proposed regulations. Companies such as Lufthansa, British Airways and Rolls Royce expressed all their concerns that such regulation would hit non-financial companies who routinely use products such as OTC derivatives to manage their business risks. Lufthansa demonstrated that a US$1 change in the price of crude oil "has a US$60 million impact on [our] cost base", which they resolved via hedging in the OTC derivatives market.

It is clear that there is a deep-rooted concern that, should the majority of OTC derivatives trading be moved on-exchange, this could force companies to post considerable sums of collateral as a result of even minor fluctuations in currency or commodity prices.

In a recent interview, Gensler said: "Treasury's legislative proposal is a very important step toward much-needed reform to protect the American people by lowering risk, promoting transparency and protecting market integrity. I believe that all over-the-counter derivatives and dealers should be brought under comprehensive regulation. I look forward to working with Congress to make sure that the law covers the entire marketplace without exception".

What is clear in the midst of all this is the fact that 2010 may well be the year in which the boundaries of both regulators and financial services regulation will be pushed even further. Both the Commission and US regulators want to ensure that transatlantic regulatory developments, as far as possible, happen in concert and have the same end-goal. This will minimise opportunities for any regulatory arbitrage between jurisdictions. Whether or not that will be possible remains to be seen. However, whatever the regulation may be, a fine balance will need to be struck between a system which makes the cost of hedging prohibitively high, and a system with easily exploitable loopholes. •

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