

OTC derivatives: market structure and financial stability

20 November 2009
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Outline

1. OTC derivatives: overview of the market
2. Overview of current proposals for reform
3. The benefits of central clearing
4. Expanding central clearing
5. Conclusions

1. OTC derivatives: overview of the market

(USD billions)	Notional	Gross
Interest rate	437,198	15,478
FX	48,775	2,470
Credit default	36,046	2,987
Equity	6,619	879

1. OTC derivatives: overview of the market (ctd)

- Large financial markets
- Complex network of dealer exposures
- Interdependencies with other markets
- Important for funding requirements of market participants
- Some evidence of impaired liquidity in 2007-8
- Some evidence of insufficient counterparty risk management
- Relatively opaque

1. OTC derivatives: overview of the market (ctd)

- Issues to consider:
 - How to improve credit risk management?
 - How to improve liquidity resilience?
 - How to improve transparency?

2. An overview of current proposals for reform

- G-20 and Financial Stability Board (September 09)
- US Treasury (July 09)
- US legislative proposals (Autumn 09)
- European Commission (October 09)
- CPSS-IOSCO review of standards for CCPs clearing OTC derivatives (2009-10)

2. An overview of current proposals for reform (ctd)

- Common objectives:
 - Reduce counterparty credit risk
 - Increase transparency
 - Increase operational resilience
 - Enhance market integrity

2. An overview of current proposals for reform (ctd)

- Common elements:
 - Central clearing for standardised contracts
 - Exchange trading or electronic platforms for standardised contracts
 - Use of trade repositories for all OTC derivatives
 - Higher capital requirements for bilaterally-cleared contracts

3. The benefits of central clearing

- Consistent and transparent credit risk management
- Consistent and transparent post-default management processes
- Multilateral netting
- Predictable margin calls
- Standardised operational processes
- Catalyst for standardisation

3. The benefits of central clearing (ctd)

- Systemic risk reduction:
 - More resilient market liquidity
 - Reduced liquidity spirals
 - Reduced spill-over effects

4. Expanding central clearing

- CCPs will concentrate more risk and clear more complex products.
- CCPs must have robust risk controls to manage their own risk exposures:
 - Risk controls dependent on product and market characteristics
 - As CCPs take up new products, risk controls will need to be adjusted
 - International standards for oversight are being reviewed to reflect new risks

5. Conclusion

1. To ensure good progress and meet the G-20 targets, CCPs, market participants and authorities need to work together to:
 - Continue expand electronic processing and contract standardisation
 - Develop margining methodologies
 - Develop default processes
 - Ensure all CCP risk controls remain robust

5. Conclusion (ctd)

2. Bilateral clearing continues to be important, so market participants and authorities need to work together to ensure processes are transparent and robust