Future Prospects for Over-the-Counter Derivatives Markets: the U.S. View

European Capital Markets Institute

Theo Lubke

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Agenda

- Role of OTC derivatives in the financial crisis
- Addressing counterparty credit risk
  - Central clearing
  - Credit risk mitigation of uncleared trades
  - Capital reform
- Improving transparency
- Operational risk management and progress to date
- Greater standardization
- Additional elements of U.S. legislation
- Global regulatory coordination
- Q&A?

Role of OTC Derivatives in the Financial Crisis

- The financial crisis demonstrated some significant weaknesses in the OTC derivatives market
  - Fragility due to counterparty credit risk
  - Opacity of market risks and linkages
  - Weaknesses in firm-level risk management
  - Importance of strong operations
- These issues have driven regulatory efforts in Europe, Asia and North America to reduce risks caused by derivatives and to improve regulation of the markets
- Legislative efforts are underway in the U.S. to address these issues, which this presentation will cover at a high level

Counterparty Credit Risk –Central Clearing

- Counterparty credit risk concerns spurred clients to move trades and initial margin away from the riskiest dealers, exacerbating liquidity pressures for deteriorating financial institutions
- In response, regulators advocated for greater use of central counterparties
  - Launch of clearing services for credit derivatives (Clearnet SA , CME, Eurex, ICE Trust/ICE Clear Europe)
  - As of April 2010, $7.5 trillion of gross CDS notional has been cleared
- Industry established clearing commitments for credit and interest rate derivatives
  - Targets for G14 dealers to submit and clear minimum amount of clearing-eligible trades
  - Increase use of clearing to buy-side market participants
  - Expand product eligibility
- *US Legislation - Central clearing required for certain swaps that CCPs will accept for clearing; details to be determined by SEC/CFTC*

Counterparty Credit Risk—Uncleared Trades

- Bilateral collateralization practices
  - Increased frequency of portfolio reconciliation between dealers
  - Improved dispute resolution procedures
  - Consideration of methods to segregate client margin
  - Review of market practices revealed need to further automate margin call processes, standardize documentation and expand reconciliation to non-dealer counterparties
- Portfolio compression
  - Since 2008, $53 trillion of notional outstanding compressed in CDS, $39 trillion in rates
- *US Legislation -*
  - *At the request of a counterparty, segregation of initial margin at an independent custodian required*
  - *Margin requirements for non-cleared swaps*

Counterparty Credit Risk—Capital Reform

- Restructuring capital framework
  - Capital charge commensurate with risk; cleared OTC derivatives have a different risk profile from their non-cleared counterparts
- BCBS proposed capital reform for CCPs and counterparty credit risk:
  - Create reduced capital incentive for strong CCPs
  - Increase incentive for higher initial collateral and margining
  - Increase correlation assumptions for asset valuations between financial institutions to reflect interconnectedness
  - Improve stress-testing, model validation and modeling for stress periods
  - Assess liquidity and leverage impact of derivatives
  - Account for exposures to other financial institutions in capital
- *US Legislation - Higher capital requirements for non-cleared swaps*

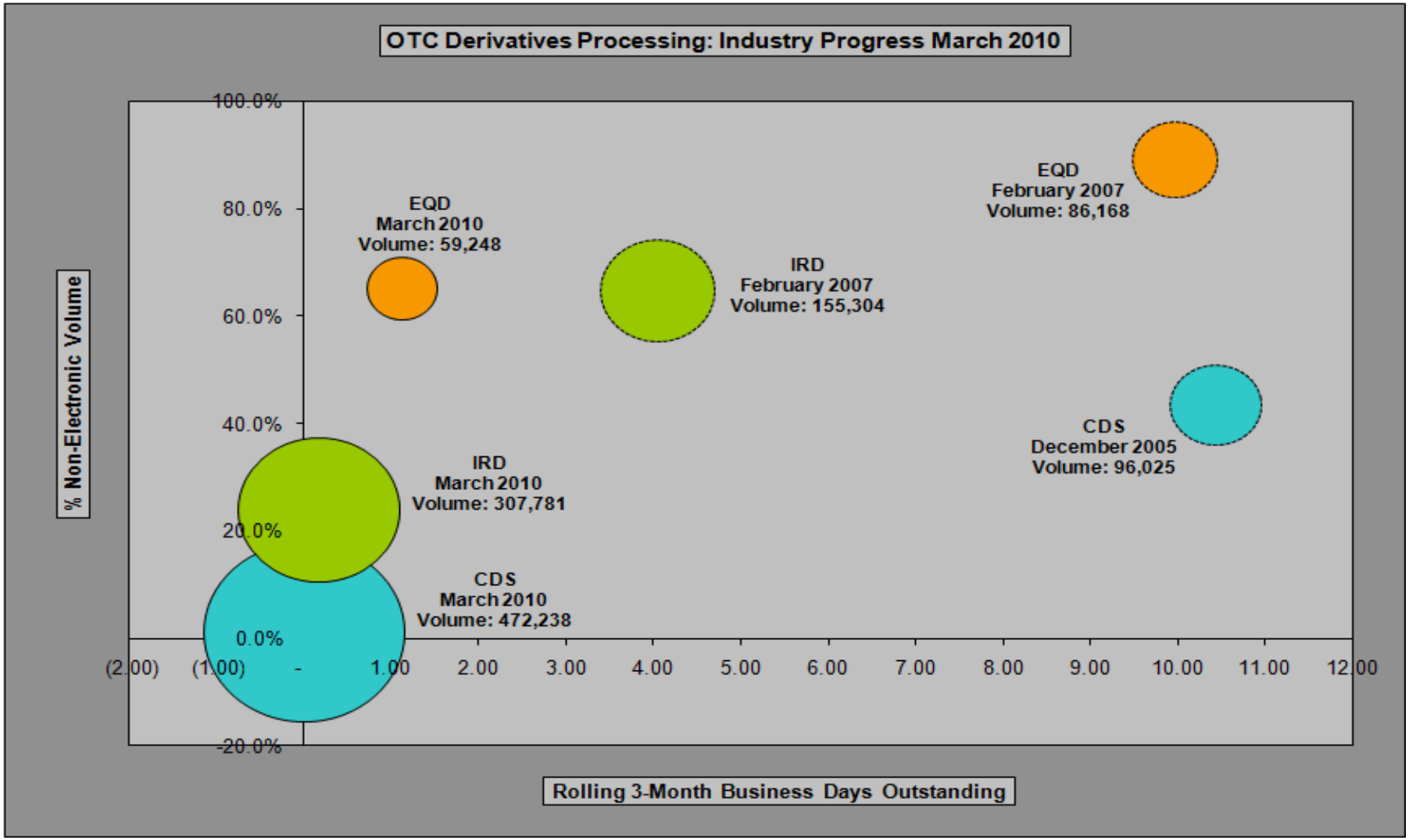
Improving Transparency

- Improve regulatory transparency
  - Reporting non-cleared trades to trade repositories will increase position and trade transparency to regulators
  - In June 2009, dealers committed to reporting trades to trade repositories for credit, interest rates and equity derivatives
- Increase public transparency:
  - Provide aggregate market data to the public via trade repositories
  - Reporting price and volume information would give insight into the liquidity, trading interest, size and depth of the market
  - Major dealers committed to provide trade data to regulators for analysis and to conduct a transparency gap analysis
- *US Legislation - Non-cleared swaps must be submitted to a swap repository or to the CFTC/SEC if no repository exists; swap execution facilities to make public timely information on trading data*

Operational Improvements

- Goal is an environment that is free of significant operational risk and relies on well-automated post-trade processing
- Processing efficiency has improved and there is no longer a material backlog of unconfirmed trades for credit and rates
- Participation in auction mandated for settlement of credit events for CDS, making the process more orderly
- Governance processes around OTC derivatives have been redesigned to be more transparent and to give buy-side firms a role in collective decisions that affect market design
- Continued targets to improve operational efficiency will remain a regulatory focus
- *U.S. legislation - Business conduct standards for major swaps participants*

Operational Risk Management-Progress to Date



Greater Standardization

- Standardization is a necessary component to achieving regulatory policy objectives
- Standardization impacts other aspects of the market, including:
  - Promoting the use risk-reducing infrastructure such as central counterparties and exchanges
  - Facilitating increased transparency
  - Making products easier to understand, price and model
  - Making the markets more orderly with agreed-upon processes
- Major dealers committed to provide their supervisors with an outline of the level of standardization across credit, interest rate and equity products
- Regulators are reviewing various methods to move the market toward use of more standardized products

Additional Elements of U.S. Legislation

- Key elements of US legislation (in addition to previous items)
  - *CFTC and SEC will be granted formal regulatory authority over the OTC derivatives market*
  - *Increased use of electronic trading platform and exchanges*
  - *Establish "major swap participant" to ensure that all major swap trading firms are regulated*
- House of Representatives passed financial reform bill in December
- Senate is currently debating financial reform
  - Many amendments have been proposed
- After (if) Senate passes bill, need to reconcile with House version

Global Regulatory Coordination

OTC Derivatives Supervisors' Group

- OTC Derivatives Supervisors Group initiatives began in 2005 and focused initially on credit derivatives and operational issues.
- Current priorities include: transparency, central clearing, standardization and bilateral risk management for all major asset classes.
- Major market participants, including 14 dealers and nine buy-side firms, have made a series of commitments to their primary supervisors detailing the specific improvements in the OTC derivatives market infrastructure they will make.
  - Last commitments were set March 1, 2010

Global Regulatory Coordination

OTC Derivatives Regulators Forum

- Forum formed in mid-2009 to coordinate and share information on developments related to CCPs and trade repositories for OTC derivatives.
- Objectives of the ODRF include:
  - Promote consistent public policy objectives and oversight approaches for CCPs and TRs
  - Adopt, promote and implement consistent standards in setting oversight and supervisory expectations
  - Coordinate the sharing of information made available to regulators or the public by CCPs and TRs
- Over 40 financial regulators, including central banks, prudential supervisors, market regulators and other governmental authorities with direct authority over OTC derivatives infrastructure or market participants or consider OTC derivatives matters more broadly.

Questions?

Theo Lubke

Federal Reserve Bank of New York

theodore.lubke@ny.frb.org