

# Future Prospects for over-the-counter Derivatives Markets

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Regulators on both sides of the Atlantic are pushing forward a wide array of reforms in order to give a proper response to the concerns raised by the financial crisis. This conference - organised by the European Capital Markets Institute and sponsored by Morgan Stanley, LCH.Clearnet and CME Europe - brought together to London US and EU regulators and key industry representatives to discuss the prospects of current reforms for over-the-counter derivatives markets. The good intentions of regulators to design an efficient framework of rules aimed at containing systemic risks and increase transparency clashed with some concerns of the buy-side of the market, which foresees a substantial increase of trading and clearing costs, higher operational risks, and less availability of customised products.

## **Keynote Speech 1 - Patrick Pearson**, Head of Market Infrastructure unit, European Commission

Patrick Pearson illustrated some aspects of the European reform for the OTC derivatives market, currently under discussion. He confirmed the strong will of an unprecedented regulatory push towards:

1. Mandatory central clearing for eligible products;
2. Harmonisation of rules for infrastructures across Europe;
3. Partial exemption for corporate;
4. Specific approach for FX products; and
5. Stronger and better supervision.

Firstly - on the obligation of centralised clearing (on a CCP) for eligible products - the Commission will take into consideration the huge concentration of financial risk created by these infrastructures when it will define requirements for the European passport. The Commission will not intervene on the governance of CCPs, but it will make sure that competition will not be made on risk requirements to become member and/or clear a product on a CCP.

Secondly, the current dispersed framework of rules for CCPs across Europe creates uncertainty, increasing prices and allowing regulatory and supervisory arbitrages. The forthcoming reforms will not be based on principles but will promote 'true' cross-border infrastructure through the implementation of common European rules.

Thirdly, corporations will be exempted as long as they do not hold a systemically important exposure to OTC derivatives. Not clear if the threshold will be set by the Commission or the assigned supervisor, but the Commission will also look at potential risks of regulatory arbitrages on a global level around this exemption.

Fourthly, FX products will not be exempted but they will get a special procedure. Thus, supervisors will decide case by case which FX product should be centrally cleared.

Last but not least, infrastructures as CCPs cannot be supervised anymore at national level. Supervision must be done at European level in order to be consistent with the work done by other relevant regulators, e.g. the United States. Convergence will be the keyword of the regulatory process.

**Keynote Speech 2 - Theo Lubke**, Senior Vice President, Banking Supervision Group, Federal Reserve Bank of New York

Theodore Lubke gave an overview of the US regulatory agenda for OTC derivatives. His speech discussed around four main topics:

1. International cooperation;
2. Transparency;
3. Counterparty risk; and
4. Operational improvements.

The global nature of OTC derivatives markets calls for a coordinated approach between Europe and the US. However, specific regulation will be based on the response of national governments; therefore it is also crucial strengthening coordination between national and supranational levels.

OTC derivatives contributed to the financial crisis when a mixture of unsustainable counterparty risk and opacity around exposures to OTC derivatives created a liquidity squeeze for big financial institutions. Wrong business and risk management decisions have created big concerns for the whole market. These issues may be addressed, on one side, extending the range of eligible products for central clearing and increasing requirements for bilaterally cleared products (e.g. capital charges, segregation of margins and portfolio reconciliation services); on the other side, data repositories will help increasing transparency and thus availability of prices.

Finally, Mr Lubke highlighted the importance of pushing operational improvements in the transaction value chain, although in the last years the industry itself is sensibly improving the trading and clearing environment. Most notably, he urged the introduction of business conduct standards and greater standardisation of products

and processes. CFTC and SEC will be regulatory and supervisory authorities for this market. The Federal Reserve will exercise a more marginal role.

### **Panel 1 - The Impact of current reforms on business models and market initiatives**

Chair: **Stephen O'Connor**, ISDA Board Member, Chair of the ISDA Industry Governance Committee, and Managing Director, Morgan Stanley

Panellists: **Theo Lubke**, Senior Vice-President, Banking Supervision Group, Federal Reserve Bank of New York; **Daniela Russo**, Director General Payments and Market Infrastructure, European Central Bank; **Patrick Pearson**, Head of Financial Markets Infrastructure Unit, European Commission; **David Bailey**, Manager, OTC Derivatives & Post Trade Policy, Financial Services Authority (FSA); **Athanassios Diplas**, Managing Director, Global Head of Systemic Risk Management, Global Credit Trading, Deutsche Bank; **Roger Liddell**, Chief Executive Officer, LCH.Clearnet

The regulatory panel gave an overview of what needs to be done in order to implement current reforms. Panellists highlighted major areas, as systemic risk reduction, transparency and market confidence, as well as specific actions, as segregation of assets and increasing use of trade repositories.

Mrs Daniela Russo remarked the important role played by the CPSS-IOSCO and ECB in setting standards for market infrastructures. For instance, the committee supports trade repositories, which should be resilient to operational risks only. For other infrastructure - as CCPs - Mrs Russo pointed out the importance of raising the regulatory bar, requiring for instance: segregation and portability; coordination and uniform rules; stronger liquidity management requirements, designing tests around different possible scenarios; a model of governance ensuring that users' interests are taken into account; and more effective and powerful supervision. Finally, ECB and Federal Reserve are coordinating their efforts in this market to increase: transparency, financial stability (for central and bilateral clearing), enforcement, consistency between supervisors' approaches.

Roger Liddell, then, recognised the need for a regulatory intervention and he warned about the risks of CCPs competing on risk and margin requirements. Athanassios Diplas added that standardisation, transparency and risk management practices will play a crucial role in this process of centralisation. In addition, he urged a full cost-benefit analysis of the regulatory proposals and he worried about trading on exchange-like platforms. Of more than 2,000 names derivatives, only 125 are traded more than 10,000 times a day. With these premises, it will be difficult that OTC derivatives will be traded on these platforms.

David Bailey pointed out that details of the regulation need to be designed around three paramount principles: transparency, confidence and systemic risk reduction. Patrick Pearson, then, replied to rumours concerning the risk of fragmented rules across Europe: "we need to make rules uniform on a global level". He also mentioned that rules will be proposed as Regulation instead of Directive in order to make implementation more effective. The tension between local and global levels was picked up by Theo Lubke, who said that although there is no formal process to harmonise rules between Europe and the US, SEC and CFTC are closely working with the Commission in order to avoid relevant divergences.

On the role of CCPs, Patrick Pearson addressed the importance of defining efficient eligible requirements. Mr Liddell therefore proposed a 'comply or explain' approach: CCPs should get the possibility to refuse eligibility if the transaction is too risky. He also expressed concerns on how requirements should be set in case products need to be excluded from central clearing as they no longer comply with them. Mrs Russo added that the verification of the eligibility requirements needs more: legal standardisation, price transparency and availability of prices and trades. Finally, on the one hand, Mr Lubke confirmed that CCPs should be not forced to clear products. There is a need to reach a certain volume in order to be able to process trades. On the other hand, bilaterally-cleared trades will face stricter margin and capital requirements, pushing some products to be centrally-cleared.

Finally, Daniela Russo replied to a question addressing the possibility for CCPs to access lending of last resort. She excluded any involvement of central banks to keep moral hazard under control. However, she kept open the possibility to intervene in the money market whether a lack of liquidity freezes the entire market. Roger Liddell concluded that the potential share of bilaterally-cleared trades will be below 20% (around 10 and 15%). He also addressed the role of dealers in supporting members that would not be able to access CCPs with the new requirements (indirect access). The market needs to invest more on standardisation and electronic systems for confirmation and affirmation.

## **Panel 2 – Issues and prospects of OTC derivatives markets: Where will the risk lie? How will reforms impact on current business models?**

Chair: **Jeremy Grant**, Editor, FT Trading Room, Financial Times

Panellists: **Aron Landy**, Chief Risk Officer, Brevan Howard; **Andreas Roemer**, Managing Director, Head of Credit, DWS Investments; **Steven Maton**, Head of Middle Office, Legal & General Investment Management; **Barry Hadingham**, Senior Manager, Derivatives & Alternatives, Compliance & Business Risk, Aviva Investors; **Andrew Lamb**, Chief Executive Officer, CME Clearing Europe; **James Hill**, Managing Director & Global Credit Derivatives Officer, Morgan Stanley.

The second panel collected comments and thoughts of the buy-side representatives. Major concerns grew around the implementing costs of these measures. Clearing costs will go up and access to these platforms will request members to inject high amounts of collateral. The role of dealers will be more relevant. On the way CCPs manage collateral and fees structure, Andreas Roemer called for more transparency in pricing. In addition, Steven Maton highlighted the importance of three areas: risk management processes; efficient portfolio processes; liability management processes. Operational risks are important, as well as price transparency (exchanges can be a very good example). Market has to be operationally simple and assets should have a certain security (e.g. segregation). These services are not currently provided by CCPs. Aron Landy, therefore, pointed out two relevant aspects: efficiency and standardisation of processes. James Hill, then, stressed the importance of default management funds and the role of big dealers to assist the buy-side in the connection with a CCP.

Andrew Lamb, for CME Clearing, recognised that in the past very little has been done to manage relationships with clients, but today – through direct and indirect access – it is time to design a partnership between CCPs, dealers and clients. CCPs, in Europe, also need to increase transparency.

In general, the panel remarked the lack of involvement of the buy-side in this process of centralisation. More involvement in the governance of these infrastructures should also receive greater attention. At the moment, there is no big choice of centralised clearing services providers. Competition on eligible products and freedom of choice are crucial as well as costs and resiliency of the infrastructure.

In conclusion, Barry Hadingham warned about the current status of CCPs offering services in specific countries, while the whole market is global. CCPs should be able to offer global solutions, otherwise clearing will be inevitably more costly, especially in a standardised world where CCPs tend to look less to members' risk and more to their name and function. Someone has gotten to pay the regulatory bill and, at the moment, only the buy-side will bear these costs. Meeting the foreseen stricter requirements will be difficult and costly, also in case dealers will strongly support the access with – for instance – provision of collateral. The risk of 'investment leakage' will be quite high.

**Keynote Speech 3 – David Bailey**, Manager, OTC Derivatives & Post Trade Policy, Financial Services Authority (FSA).

David Bailey stressed the importance of strengthening the robustness of the market for over-the-counter derivatives through less counterparty credit risk and greater transparency. On the eligibility, he pointed out that – once a product has been authorised to clear – there should be certainty that a sufficient number of CCPs can process the product. Exemptions should be granted taking always into account the overarching goal to reduce systemic risk.

Mr Bailey made clear that supervision over these infrastructure should have a strong link with national authorities, due to the fiscal accounting. Regulators need to ensure that non centrally-cleared trades will be supported by a more robust risk management process. Greater transparency, then, means using trade repositories, which will need to provide info to the market and unfettered access to financial regulators, and greater post-trade information and transaction reporting (with an important role played by trade repositories). However, regulators should find the right balance between transparency and liquidity. To conclude, Mr Bailey concluded that key areas in the implementation of the forthcoming rules will be clearing obligations and trade reporting. A lot of progresses needs to be done. However, a well-designed regulation cannot reach its overarching objectives without consistent application and strong enforcement by financial supervisors.

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