

A Case of Standardised Financial Market Regulation: The OTC Derivatives Regulations for Fair and Efficient Market

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Abstract: The aim of this paper is to increase knowledge concerning financial institutions and capital market regulations. It is to improve communication between the academics, policy makers and research communities in their operational decision for financial institution.

Keywords: Banking regulations; banking efficiency; Bank Solvency; Capital structure Corporate, Finance; Corporate Governance Ethics, Energy Market; Risk Market Analysis; Portfolio optimization and trading.

1. INTRODUCTION

In June 26, 2009, the House passed the American Clean Energy and Security Act (Waxman-Markey), which would impact a wide range of derivatives.¹ In August 11, 2009, the Obama administration released its proposed “Over-the-Counter Derivatives Markets Act of 2009” (the Treasury plan).² In September 2009, G-20 Leaders agreed in Pittsburgh that: All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end- 2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. The FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.

2. IDENTIFICATION OF DERIVATIVES

Initially, the Financial Stability Board (FSB), in April 2010, a working group led by representatives of the Committee on Payment and Settlement Systems (CPSS), the International Organization of Securities Commissions (IOSCO) and the European Commission was formed to make recommendations on the implementation of the G-20 objectives. Their report includes 21 recommendations summarised below, which address practical issues that authorities may encounter in implementing the G-20 Leaders’ commitments concerning the followings:

- ❖ **Standardisation:** The proportion of the market that is standardised should be substantially increased in order to further the G-20’s goals of increased central clearing and trading on organised platforms, and hence mitigate systemic risk and improve market transparency. The report sets out recommendations for authorities to work with market participants to increase standardisation, including through introducing incentives and, where appropriate, regulation.
- ❖ **Central clearing:** To implement the G-20 commitment effectively, it is necessary to specify the factors that should be taken into account when determining whether a derivative contract is standardised and therefore suitable for clearing. The recommendations do this, as well as address mandatory clearing requirements; robust risk

¹ H.R. 2454 (111th): American Clean Energy and Security Act of 2009. Available at: <http://www.govtrack.us/congress/bill.xpd?bill=h111-2454> – accessed on 07/05/2012

² “Over-the-Counter Derivatives Markets Act of 2009” (the Treasury plan) Available at financialservices.house.gov/Financial%20Regulatory%20Reform/Section-by-Section/Title%20VII%20sec-by-sec%20FINAL.pdf

management requirements for the remaining non-centrally cleared markets; and supervision, oversight and regulation of central counterparties themselves.

- ❖ **Exchange or electronic platform trading:** Further work is being set in train in the coming months to identify what actions may be needed to fully achieve the G-20 commitment that all standardised products be traded on exchanges or electronic trading platforms, where appropriate.
- ❖ **Reporting to trade repositories:** Authorities must have a global view of the OTC derivatives markets, through full and timely access to the data needed to carry out their respective mandates. The recommendations help achieve this objective, including that trade repository data must be comprehensive, uniform and reliable and, if from more than one source, provided in a form that facilitates aggregation on a global scale.

3. EVALUATION

At the global level, OTC derivatives regulation is being undertaken by CPSS and IOSCO and focuses on efforts to update and strengthen standards for CCPs, CSDs, payment systems and the treatment of trade repositories.³

I. Increasing standardization and moving to central clearing:

The OTC derivatives markets have traditionally been characterized by privately negotiated transactions entered into by two counterparties, in which each assumes the credit risk of the other and manages this risk bilaterally. The downside is the risk of failure as the clearinghouse itself might pose a systemic risk. By transferring counterparty risk to the CCP, the bank or broker is thus assuming a new type of risk: mutualisation risk. This refers to the possibility that in case of a default where the defaulting member's initial margin turns out to be insufficient, the clearing house is forced to draw on its other members' default fund and in extreme cases to allocate contracts to its non-defaulting members.⁴ Derivatives dealers provide liquidity to the market by selling derivatives contracts to customers and managing the resulting risk exposures through offsetting transactions in the underlying assets, exchange traded derivatives, and further trades with dealers and customers in OTC markets. These dealers are therefore highly interconnected through a network of trades, creating contagion risk in the market.

To fully achieve the benefits of central clearing, a critical mass of OTC derivatives products must move to CCPs. This implies increasing the standardisation of products in order to make them suitable for central clearing. In addition to expanding the pool of derivatives contracts that are suitable for central clearing, increasing standardisation of OTC derivatives products provides other benefits including facilitating effective reporting to trade repositories and improving overall market transparency including pricing. Central clearing should thus not be mandatory for all standardised derivatives as certain counterparties do not pose a systemic risk, bilateral risk management techniques will be sufficient in these cases.⁵

II. Trade platforms:

The OTC derivatives markets are currently relatively opaque due to their privately negotiated, bilateral nature and the limited availability of transaction data such as prices and volumes. In stressed financial circumstances, these characteristics may make OTC derivatives markets less reliable and could lead to increased market and liquidity risks for participants. This depends on factors facilitating the exploitation of the leverage generated by the system of settlement at the margin (Carlton, 1984). Even though organized platforms are likely to improve transparency, they affect market liquidity and prices in ways that are beneficial for some participants while potentially not beneficial for others.

III. Reporting to trade repositories:

Regulators are currently lacking practical means of acquiring a full picture of market participants' direct and indirect counterparty credit risk exposures. This incomplete picture of risk exposures makes it difficult for regulators to gauge the concentration of risk-taking activities across markets. Hence during times of stress, this incomplete picture of risk exposures also may complicate official sector actions to stabilise markets. By centralising the collection, storage and dissemination of information in a consistent fashion, trade repositories can fulfil an important function as a credible

³ Duetche Bank Research (2011) OTC Derivatives Market: Updating Regulations. November 2011

⁴ Ibid

⁵ Duetche Bank Research (2011) OTC Derivatives Market: Updating Regulations. November 2011

source of data on OTC derivatives transactions for authorities, market participants and the public. The recommendations are clear on regulatory actions to ensure detailed reporting of all OTC derivatives transactions

IV. Standardization:

Adequate standardization is a prerequisite for central clearing and exchange or electronic platform trading. Thus implementation of the G-20 commitments to central clearing and appropriate organized platform trading in relation to particular OTC derivatives products demands a certain level of judgment regarding the degree of standardization needed. Nevertheless, increasing standardization in OTC derivatives markets has a number of benefits beyond increasing suitability for central clearing and organized platform trading and it should improve the market in a number of ways, including: facilitating automated processing of transactions; increasing the fungibility of the contracts which enables greater market liquidity; improving valuation and risk management; increasing the reliability of information; reducing the number of problems in matching trades. Derivatives, moreover, provide an efficient method for end users to better hedge and manage their exposures to risk from price and interest rate fluctuations. Interest rate swaps, for example, help banks of all sizes to manage better the asset/liability mismatches inherent in funding long-term assets, such as mortgages, with short-term liabilities that re-price more frequently, such as certificates of deposit.⁶ It should be noted that this is a long way from the conventional picture of derivatives as a form of insurance against simple price risk (Williams, 1986: 77-81).

While automated post-trade processing helps to promote product standardization, and is necessary to make central clearing and organized platform trading feasible. As such, CCPs are meant to reduce complexity in the OTC market and thereby enhance the stability of the system. Since counterparty risks are concentrated in each CCP itself, the central mechanisms should then be subject to high risk management standards, and be effectively regulated and supervised and also sufficient collateralisation.⁷

V. Post-trade processing for OTC derivatives:

The report by FSB in 2005, supervisors became concerned with the manually intensive nature of post-trade processing practices leading to lengthy confirmation lags, particularly in the credit default swap market. That combined with increasing volumes, these issues contributed to a large backlog of unconfirmed trades. This backlog was a source of operational risk, as well as counterparty credit risk because counterparties did not have a full picture of their real exposures.

According to FSB, over the past five years, market participants have worked with their primary supervisors to improve the post-trade processing environment (with supervisory cooperation having evolved to form the ODSG). While significant progress has been made in automating CDS processing, in other asset classes, supervisors and market participants continue to work on the early prerequisites to full automation, such as greater documentation standardization and electronic matching.

VI. Automation and straight-through-processing:

According to FSB, while the improvements since 2005 have laid the groundwork for achieving current G-20 objectives and have increased standardization in the market, further standardization and improvements are necessary to enable central clearing of large volumes of OTC derivatives by automating and further integrating the systems and processes. Full automation and straight-through-processing facilitate central clearing and reporting to TRs, but cannot be accomplished without further product standardization as well as standardization of documentation, automation of manual processes, and changes to business practices.

For STP, automation is required particularly in the early steps of a transaction. For instance in 2005, a backlog of unconfirmed trades had accumulated in the credit derivatives market as a result of inefficient manual confirmation processes, STP therefore facilitates novation and ensures that trades can be processed safely.⁸

VII. Standardization for central clearing and organized platform trading:

In order to determine if an OTC derivative contract is to be regarded as standardized and suitable for central clearing, the authorities should take into account the degree of standardization of a product's contractual terms and operational

⁶Castro institute. *Regulation Vol. 17 No. 4, 1994.*

⁷Duetche Bank Research (2011) OTC Derivatives Market: Updating Regulations. November 2011

⁸Bank of England. Financial stability paper no. 14, March 2012

processes; the depth and liquidity of the market for the product in question; and the availability of fair, reliable and generally accepted pricing sources.

VIII. Legal and operational standardization:

The OTC derivatives contractual terms must be standardized to facilitate organized platform trading and central clearing but they need not be identical for each parameter. This allows market participants to trade in and out of contracts more easily, which in turn enables greater market liquidity. Industry standard could be seen in documentation such as those widely used by ISDA. Common handling of lifecycle events indicates that an OTC derivative market may be suitable for central clearing because the clearing process incorporates many of these practices as a matter of course but degree of customization can impact the liquidity of the contract. Williams' conclude that, the primary reasons for this emergence are legal factors (Williams, 1986: 174) is of the greatest interest.

IX. Market liquidity of OTC derivatives products:

Authorities should consider market liquidity when determining whether a product is standardized and suitable for central clearing and appropriate for organized platform trading. With regard to suitability for central clearing, authorities should consider a CCP's ability to manage its position in the product if a clearing member defaults. A CCP faces market risk following a default by a clearing member, as the default results in the CCP having an unbalanced book. Thus, the CCP's ability to rebalance its book via the market by closing out, liquidating or hedging its positions with the defaulting member, or through default management mechanisms with the remaining clearing members by auctioning off or allocating defaulted positions, is critical. Nevertheless, a derivatives product still may be suitable for clearing by a CCP, even if it cannot be reasonably ruled out that the market for the product could become illiquid in times of stress. In assessing liquidity, consideration should be given to whether the liquidity in the market for the OTC derivatives product has historically remained stable through time, and whether it is likely to remain sufficiently liquid following the default of a clearing member.

4. CONCLUSION

In order to prevent geographic regulatory arbitrage between jurisdictions, frameworks for CCPs and risk management standards should be consistent globally. It seems, some smaller countries are waiting to see what rules will emerge in the US and the EU before developing their own regulation. Above all, the regulator's approval of exchange and trading system operators and of trading rules helps to ensure fair markets, protection of investor and, in particular, the prevention of improper trading practices. Regulation should detect, deter and penalize market manipulation and other unfair trading practices. In addition, they should aim at ensuring that investors are given fair access to information on market facilities and price reliability. Nevertheless, Credit spreads are tight by historical standards, but fundamentals are still highly favorable, thus, it is hard to make the case that credit risks are wildly mispriced, but it is also difficult to distinguish between the secular and cyclical forces contributing to tight credit spreads.⁹

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