INSTITUTE FOR AGRICULTURE AND TRADE POLICY

Consultation Document: "Proposed Framework for Post-Implementation Evaluation of the Effects of the G20 Financial Regulatory Reforms"[1] ("Proposed Framework")

Financial Stability Board

11 May 2017

Submitted Electronically

Introduction

The Institute for Agriculture and Trade Policy (IATP)[2] appreciates the opportunity to comment on this consultation paper, which applies to several financial reform topics and which poses many methodological challenges. Of the core reform topics addressed in the Proposed Framework, IATP will respond only to the objective of "making derivatives markets safer." (5)

Regarding methodologies, IATP cautions the FSB against over-relying for evidence of reform causality on econometric modeling that claims to have the rigor and replicability of natural science experiments. Large and repeated gaps between econometric projections and historical economic performance have drawn attention to policy scenario dependence of computable general equilibrium theory.[3] When policy scenario assumptions are un-representative of real world economics and/or based on data sets with large gaps, the replicability of an econometric model experiment should not be considered the gold standard of evidence for the post-implementation evaluation.

The Proposed Framework is intended to evaluate the G20 financial regulatory reforms in terms of empirical data relevant to specific reforms. Such data can give the clearest indication of the effect of specific reforms, to the extent that they have been implemented and to the extent that the data reported represent the universe of financial activities in specific asset classes and instruments. However, consider the view of one market observer relative to the reform of Over the Counter trading of derivatives contracts: "All of the world's swaps regulators recognize that [trade data] reporting is a mess."[4] A more charitable view of swaps reporting is that regulators are struggling to close loopholes in the face of financial industry resistance to providing such data for regulators' monitoring of OTC derivatives trading.[5]

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The Proposed Framework should consider how to evaluate the risks to financial stability by unreported or misreported trading data and when regulators lack the resources to investigate indications of cases of misconduct, which, in aggregate, pose risks to financial stability. For example, the U.S. Commodity Futures Trading Commission's ("CFTC" or "Commission") director of enforcement during the Obama administration said that the Commission did not have the financial, personnel or computer infrastructure required to investigate trade data signs of a "massive amount of misconduct" in futures, options and swaps markets.[6] The FSB's Chairman has not hesitated to inform G20 finance ministers and central bank governors of the risks to financial stability resulting from massive misconduct.[7] The Framework should propose a method for quantifying the misconduct and the risks it poses to financial stability.

General comment

Financial Stability Board Chairman Mark Carney wrote in his August 31, 2016 letter to G20 leaders, "The **G20 reforms are working** (bold in the original). The system is providing more reliable financial services and has proven resilient in the face of recent shocks. As implementation progresses, the financial system is increasingly absorbing shocks, rather than amplifying them,"[8] as happened during the 2007-2009 crisis. U.S. Commodity Futures Trading Commission Chairman Timothy Massad, in effect, seconded these remarks, in his December 6th speech to the Economics Club of New York, noting that the financial system absorbed, rather than amplified, the shock of the Brexit decision.[9]

These positive evaluations of the G20 reforms are, of course, qualitative, and should not prejudice the more quantitative evaluation to be carried out under the final version of the Proposed Framework. In the final Framework, it will be important to characterize the shocks not just as specific events, but in terms of the data and data gaps that pertain to different categories of banking risk, including, but not limited to, credit risk, liquidity risk, market risk and operational risk. While financial actors may absorb or amplify shocks attributed to news events, the capacity of the financial system to amplify or absorb shocks depends in no small part on the ability of financial actors and regulators to access and evaluate financial data that is standardized, accurate, comprehensive and reported in near real time. If data remains customized, partial, not readily subject to computer enabled surveillance and data mining, and reported at the convenience of the financial actor, we will remain in the Dark Ages of OTC trading, particularly in the 2007-2010 period.

Responses to specific questions in the Proposed Framework

1. Do you have any comments or suggestions on the main elements of the evaluation framework (e.g. are there other elements that should be considered for inclusion in the framework)?

"The focus of the framework is on post-implementation evaluation; that is, evaluating the effects of G20 reforms for which implementation is well underway or completed." (5) The final Framework should define stages of implementation, to better determine which effects have taken place and to what end. Market actors may change how and where they trade in anticipation of compliance with a rulemaking, e.g. less than fully implemented swaps trading rules and the establishment of Swaps Execution Facilities. The so-called "futurization of swaps" should, in theory, make derivatives trading safer by standardizing derivatives contracts, by near real time and uniform reporting, by expediting portfolio compression, by centralized clearing and other safety and soundness measures.

However, the futurization of swaps has occurred more slowly than anticipated in many markets and has affected different asset classes differently.[10] Safety and soundness, however necessary for the system, may hold no attraction for a market actor who prefers to trade in unlit markets and to risk getting caught violating swaps reporting rules, since the penalty for the convicted is too small to be dissuasive. As Professor Anat Admati recently noted, "There are enormous rates of recidivism in corporate misconduct. Paying a fine need not lead to significant change."[11] When the violator is a Systematically Important Financial Institution, such as Deutsche Bank,[12] the question arises whether reporting failures may mask operational and solvency risks that could cascade through other SIFI and large financial institution counterparties.

The FSB will evaluate the effect of specific reforms that can be readily quantified, e.g. the volume of swaps contracts that have migrated to futures and options markets or the volume and value of swaps transactions that have not been centrally cleared. However, the Framework should not neglect to attempt to estimate the effect of the less readily quantified indicators of reform implementation, such as the leverage ratios of unreported swaps transactions or the overall leverage ratios of entities that have reported swaps transactions inaccurately and/or incompletely. A critical mass of unreported or misreported transactions may point to derivatives reform that is on the rulebooks but not practiced in the marketplace.

Rulemaking and implementation of reform measures concerning automated trading, including High Frequency Trading, is not well underway in FSB jurisdictions. Nevertheless, because a high percentage of derivatives trading transactions in all asset classes are designed and executed by Algorithmic Trading Systems (ATS),[13] the FSB evaluation should consider how ATS strategies and practices effect reform measures that have been implemented.

2. Would you suggest any refinements or additions to the concepts and terms?

Regarding evaluation of "interaction and coherence among the reforms" identification of interaction among the reforms may not indicate a coherency of reforms or effects, so evaluation of interaction and coherence of reforms should be considered separately. For example, reforms to the definitions of who is responsible for reporting and aggregating the swaps positions of parent firms and their foreign affiliates may show a clear interaction within one jurisdiction's rule. However, such an interaction may not be coherent with the rules for cross border swaps aggregation in another FSB jurisdiction. Notwithstanding the excellent work of the Financial Stability Board on the aggregation mechanism for cross border trading data, FSB members have yet to harmonize rules on cross border swaps trading and clearing. According to one observer, "Multinational entities have many questions concerning issues of cross-border regulation, particularly where the U.S. and EU regulatory approaches, though similar in intent, appear to diverge in content. In particular, these entities are concerned about how best to reconcile the sometimes disparate equivalence and substituted compliance approaches in the U.S. and EU."[14]

> 10. Do you have suggestions on information sharing arrangements (publication of results, repository of evaluations, and data availability, particularly as it pertains to replicability)?

The evaluation Framework should survey FSB members on the status of their swaps data reporting and swaps data quality. That survey should include not only the regulatory status of swaps data reporting, but questions to determine the data quality and comprehensiveness of swaps reporting among each FSB member. For example, are there instances of regulations that have been approved but not implemented, whether due to inadequate regulatory resources, disputes with industry over reporting requirements and/or non-compliance by rule defined reporting entities? Absent reported data to verify compliance with reporting rules, what other means have authorities to evaluate whether derivatives markets serve the interests of market actors and the public interest per statutory authorities in FSB jurisdictions?

In the United States, commodity swaps data reporting is so inconsistent and of such poor quality that as of October 28, 2015, the CFTC no longer requires exchanges and swaps data repositories to report commodity swaps trading for the CFTC Weekly Swaps Report.[15] If FSB members do not have access to swaps trading data according to reporting regulations in their jurisdictions, the evaluation Framework should propose how to use unofficial data, such as that of private data reporting services, to help assess the effect of G20 reforms to make derivatives markets safer.

More generally, as the FSB knows from the 2014 Senior Supervisors' report on counterparty data quality, SIFIs and other large financial institutions have often been unable to provide authorities with high quality data. The Senior Supervisors wrote in their transmission letter to FSB Chairman Mark Carney,

> Our observations in this report indicate that firms' progress toward consistent, timely, and accurate reporting of top counterparty exposures fails to meet supervisory expectations as well as industry self-identified best practices. Data quality is of particular concern. Additionally, we believe that the supervisors of these firms must prioritize the effort within the scope of their own work and commit to impressing upon firms the importance of being able to quickly and accurately aggregate top counterparty exposures. The SSG will continue to monitor and review these practices periodically to ensure their effectiveness going forward.[16]

As part of the evaluation Framework, the FSB should include a data quality section with an update to the 2014 Senior Supervisors' report. If data quality on counterparty exposures continues to be deficient, the evaluation Framework should propose other means, including qualitative means, for assessing the impact of G20 reforms in the absence of high quality data in each asset class.

> 11. How can the FSB and SSBs best engage with external stakeholders (e.g. financial services providers, various kinds of end-users, and academics) in their evaluation work (going beyond public consultations)?

The FSB may wish to consider proposing in the Framework an addendum to the Evaluation that would report the results of a survey of external stakeholders. The survey must be anonymous, to improve the likelihood of receiving full and frank responses, which otherwise might be impeded by the disclosure of the identities of the commenters. Survey questions would elicit responses concerning which G20 committed reforms have been implemented, in full or part, and with what effect; which reforms remain to be implemented and why implementation has not taken place; which changes in market regulation and technology have circumvented reforms and/or made them obsolete; and which additional reforms need to be agreed to expedite realization of committed reforms or to improve synergy among the interaction of reforms. There should be a survey section dedicated to questions that would explore FSB member modifications or nullifications of legislation, regulations and/or administrative procedures that individually, or in combination, would signal FSB member changes to and/or abandonment of G20 committed reforms.

12. Do you have comments or suggestions on which individual reforms or interacting set(s) of reforms should be initially considered for evaluation as a matter of priority?

Per the comments above, evaluating data quality generally and swaps trading and clearing data particularly, should be a Framework priority. No matter how well and clearly drafted a regulation to implement the reform commitments, no matter how assiduous compliance with such regulations by individual market actors and exchanges, authorities cannot determine the individual or aggregate effect of reforms nor the modifications that may be needed to those reforms without high quality and comprehensive data.

A related priority is to evaluate the implementation status among member governments of FSB incubated cross border data trading tools, including the Legal Entity Identifier, the Universal Transaction Identifier and the Aggregation Mechanism. One step towards evaluation would be to include questions about the implementation and effect of these tools in the survey proposed in response to question 11.

Finally, if the FSB wishes to claim that the "G20 reforms are working" to absorb shocks and not amplify them, it should define "shocks" in a data driven way and specify absorption and amplification mechanisms. For example, is the persistence of mini-flash crashes in the derivatives market a data source to illustrate the absorption of shocks by "circuit breakers," whether regulatory or algorithmic? Or does this persistence illustrate a new mechanism for amplification of shocks that remains unrecognized by regulators because of the scale and dispersion of flash crashes across asset classes and markets or because of the lack of official monitoring of intraday HFT activities? As one pundit said of a mini-flash crash of the value of the British pound, "For once, why don't the international regulators get together and work out, properly this time, exactly what happened; who profited, which trades came from which servers, why and how. And I mean properly how, not just blame-a-day-trader-in-Hounslow how."[17]

Conclusion

IATP thanks the FSB for the opportunity to comment on this critically important consultation paper. We do not take this privilege for granted and hope that this short comment will aid the FSB as it finalizes the Framework for presentation to the G20 finance ministers and central bank governors in June. IATP hopes that it will have the opportunity to comment on the draft Evaluation.

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[1] http://www.fsb.org/wp-content/uploads/Framework-for-the-post-implementation-evaluation-of-the-G20-financial-regulatory-reforms.pdf

[2] IATP is a U.S. nonprofit, 501(c)(3) nongovernmental organization, headquartered in Minneapolis, Minn., with an office in Washington, D.C. and a just opened office in Berlin, Germany. IATP is a member of the NGO/academic networks, FSB Watch, and Americans for Financial Reform, and a participant in the Commodity Markets Oversight Coalition since 2009. IATP has submitted several comments on U.S. Commodity Futures Trading Commission rulemaking, and on consultation papers of the International Organization of Securities Commissions, Financial Stability Board, the European Securities and Markets Authority, and the European Commission's Directorate General for Internal Markets.

[3] Alejandro Nadal, Frank Ackerman and Kevin Gallagher, *The Flawed Foundations of General Equilibrium: Critical Essays on Economic Theory.* Routledge 2004.

[4] George Bollenbacher, "SDRs: The SEC Weighs in on Swaps Reporting: Part 2," Tabb Forum, 24 February 2015. http://tabbforum.com/opinions/sdrs-the-sec-weighs-in-on-swaps-reporting-part-2?print_preview=true&single=true and Bollenbacher, "ESMA Gets Semi-Serious About Swaps, the CFTC Not So Much," *OTC Space*, June 19, 2015. http://www.theotcspace.com/2015/06/19/esma-gets-semi-serious-about-swaps-reporting-cftc-not-so-much

[5] E.g. Andrew Ackerman, "CFTC Attempts to Close Swaps Loophole for Large U.S. Banks," *Wall Street Journal*, June 9, 2015. http://www.wsj.com/articles/cftc-aims-to-close-swaps-loophole-for-large-u-s-banks-1433856763

[6] Karen Freifeld, "Misconduct rife in derivatives—ex-CFTC enforcement chief," Reuters, March 24, 2017. http://www.reuters.com/article/us-cftc-enforcement-goelman-idUSKBN16V1D0

[7] Mark Carney, "Letter to G20 Finance Ministers and Central Bank Governors," Financial Stability Board, 4 February 2015. http://www.fsb.org/wp-content/uploads/FSB-Chair-letter-to-G20-February-2015.pdf

[8] http://www.fsb.org/wp-content/uploads/FSB-Chair%E2%80%99s-letter-to-G20-Leaders-in-advance-of-their-meeting-in-Hangzhou-on-4-5-September.pdf

[9] http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-52

[10] Terry Flanigan, “OTC Swaps ‘Futurization’ Parsed,” Markets Media, 2 October 2014. http://marketsmedia.com/otc-swaps-futurization-parsed/

[11] Cited in Telis Demos, “Banks Seek Change to a Risk Measure,” *Wall Street Journal*, May 1, 2017.

[12] “CFTC Charges Deutsche Bank AG With Multiple Swaps Reporting Violations, Related Supervision Failures and Violation of a Prior CFTC Order,” August 18, 2016. http://www.cftc.gov/PressRoom/PressReleases/pr7430-16

[13] For example, CFTC Chairman Timothy Massad noted, “more than 70 percent of trading in futures is automated,” (Federal Register (FR) Appendix 2, 85395). The Commission’s study of two years of futures contract data showed that “ATSs were presented in at least 38 percent of [agricultural] futures volume analyzed” (FR, Vol: 80, No. 42, December 17, 2013, p. 78826, footnote 6).

[14] Mark D. Young, Maureen A. Donley and Patrick Brandt, “Reconciling Regulatory Requirements in Cross-Border Derivatives Takes Center Stage,” *Skadden Insights*, January 2015. https://www.skadden.com/insights/reconciling-regulatory-requirements-cross-border-derivatives-takes-center-stage

[15] http://www.cftc.gov/MarketReports/SwapsReports/Archive/index.htm

[16] “Progress Report on Counterparty Data,” Senior Supervisors Report, 14 January 2015. https://www.newyorkfed.org/medialibrary/media/newsevents/news/banking/2014/SSG_Progress_Report_on_Counterparty_January2014.pdf

[17] Jim Armitage, “This flash crash must not be shrugged off,” *Evening Standard*, 7 October 2016. http://www.standard.co.uk/business/jim-armitage-this-flash-crash-must-not-be-shrugged-off-a3363916.html