19 November 2018

Evaluation of incentives to centrally clear OTC derivatives

Overview of responses to the consultation

Introduction

The Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS), the Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO) published a consultative document on incentives to centrally clear over-the-counter (OTC) derivatives on 7 August 2018, with a closing date for responses of 7 September 2018. A total of 40 responses were received, including from banks, CCPs, asset managers and industry associations.[1]

Respondents generally welcomed the evaluation study, its findings and the opportunity to comment. Some respondents suggested that the study should be continued, repeated or extended (for example, to cover all central clearing) as implementation of relevant reforms beds down further. A number of respondents also urged the Standard Setting Bodies (SSBs) to develop plans (or single coordinated plan), to address issues identified in the consultative report.

This is one of the first exercises under the framework for the post-implementation evaluation of the effects of the G20 financial regulatory reforms. Evaluations, if findings warrant it, could provide a basis for possible fine-tuning of post-crisis regulatory reforms, without implying a scaling back of those reforms or undermining members' commitment to implement them. The final responsibility for deciding whether and how to amend a particular standard, guidance or policy remains with the relevant SSB.

This note summarises the comments made in the public consultation and sets out the main changes that have been made to the evaluation report. The summary is intended as an overview and does not seek to include every comment raised in consultation responses. Inclusion or exclusion of a point in the summary does not necessarily mean that the evaluation team agrees or disagrees with points made in consultation responses.

Overall incentives to centrally clear OTC derivatives

Respondents generally agreed with the main findings of the report that strong incentives to centrally clear OTC derivatives are in place for dealers and larger clients, but that incentives

[1] The comment letters (except for those where respondents requested their letter not to be published) are available on the FSB's website at www.fsb.org/2018/09/public-responses-to-the-consultation-on-incentives-to-centrally-clear-over-the-counter-otc-derivatives/.

are less strong for smaller or more directional firms. Respondents broadly agreed that the regulatory and non-regulatory factors identified in the report are important.

Many respondents felt that one of the key goals of clearing mandates and other reforms was to reduce systemic risk, and so the focus of reforms and incentives naturally should be on larger and systemic firms.

Whilst many respondents expressed the view that incentives are approximately correct for larger firms, these respondents generally expressed the view that similarly strong incentives were not always in place for other types of firms. Some respondents expressed the view that smaller firms pose lower systemic risk and therefore should be excluded from the scope of certain reforms.

As well as highlighting the disincentives for smaller and large directional firms that were set out in the report (such as high costs of clearing, effects of certain reforms on client clearing, access and client clearing service provider concentration concerns), respondents also noted that, for clients/firms seeking primarily to hedge risks and achieve trade certainty, factors such as collateral requirements (especially, for some types of client, the demand for variation margin in the form of cash by CCPs), the potential unpredictability of margin calls in stressed market conditions, and the possible outcomes following member failure (such as failure of porting) were also disincentives. Some also considered that the upfront costs of establishing access to central clearing are an important factor not incorporated into the analysis set out in Part D the report.

A number of end users highlighted concerns over possible outcomes in the event of a CCP recovery or resolution scenario, citing objections to the use of tools such as variation margin gains haircutting and contract tear up.

Some respondents stated that while central clearing can provide similar benefits to smaller firms in terms of price, netting, liquidity, transparency and counterparty risk management, these are not as significant in size as the benefits available for larger firms. Some respondents noted that 'small' firms covers a range of firm types, and that the issues faced by different types of firms could vary.

Partly as a consequence, some respondents felt exemptions from central clearing mandates for certain types of market participants should be maintained (or extended), and exemptions should also be applied or extended in other relevant reforms such as the uncleared margin requirements.[2] They raised concerns that if such smaller/non-financial firms are forced to centrally clear, and/or other disincentives are not addressed, this could lead to risks being left unhedged and thus increase the risk in the system.

A few respondents said that it was too early to reach conclusions on incentives given that the implementation of certain reforms such as margining for uncleared derivatives is still in progress.

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[2] A summary of exemptions from clearing mandates, or 'out of scope' definitions of requirements, is set out in Appendix J of FSB, *OTC derivatives market reforms: Twelfth progress report on implementation* (June 2017) at www.fsb.org/2017/06/otc-derivatives-market-reforms-twelfth-progress-report-on-implementation/.

Some comments were received on other cleared markets or other types of transactions, such as exchange traded derivatives or securities financing transactions, but those are outside the scope of this evaluation report.

Changes in response to the comments

The report has been updated to note that the term 'small client' in fact covers a heterogeneous population that typically, but not always, engage in lower volumes of derivatives transactions, which may include smaller banks, insurers, asset managers and non-financials.

It has been clarified that the quantitative survey discussed and analysed in Part D of the report did not collect data on the upfront costs of establishing access to central clearing or bilateral trading such as those associated with operational, legal and compliance requirements.

The report also contains other minor amendments.

As noted in the report, this evaluation has not studied the incremental effect of CCP recovery and resolution standards and related guidance on the incentives to clear, partly because policy development for CCP resolution is still underway.

Effects of individual reforms

Respondents generally agreed with the report's characterisation of the incentives that individual regulatory reforms have provided.

Regarding clearing mandates, a number of respondents emphasised that central clearing should not be mandated for non-financial and/or small market participants, given that, in their opinion, they do not contribute to systemic risk. Some respondents (especially CCPs) cautioned against rolling back mandates despite the incentivising effects of other regulatory and non-regulatory factors. Equally, there were few calls for expanding clearing mandates by product or entity. Respondents noted (as does the report) that not all types of derivatives are suitable for central clearing. There were however, some calls for consistent application of clearing mandates across jurisdictions.

Regarding margin requirements for uncleared derivatives, respondents struck a cautious tone, noting that requirements are still subject to phase-in schedules (as noted in the report) which will last until 2020, and that other regulatory and non-regulatory factors are more important for providing incentives. Some respondents supported prompt and consistent implementation of this reform. Whilst respondents recognised the risk mitigating benefits of exchanging margin, some felt that the threshold for exchange of initial margin should be raised significantly, and margin requirements recalibrated. There was concern that otherwise, uncleared margin requirements would have a penalising effect on smaller firms who are also facing issues in accessing central clearing. Some respondents also supported excluding inter-affiliate transactions.

On capital standards for banks, there was feedback on the effects of the leverage ratio as a disincentive for client clearing, with a number of responses referring to previous comment letters and consultation responses on the topic. Respondents generally called for client initial margin to offset the potential future exposure (PFE) component of the ratio's exposure measure. Some respondents also expressed support for excluding client margins held on the clearing members' balance sheets from the leverage ratio. However, some respondents suggested that changes to the leverage ratio may not automatically improve access for all clients, notably small clients, and other disincentives such as fixed costs would also continue to be relevant factors.

Some respondents commented that the standardised approach to counterparty credit risk (SA-CCR), whilst an improvement upon the current exposure method (CEM), would benefit from a recalibration in some areas.

Respondents broadly agreed with the report's characterisation of credit valuation adjustment (CVA) risk capital requirements. A number of respondents suggested that the calibration and scope of application of the requirements should be reassessed, to ensure that CVA requirements do not create material central clearing disincentives for market participants that are otherwise exempt from clearing mandates or margin requirements.

A few respondents also suggested that the G-SIB methodology could be reassessed to better incentivise central clearing and the provision of client clearing services. A number of respondents noted concern in the methodology's use of the leverage ratio's exposure measure as the 'size' indicator (citing disincentives created due to the treatment of client initial margin for client cleared transactions) and in the methodology's treatment of client cleared exposures.

Changes in response to the comments

The report has been updated to make clearer that the objectives of the uncleared margin requirements include to reduce systemic risk as well as to incentivise central clearing. The impact of the leverage ratio's exposure measure on the G-SIB scoring methodology has also been made clearer.

The report already notes that exemptions have been applied to some reforms; for example, exemptions to some clearing mandates are granted to small entities, given their expected lower impact on financial stability.

Access to derivatives markets and central clearing

Most, though not all, respondents agreed with the report's characterisation of the impact of the reforms and identification of access issues for some types of client especially smaller firms; and concentration in client clearing service provision. This included that the concentration in client clearing services exacerbated access challenges and could reduce the effectiveness of porting, due to the likelihood of insufficient market capacity to absorb clients' positions in the event of a major default. A few respondents highlighted concentration concerns at the CCP level in specific asset classes, and noted that concentration at both CCP and clearing member levels could represent systemic risks.

Almost all respondents agreed that high fixed costs make clearing services expensive, and that these costs are substantially higher than the benefits that a smaller participant might accrue from central clearing. There was similar agreement on the costs for providing client clearing services. Other respondents mentioned potential issues with procyclical behaviour by client clearing service providers (e.g. requiring better quality or more collateral in times of stress).

Although concentration of client clearing service provision was a common concern, there were few offered solutions to this. Some respondents acknowledged the factors such as economies of scale that contributed to this outcome. Some also noted that concentration is not universal across asset classes, and there has been a slight decrease in concentration in at least one instance, as noted in the consultative document.

Respondents other than CCPs were generally cautious about innovations such as direct access models, given that they are new and not yet widely adopted. A number of respondents said that the effects of such models would be less significant than existing disincentives such as treatment of client initial margin under the leverage ratio; they further indicated that many of these industry efforts are unlikely to help smaller participants especially those with directional portfolios. In a similar vein, some respondents noted that, whilst potential adjustments to bank capital requirements would also help reduce disincentives, these alone might not be sufficient to address all challenges (especially for smaller firms) and likely would not be sufficient to attract new service providers to client clearing in isolation.

Changes in response to the comments

The report notes that market capacity and access issues are relevant considerations for the scope of clearing mandates. The report's discussion of direct access models has been slightly expanded, though it remains too early to assess their impact on incentives to centrally clear, as well as on CCP risk management practices. Concerns of some firms related to trade certainty, should they lose access to central clearing, also have been noted in the report.

Other issues

Regarding issues not mentioned in the consultative report, disincentives to centrally clear for smaller firms, non-banks and non-financials due to CCP margin/collateral requirements was the most commonly cited issue. Respondents noted the typically narrow set of eligible collateral accepted by CCPs (and some respondents noted that clearing service providers can impose even narrower restrictions than CCPs), as well as the common requirement that variation margin is posted in cash. This latter requirement can be challenging for firms that typically do not hold surplus cash, including asset managers, pension funds and non-financial corporates. It can also, in their view, result in lower returns and increased liquidity risk, especially if cash must be generated at short notice and/or in stressed market circumstances. Some respondents noted the criticality of the sound functioning of repo markets, for these firms to generate cash to meet margin calls, not just for OTC derivatives clearing but also for other markets too.

Other concerns were raised about possible outcomes in stressed market circumstances. A number of respondents supported the report's discussion of concerns about the effectiveness of porting arrangements for client positions following the default of a major clearing member, especially given the concentration in client clearing service provision. A number of responses linked this porting concern to capacity constraints associated with the effects of the leverage ratio's treatment of client clearing initial margin; but also with other factors such as know-your-customer, anti-money laundering, and others such as compliance and conduct requirements. More broadly, market capacity was considered relevant to whether and how far clearing mandates and incentives should be extended.

On innovations in clearing, portfolio compression was mostly supported, however some respondents noted that benefits accrued mostly to larger participants. Fewer respondents mentioned direct access models.

Some respondents noted the importance of consistency of reform implementation in different jurisdictions and regulatory deference.[3]

Changes in response to the comments

CCP collateral eligibility criteria and requirements to post variation margin in cash are noted as a disincentive for clients, in addition to those already identified in the report. A possible future research question regarding changes in trading liquidity between centrally cleared and uncleared markets, and the potential liquidity bifurcation problem, has also been added.

[3] A summary of OTC derivatives reforms related deference decisions is set out in Appendix G of FSB, *OTC derivatives market reforms: Thirteenth progress report on implementation* (November 2018) at www.fsb.org/2018/11/otc-derivatives-market-reforms-thirteenth-progress-report-on-implementation.