

OTC Derivatives Reforms Progress

Report from the FSB Chairman for the G20 Leaders' Summit

Executive summary

In response to concerns about **systemic risks** in over-the-counter (OTC) derivatives markets, the G20 Leaders agreed in 2009 to a comprehensive reform agenda to improve transparency in these markets, mitigate systemic risk, and protect against market abuse.

To achieve these objectives, the G20 has agreed that by end-2012:

- all OTC derivatives contracts should be reported to **trade repositories** (TRs);
- all standardised contracts should be traded on **exchanges or electronic trading platforms**, where appropriate, and cleared through **central counterparties** (CCPs);
- non-centrally cleared contracts should be subject to **higher capital requirements and minimum margining requirements should be developed**.

Substantial progress has been made in implementing this agenda:

- By the start of 2014, three-quarters of FSB member jurisdictions intend to have legislation and regulation adopted to require transactions to be **reported to trade repositories**.
- Frameworks for **central clearing requirements** are in place in most of the largest derivatives markets, with concrete rules now starting to go into effect.
- International minimum standards are in place for sound **risk management of financial market infrastructures** (FMIs), including CCPs, supporting OTC derivatives markets.
- Guidance on **FMI recovery and resolution** has been proposed, to avoid a situation in which these institutions would otherwise be 'too big to fail'.
- International standards for **bilateral margin requirements** and for **capital requirements** have been proposed or agreed. These promote sound risk management and encourage use of central clearing.
- Regulators from a number of large OTC derivatives markets have reached understandings to improve the **cross-border implementation** of OTC derivatives reforms.
- A **macroeconomic assessment** estimates net long-run benefits from the reforms.

Further work is needed in the following areas:

- Authorities should take every opportunity to increase market use of **central clearing**, and minimise opportunities for regulatory arbitrage.
- Authorities should renew their focus on the commitment to increase the use of **exchanges and electronic trading platforms**.
- Authorities should implement finalised **capital and margin requirements** in accordance with agreed phase-in schedules.
- Jurisdictions are expected to adopt resolution regimes for FMIs, including CCPs, and should ensure that **recovery and resolution** plans for FMIs are developed in line with international guidance.
- Regulators should continue to cooperate in the **application of regulations in cross-border contexts**, to enable them to defer to each other's rules where these achieve similar outcomes.
- Regulators should **provide clarity** regarding the detailed rules on the treatment of cross-border transactions and the timetables for implementation.
- Authorities will need to ensure that they can make full use of the data collected by **trade repositories** in fulfilling their financial stability mandates; to assist in this, a feasibility study on approaches to the aggregation of TR data is underway.

In addition, there is a **role for authorities to continue monitoring** to ensure that jurisdictions finalise their reform programmes and to identify new risks that may emerge as market participants adapt to the new regulatory environment:

- The **FSB** will continue to monitor implementation of the OTC derivatives reforms to ensure the **G20 objectives** are met.
- **CPSS-IOSCO** has started monitoring implementation of their new Principles **for FMIs**.
- **BCBS** and **IOSCO** will monitor the implementation and impact of their standards for **margin requirements** for non-centrally cleared OTC derivatives.
- The FSB is committed to monitoring any new risks, including from potential **concentration of activity** and **market innovations**.
- Authorities should continue to monitor the role of intermediaries who provide smaller market participants with access to central clearing and other infrastructure.

Introduction

The 2009 G20 agreement to reform the global OTC derivatives market was a much needed and ambitious financial regulatory project. The need for reforms in this area had been building even prior to the crisis events of 2007–2008. Large volumes of outstanding bilateral transactions had created a complex and deeply interdependent network of exposures that ultimately contributed to a **build-up of systemic risk**. The stresses of the crisis exposed these risks: insufficient transparency regarding counterparty exposures; inadequate collateralisation practices; cumbersome operational processes; uncoordinated default management; and market misconduct concerns.

In response, the G20 Leaders agreed to reform OTC derivatives markets with the **objectives** of improving transparency, mitigating systemic risk, and protecting against market abuse. To achieve these objectives, the G20 agreed that by end-2012:

- all OTC derivatives contracts should be reported to trade repositories (TRs);
- all standardised contracts would be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties (CCPs);
- non-centrally cleared contracts should be subject to higher capital requirements and minimum margining requirements should be developed.

Since then, the FSB has developed recommendations for implementing OTC derivatives market reforms and has been closely monitoring progress in implementation; a sixth progress report has been published ahead of the G20 Leaders' summit.¹ Although the original deadline set by the G20 was missed, significant progress has been made, as discussed below.

The reform process to implement these commitments has consumed significant resources across both regulatory agencies and financial market participants. But there are clear benefits that will flow from these reforms once implemented. Important but hard-to-quantify improvements such as greater transparency and enhanced market integrity are coupled with more tangible benefits to long-term macroeconomic outcomes.

At the request of the FSB, a working group coordinated by the BIS has undertaken **a macroeconomic assessment** of the expected impact of OTC derivatives market reforms.² This study acknowledges that the reforms are not costless over the long run; increased capital and margin requirements will likely result in some higher prices in markets for risk transfer and other financial services. However, these costs are likely to be more than offset by the benefit that flows from a lower frequency of financial crises, due to reforms that reduce counterparty exposures through more widespread central clearing and more comprehensive collateralisation. The central estimate of this study therefore is that the net benefit of reforms is roughly 0.12 per cent of GDP per year.³ Importantly, this study notes that benefits will be

¹ FSB (2013), *OTC Derivatives Market Reforms: Sixth Progress Report on Implementation*, September; available at: http://www.financialstabilityboard.org/publications/r_130902b.pdf.

² BIS (2013), *Macroeconomic impact assessment of OTC derivatives regulatory reforms*, Macroeconomic Assessment Group on Derivatives, August; available at: <http://www.bis.org/publ/othp20.pdf>.

³ Among the assumptions used in the study is that there is sufficient collateral available to fulfil the requirements of all regulatory reforms currently planned. This assumption is based on BCBS QIS data and studies and a recent report by the Committee on the Global Financial System, which found no evidence or expectation of any lasting or widespread scarcity

maximised where the agreed reforms are most fully implemented, and in particular where as many transactions as possible are standardised and centrally cleared. This provides even **further impetus for jurisdictions to ensure these reforms are speedily and comprehensively implemented so that this pay-off is seen.**

Building the regulatory foundation

Implementing the committed reforms has required substantial changes in many jurisdictions' legislative and regulatory frameworks over recent years. Simultaneously, international groups have been developing new (or revising existing) standards and guidance on how to achieve the G20 commitments. Many of these pieces are now falling into place.

International standards and guidance

Most of the planned international guidance to assist with implementation of reforms has been issued. Foundational elements such as **CPSS-IOSCO's principles for financial market infrastructure** (including CCPs and TRs) and **BCBS's enhanced capital framework** are now actively being implemented by authorities. Several pieces of supporting guidance have also been completed or are close to finalisation, including, for example: work by IOSCO on appropriate trading platforms for derivatives markets, and principles for derivatives markets intermediaries; and work by CPSS-IOSCO on data aggregation and reporting, and authorities' access to information held in TRs (with a final report published in August 2013).⁴

Further international standards have recently been issued – for banks' capitalisation of counterparty exposures arising from centrally cleared derivatives for consultation, and for minimum margin requirements for non-centrally cleared derivatives in final form.⁵

The implementation of these standards is essential to ensuring that incentives within the financial system support the agreed policy goal that standardised OTC derivatives contracts be centrally cleared, and that systemic risks from non-centrally cleared derivatives are reduced.

Although the OTC derivatives reforms underway increase the reliance of the financial system on CCPs and other centralised infrastructure, work is also underway to prevent the rise of a new set of 'too big to fail' entities. FSB jurisdictions are expected to adopt by 2015 resolution regimes for systemically important FMIs, including CCPs, consistent with international guidance to be finalised by end-2013. Important work is being undertaken by CPSS-IOSCO and the FSB, who have recently proposed a comprehensive set of guidance on **recovery and resolution** for FMIs, including CCPs.⁶

of such assets in global financial markets. See BIS (2013), *Asset Encumbrance and the Demand for Collateral Assets*, May; available at: <http://www.bis.org/publ/cgfs49.pdf>.

⁴ CPSS and IOSCO (2013), *Authorities' access to trade repository data*, August; available at: <http://www.bis.org/publ/cpss110.pdf>.

⁵ BCBS and IOSCO (2013), *Margin requirements for non-centrally cleared derivatives - final document*, September; available at: <http://www.bis.org/publ/bcbs261.pdf>.

⁶ In August 2013 CPSS-IOSCO published *Recovery of financial market infrastructures - consultative report* (available at: <http://www.bis.org/publ/cpss109.pdf>) and the FSB published for consultation a draft Annex to the *Key Attributes of Effective Resolution Regimes* (Key Attributes) on FMI resolution which sets out sector-specific considerations for how

Jurisdictional progress

Based on information provided by individual jurisdictions to the FSB, currently over half of FSB member jurisdictions now have legislative frameworks in place to enable all reform commitments to be implemented. While the current schedule for further changes in legislative and regulatory frameworks is uneven across jurisdictions and commitment areas, this does not detract from the remarkable progress that has already been made.

Jurisdictions are moving ahead most rapidly in requirements for transactions to be reported to TRs: by the start of 2014, three-quarters of FSB member jurisdictions intend to have legislation and regulation adopted, and a little over half expect to have specific requirements in force. These jurisdictions include most of the largest OTC derivatives markets. In general these requirements will at least cover the largest market participants with regard to interest rate and credit derivatives, with requirements for other participants and products being phased in over the course of 2014. Jurisdictions continue to work through possible solutions to address legal barriers to reporting of counterparty data on transactions and authorities' access to TR data. Many jurisdictions indicate that data held in trade repositories will be a key input in considering further regulatory reform implementation. **The acceleration in trade reporting, therefore, is very welcome.**

Legislative and regulatory steps to drive progress in central clearing are moving forward more slowly. Twelve jurisdictions have the necessary legislation in place to give effect to mandatory central clearing requirements. Though currently only two jurisdictions have implemented specific mandatory clearing obligations (these cover two of the largest OTC derivatives markets globally), other jurisdictions have firm plans to implement mandatory clearing obligations for some products in the coming year. Other jurisdictions with the capacity to implement mandatory clearing obligations are still in the process of developing specific requirements, or are monitoring market developments to consider whether products are clearing-eligible in the first instance. Some jurisdictions intend to rely initially on incentives such as Basel III requirements; however, there is a risk that relying on incentives alone will not be sufficient to meet the G20 objective, and they should examine the effectiveness of those incentives in order to determine whether requirements are subsequently warranted.

As noted above, the benefits of the OTC derivatives reform project are realised through more widespread central clearing and more comprehensive collateralisation. In some asset classes, notably interest rate and credit derivative products, the proportion of transactions being centrally cleared is increasing. But, even in these asset classes, there is substantial scope to increase the volume of central clearing. For other asset classes, central clearing is not yet widespread. **Authorities should, therefore, take every opportunity to increase the extent of central clearing in OTC derivatives markets.**

Additionally, the increasing demand for indirect access to central clearing presents challenges: clients need access to central clearing services and, at the same time, intermediaries offering client clearing services need to carefully manage the associated risks.

the Key Attributes should apply to FMIs generally and particular classes of FMIs (available at: http://www.financialstabilityboard.org/publications/r_130812a.pdf).

If too few intermediaries were willing or able to offer certain products, this may result in insufficient capacity to meet client demand as well as higher levels of market concentration. Authorities should continue to monitor the role of intermediaries who provide smaller market participants with access to central clearing and other infrastructure.

Enhanced prudential standards resulting from Basel III implementation are now in effect in around half of FSB member jurisdictions. With internationally agreed minimum margin requirements for non-centrally cleared transactions only published just ahead of the G20 Leaders' Summit, understandably few jurisdictions have made concrete implementation steps in this area. This should change over the next year, since it is intended that these requirements will begin phasing in from December 2015.

One area that needs to be **pursued with more vigour is in promoting the execution of standardised contracts through exchanges or electronic trading platforms, where appropriate**. As with central clearing, in many instances authorities have indicated they are waiting for more detailed market information to become available through trade reporting before moving ahead in this area. However, with more extensive use of organised trading platforms greater benefits in terms of market transparency and market integrity are expected. Authorities should renew their focus on this commitment.

The importance of international cooperation

With many jurisdictions now implementing specific requirements for market participants, clarity in how jurisdictions' regulatory regimes interact is crucial for all stakeholders. This is more so since cross-border transactions dominate activity in the OTC derivatives markets of most FSB member jurisdictions.⁷ Given the complexity of the reforms, issues related to the cross-border application and interaction of rules are taking time to emerge and to be resolved.

Cross-border regulatory issues, if unresolved, may affect the functioning of global markets. To address this risk, authorities have made progress in considering how to apply flexible, outcomes-based substituted compliance or equivalence assessments whereby authorities will assess whether aspects of another regime are comparable and therefore can be deferred to. In undertaking such assessments, authorities have recognised that similar outcomes may be achieved by different regimes, taking account of the different frameworks, local market practices and characteristics across jurisdictions. **Two major, constructive steps forward in this area have been taken**: first, the announcement in July by the US Commodity Futures Trading Commission and the European Commission of their joint understandings on cross-border issues; and subsequently, a multilateral set of understandings to improve the cross-border implementation of OTC derivatives reforms, announced in August by the

⁷ For example, BIS data on OTC interest rate derivatives markets indicates that an average of 70% of the turnover of dealers located in each of these jurisdictions is with foreign counterparties. As well, in most jurisdictions the local operations of foreign financial institutions play an important role in the local dealer community.

OTC Derivatives Regulators Group (consisting of market regulators from jurisdictions with large OTC derivatives markets).⁸

The Regulators Group has been meeting periodically, and the FSB had asked this group to report on how outstanding cross-border issues have been resolved by the time of this Summit. A key understanding of the group is that a flexible outcomes-based approach should form the basis of final assessments regarding equivalence or substituted compliance. A number of other understandings were set out by the group on cross-border issues, as well as agreement that jurisdictions should remove barriers to reporting to trade repositories by market participants, in particular of counterparty data, and barriers to authorities' access to trade repository data. The group also identified a number of issues that require further discussion in the months ahead.

Regulators should continue to cooperate in the cross-border application of regulations, to enable them to defer to each other where these achieve similar outcomes. Regulators should build on the recent understandings to achieve this, providing clarity on their planned treatment of cross-border transactions and timetable for implementation. Given the likely differences in the detail of jurisdictions' reform implementation, focusing decisions about substituted compliance or equivalence/recognition on comparisons at a very granular level would not be helpful. Instead, substituted compliance and equivalence assessments of others' regulatory regimes should be based on whether jurisdictions broadly achieve similar outcomes. At the same time, in applying such an overall broad approach, regulators will need to decide in different policy areas how much flexibility to apply in assessing the similarity of outcomes. For instance, there may be some particular policies (such as CCP margin rules) where differences in key requirements between jurisdictions could lead to regulatory arbitrage, and where further discussion between regulators is needed. **Detailed work, and a timeline for action, is thus needed to address the challenges in translating the encouraging recent cross-border regulatory understandings into practice.**

IOSCO is undertaking work to develop approaches for authorities in considering cross-border market regulation more generally and various other international cooperative efforts are underway to ensure the reforms are implemented in a way that best achieves the G20's underlying objectives. For instance, to address challenges to comprehensive market monitoring and transparency, the FSB, in consultation with CPSS and IOSCO, has launched a feasibility study of options for how information from TRs can be aggregated and shared among authorities, the results of which will be published in the first half of 2014.

To promote the consistent implementation of the *Principles for Financial Market Infrastructures* (PFMIs), CPSS-IOSCO has been monitoring regulatory implementation of these principles, notably for CCPs and TRs, with a first assessment published in August 2013.⁹ Further assessments of PFMI implementation will include a greater focus

⁸ The Regulators Group's *Report on agreed understandings to resolving cross-border conflicts, inconsistencies, gaps and duplicative requirements* (16 August 2013) has been separately forwarded to the G20 Leaders; available at: <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/odrgreport.pdf>.

⁹ CPSS and IOSCO, *Implementation monitoring of PFMIs – Level 1 assessment report*; available at: <http://www.bis.org/publ/cpss111.pdf>.

on those CCPs and TRs servicing OTC derivatives markets, given the importance of these for the successful implementation of the G20 commitments.

The FSB is also undertaking targeted reviews of the effectiveness of jurisdictions' implementation of OTC derivatives reforms. In late 2013 a peer review is expected to be launched that will consider the extent to which the G20 commitment that all OTC derivatives be reported to TRs is being met, with this review extending through the first half of 2014.

Looking forward

As regulatory reforms come into effect, the FSB has also been monitoring how market participants are adapting to this new environment. The FSB's most recent OTC derivatives progress report reviewed market participants' practical readiness to meet the requirements of reforms as they are implemented, concluding that participants in general appear to be making good progress in their preparations. Market participants are more advanced in their readiness where regulatory regimes and requirements are more settled; in contrast, regulatory uncertainty has held back the finalisation of preparations by some market participants. Again, therefore, it is imperative that jurisdictions move forward in finalising and implementing requirements.

The FSB will continue monitoring reform implementation, as well as reporting on the effectiveness of reforms in meeting the G20 underlying objectives. Some areas where further analysis and monitoring is needed include:

- the potential for **concentration** of activity and services within a limited number of intermediaries, and market innovations (such as collateral transformation or futurisation) that may develop in response to the changed regulatory environment;
- the scope for more products to be **standardised** and shifted into CCPs and trading platforms, and additional risk mitigants where activity remains outside such infrastructure; and
- developments in **cross-border activity**, and whether more is needed to enable cooperative oversight of this market.

The FSB will publish a further progress report on OTC derivatives reforms by April 2014.