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"All Change - The New Global Environment for Derivatives"

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Introduction:

The global financial crisis has been attributed to the failure to regulate complex financial instruments, especially derivatives which contributed extensively to the financial crisis. Gretchen Morgenson in his article[1] states that derivatives were responsible for much of the interconnectedness between banks and other institutions that made the financial collapse accelerate in the way that it did, costing taxpayers hundreds of billions in bailouts. In response to the financial crisis, an international consensus quickly formed and heightened global financial regulation generally and derivatives regulation in particular. When the G-20 leaders met in Pittsburgh, United States (U.S), in September 2009[2], the political leaders agreed that in future all over-the-counter (OTC) derivatives, including swaps would be traded effectively on exchange. This essay will proceed as follows: Part A will provide a background on derivatives and the situation leading to the financial crisis. Part B will describe the reforms in the global regulatory sphere with emphasis on the European Union (EU) and the U.S., the challenges faced so far and the industry response to these developments. Part C will provide recommendations and conclude the essay.

A. DERIVATIVES AND THE SITUATION LEADING TO THE FINANCIAL CRISIS

Derivatives are all about risk. They are useful in managing risks in the financial system and in the real economy alike. They are nothing more than a contractual means by which parties allocate the risk of a fluctuation in price of an underlying reference asset. A derivative is simply a financial arrangement the value of which is derived from another financial instrument, index, measure of economic value[3]. In the contract, the two sides or counterparties commit to one or several payments at some time in the future, the

[1] Gretchen Morgenson, Its Time for Swaps to Lose Their Swagger, N.Y. TIMES, Feb. 28, 2010 at BU1.
[2] Almost a year to the day since the collapse of Lehman Brothers.
[3] See Schuyler K. Henderson, Henderson On Derivatives 5 (2d ed. 2010).

amount of which will depend upon the value of the underlying reference asset at that time[4]. This exchange of payments thus allows the counterparties to reallocate risk, allowing for risk mitigation like hedging[5] as well as speculation[6].

Derivatives are classified into two categories; exchange-traded and OTC derivatives. As the names suggests, the distinction depends primarily upon the way in which the business is transacted. Mainly standardised derivatives, such as futures and many forms of options may be traded on exchanges[7]. As a result of their standardization, exchange traded derivatives offer buyers fewer choices on; underlying assets, settlement amounts, maturity dates and strike prices[8]. Most of the world's derivatives are transacted over-the-counter[9]. OTC derivatives are essentially individually negotiated contracts; their terms including the underlying asset, settlement amounts, maturity dates and other features are infinitely variable. This allows the sellers of OTC derivatives typically major financial institutions acting as dealers to manage or speculate on risk in an infinite variety of ways[10]. The primary drawbacks of OTC derivatives relative to their exchange-traded counterparts stem from a potential lack of secondary market liquidity and the absence of a third party clearing house to absorb counterparty credit and settlement risk[11].

Derivatives received a significant share of blame towards their contribution to the global financial crisis of 2007-2008. It has been said that the crisis began when the bursting of the bubble in the U.S. housing market revealed the over exposure of major financial institutions to housing, principally though securitised

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[4] See Robert W. Kolb & James A. Overdahl, Financial Derivatives: Pricing and Risk Management, at 16-19
[5] See Ibid at 575-82
[6] Both hedging and speculation are vital features of a working financial system – hedging because it enables parties to eliminate unwanted risk and speculation because it speeds price discovery and therefore market efficiency. Reference from Kolb & Overdahl above.
[7] See Kolb & Overdahl, supra at p.21.
[8] See Dan Awrey, The Dynamics of OTC Derivatives Regulation: Bridging the Public-Private Divide, 11 EUR. BUS. ORG. L. REV. 155, 161 (2010).
[9] See Darrell Duffie, The Failure Mechanics of Dealer Banks, 24 J. ECON. PERSP. 5151(2010) at 56-58 - that is in the form of privately negotiated bilateral contracts without an exchange intermediary.
[10] See Randall Dodd, The Structure of OTC Derivatives Markets, 9 FINANCIER 41, 41-44 (2002).
[11] Awery, Dynamics, supra note 8, at 162.

products such as mortgage-backed securities and collateralised debt obligations[12]. The collapse of several such institutions and the severe weakening of many others reduced the availability of credit and led to a sharp contraction in the real economy[13]. Derivatives have been implicated in the crisis in several ways[14]. Rene argued that derivatives contributed to the financial crisis by enabling the credit boom, allowing financial institutions take on massive risk, providing a total lack of transparency regarding risk exposures and resulting strength of financial institutions with large positions.

Derivatives expanded the ability of investors to speculate on the direction of the U.S housing market through the creation of synthetic collateralised debt obligations; that is a swap where the underlying asset was a pool of collateralised debt obligations. Further, because derivatives enable parties to take on risk without actually owning the underlying asset, these instruments allowed investors to take more exposure to subprime mortgages than there were such mortgages[15]. This fuelled the credit boom and the further expansion of risk-taking in these markets.

Secondly, derivatives allowed financial institutions to take massive but almost entirely opaque positions resulting not only in very large losses, but also in the inability of outsiders to assess their financial strength[16]. This prompted worried investors to withdraw liquidity from institutions dependent on short term financing, thereby creating the conditions for a bank run[17].

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[12] See Andrea J. Boyack, Laudable Goals and Unintended Consequences: The Role and Control of Fannie Mae and Freddie Mac, 60 AM. U.L.REV. 1489,1502-09 (2011).

[13]See generally The FIN. Crisis Inquiry Commission, The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States (2011).

[14] See Rene M. Stulz, Credit Default Swaps and the Credit Crisis 3-4 (National Bureau of Economics Research, Working Paper No. 15384, 2009) – http://www.nber.org/papers/w15384.

[15] Stulz, supra 14, at 11.

[16] Stulz, Supra 14

[17]See Colleen M. Baker, Regulating the Invisible: The case of Over-the-Counter Derivatives, 85 NOTRE DAME L. REV. 1287, 1306-07 (2010).

B. DESCRIPTION OF THE REFORMS IN THE GLOBAL REGULATORY SPHERE

In 2009, G-20 leaders agreed that by no later than December 2012, all standardised OTC derivatives would be traded on exchanges or electronic trading platforms. The OTC market is composed of banks and other sophisticated market participants, like hedge funds, and because there is no central exchange, traders are exposed to more counterparty risk. The leaders agreed on regulatory initiatives aimed at strengthening the infrastructure of this large and economically important financial market segment. The limited transparency, massive size and interconnectedness of the derivatives market created impetus for more regulation with a view to improving the robustness and resilience of this market[18].

Three of the key G20 commitments for OTC derivatives were the:

a) reporting of all OTC derivatives transactions to trade repositories
b) clearing of all standardised OTC derivatives through central counterparties, and
c) execution of all standardised OTC derivatives on exchanges or electronic trading platforms, where appropriate.

These commitments aimed to bring transparency to these markets and improve risk management practices. These changes provided a framework for the regulation of OTC derivatives reporting, clearing and trade execution. The Dodd-Frank Act (DFA) and European Market Infrastructure Regulation (EMIR) are the legislative frameworks that were developed to transpose the G-20 commitments. I will now proceed to look at the two jurisdictions; the EU and U.S.

[18] Orcun Kaya, Reforming OTC Derivatives Markets – Observable Changes and Open Issues, 7, August 2013 under Deutsche Bank Research.

Regulations in Europe

The EU is implementing the new rules for derivatives markets mainly through two legal instruments; the EMIR and the revised Markets in Financial Instruments Directive (MiFID 2). Consistent with the G-20 proposal, EMIR introduced a reporting obligation for OTC derivatives, a clearing obligation for eligible OTC derivatives, measures to reduce counterparty credit risk and operational risk for bilaterally cleared OTC derivatives, common rules for central counter parties (CCPs)[19] and trade repositories (TRs)[20], and rules on the establishment of interoperability between CCPs. The first MiFID legislation dating back to 2007 just before the outbreak of the financial crisis and its aim was to create a common market and more competition among trading platforms. Responding to the G-20 agenda and the lessons learned from the crisis, the EU released a revised proposal in October 2011 and introduced MIFID 2 and the complementary Markets in Financial Instruments Regulation (MiFIR). The MiFID 2 covers a number of additional requirements on market structure, exemptions from financial regulation, organisation and conduct of business requirements for investment firms and trading venues, powers of national authorities, sanctions and rules for non-EU firms operating through a branch[21]. MiFIR on the other hand sets out requirements for trade transparency. As regards EMIR, while it was the first legislative proposal dating back to 2010, the final legislation was only passed in August 2012. Several technical implementation standards have been developed subsequently[22].

[19] Central clearing corresponds to a platform where the counterparty risk mitigation, netting and collateral posting take place. With central clearing, counterparties trade through a CCP rather than directly trading with each other. Counterparty risks are passed to the CCP and the CCP determines the margin requirements on an ongoing basis.

[20] Trade repository is an entity that centrally collects and maintains the electronic records of derivatives transaction data.

[21] Orcun Kaya, supra, Deutsche Bank.

[22] On 19 December 2012 the EU Commission adopted technical standards for the regulation of OTC derivatives, CCPs and TRs which came into force on 15 March 2015.

Regulations in the U.S.

In the U.S., the regulation and governance of the derivatives market is addressed by the Dodd-Frank Wall Street Reform and Consumer Protection Act which was adopted in July 2010. To achieve improved consumer protection and a reduction of systemic risks, the reforms cover a large range of regulatory legislation on systemic supervision, investment advisors and OTC derivatives trading. In addition, legislation was enacted to reduce risks, increase transparency in the derivatives market and promote market integrity within the financial system. While Title VII of the DFA[23] establishes a comprehensive new regulatory for swaps and security based swaps in the U.S.,it leaves the important definitions and the implementation of the rules to the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC). According to the DFA, swap and equity-swap agreements would be regulated by the CFTC and the SEC respectively; a market participant trading in both instruments would be under the regulation of both institutions. As to CDSs, there is split responsibility in that the SEC regulates CDSs on single names, loans and narrow-based security indexes, whereas the CFTC regulates CDSs based on broad-based security indexes.

Inspite the fact that EMIR and the DFA have significant commonalities in terms of implementing the G-20 commitments, notable differences can still be observed. The similarities include; the objective of achieving a more robust financial infrastructure through central clearing of standardised derivatives, a mandatory reporting requirement for derivatives trades, mandatory margin and capital requirements for non-cleared derivatives transactions, and allowing cross-border clearing by recognising non-domestic CCPs.

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[23] In the U.S., Title VII of the final rules defines instruments based on interest or other monetary rates as swaps, whereas instruments based on the yield or value of a single security, loan or narrow based security index as security-based swaps

Challenges in regulations; harmonisation prospects:

For the market participants subject to regulatory requirements in more than one country, one of the main concerns regarding the regulatory agenda is the potential regulatory overlaps, conflicts, inconsistencies and duplications which may arise between different legislative frameworks. To date, cross-border transactions, participants and infrastructures that span two or more jurisdictions are not fully specified in most countries. In the U.S., the CFTC requires that foreign entities which engage in swap deals with the U.S. counterparties should register with the CFTC and follow the U.S. requirements. However, it allows for overseas affiliates of U.S. financial counterparties to follow local regulations if they are comparably robust and comprehensive[24]. In the EU, cross-border regulation is based on the recognition of regimes as "equivalent", non-EU CCPs and TRs can be recognised by European Securities and Markets Authority (ESMA) as eligible for central clearing and trade reporting if a number of conditions are met. One of these conditions was to have cooperative arrangements between ESMA and the home supervisor of the non-EU CCPs or TRs[25].

On 11th June 2013, the U.S. and EU regulators announced in a joint statement that they had reached a common understanding in principle on how to approach cross-border derivatives[26]. The statement identified a number of issues where equivalence needs to be clarified, including the scope of U.S. transaction level requirement, non-cleared derivatives, CCP and trading venue recognition, mandatory clearing and trade reporting. Given that EU and U.S. rules for risk mitigation are essentially identical for bilateral uncleared swaps, the CFTC plan to granted so-called no-action relief[27]. It should be noted that no-action relief by the CFTC is an unilateral act which does not have the backing of a binding international treaty thus leaving the

[24] See Article titled; The path forward for EU-US derivatives Regulation by James E. Schwartz, Marissa N. Golden and Robert J. Dilworth.
[25] See FSB (April 2013) – OTC Derivatives Reforms, Fifth Progress Report in Implementation.
[26] See Article titled; The path forward for EU-US derivatives Regulation, supra note 24 – the Path Forward concept
[27] Meaning that the CFTC will effectively tolerate if the market participants operate according to EU rules.

CFTC with the ability on its own volition to modify, suspend terminate or otherwise restrict the terms of the no-action relief at some stage in the future. For CCP recognition, the statement indicates that the only key material difference is initial margin coverage and the European Commission and the CFTC will work together to reduce regulatory arbitrage opportunities. On trade reporting, regulators will work to resolve remaining issues such as consistent date fields and issues related to privacy.

In order to address the cross-border issues beyond the transatlantic space, a group of OTC derivatives market regulators including the U.S. and the EU[28] came together to make progress in resolving cross-border uncertainties[29]. It was agreed to further explore the scope of regulation and mutual recognition or substituted compliance for cross border activities. In their meeting[30], an agreement was reached; thinking globally and acting locally[31].

C. RECOMENDATIONS

Before data can be aggregated at a cross-border level and used by the relevant supervisory authorities, significant legal barriers need to be removed. Failure to address these legal barriers would make all other efforts to address derivatives transparency futile. Removing legal barriers to data sharing; some of which predate derivatives reform such as data protection laws, blocking statutes, state secrecy laws and bank secrecy laws require international regulatory cooperation for the greater public good. To this end, there is need to have bilateral agreements as useful steps towards building the case for greater cooperation as they make eventual data sharing easier at a multi-lateral level. However, multi-lateral agreements are a quicker way to achieving the ultimate goal of global transparency mandated by the G-20.

[28] The others include; Australia, Brazil, Canada, Hong Kong, Japan, Singapore and Switzerland.

[29] In their December 2012 announcement, they reported reaching an understanding on clearing determinations, sharing of information and supervisory and enforcement cooperation and timing.

[30] Held in April 2013.

[31] According to the agreement, if a category of counterparties or products were exempt from clearing of trading obligations in one jurisdiction but not in another or a product is subject to a clearing or trading obligation in one jurisdiction but not in another, the stricter rules apply – the doctrine of substituted compliance.

Conclusion:

I have looked at the pre-financial crisis era vis-à-vis the derivatives industry and the reforms that came thereafter. In board terms, the objective of the G-20 regulatory reforms was to create a robust financial infrastructure and also provide timely and reliable data. The reforms have been implemented though the U.S. seems slightly more advanced in the reforms process than the EU thus the development of path forward and the doctrine of substituted compliance in order to guide the cross-border transactions.