

## Global Developments in Derivatives Markets

The financial crisis raised issues related to the need for improvements to the infrastructure of the credit default swaps (CDS) market, and in light of the global nature of this product, to promote a consistent global framework. This note provides an overview of recent developments in the US, EU, Asia and through global bodies such as the G20 and the International Organization for Securities Commissions (IOSCO), with respect to reforms made in the CDS and over-the-counter derivative markets (OTC).

### European Developments

#### EU

In October 2009, the European Commission published a communication aimed at ensuring efficient, safe and sound derivatives markets. The communication builds on the Commission's July communication and aims to reduce counterparty systemic risk derivatives may pose by proposing legislation to: establish common safety, regulatory and operational standards for central counterparties (CCPs); improve collateralization of bilaterally-cleared contracts; substantially raise capital charges for bilaterally-cleared as compared with CCP-cleared transactions; and mandate CCP-clearing for standardized contracts. It also calls for reducing operational risk by promoting the standardization of the legal terms of contracts and of contract-processing; increasing transparency by recording positions and all transactions not cleared by a CCP in trade repositories; and giving regulators the option to set position limits.

The October Communication acknowledged that not all derivatives contracts would be suitable for central clearing either because they are highly specific to the trade concerned or due to the product not being liquid enough for central clearing. Nonetheless, the Commission stated that such derivatives should be "appropriately priced in relation to the systemic risk they entail, in order to avoid those risks being passed on to taxpayers" and noted "current collateral levels are too low and do not reflect the risk that bilaterally-cleared derivatives trades pose to the financial system when they reach a certain critical mass".

As a result, the Commission proposes that financial firms entering into non-standardized contracts will be required to post "initial margin" in proportion to the risk profile of the counterparty and "variation margin" in relation to the change in value of the contract over time. In addition to mitigating the risk of default, these measures are also intended to dissuade participants from entering into non-standardized contracts which could have been standardized and cleared centrally.

The Commission intends that central clearing for all standardized contracts should be mandatory and will work with other non-EU G20 nations in order to develop a consistent approach to defining which contracts are standardized. The key question as to what will constitute "standardized" and "non-standardized" contracts has not yet been agreed.

Bilateral non-cleared OTC contracts will also be subject to higher capital charges. The gap between the relative capital charges for cleared and non-cleared derivatives provided for within the Capital Requirements Directive ("CRD") will be widened and the Commission will work with the Basel Committee on Banking Supervision to amend the CRD appropriately. As with margin, the increased relative cost for bilateral non-cleared OTC contracts is viewed to be consistent with the increased risk associated with them.

In February 2010, the European Commission issued amendments to the Capital Requirements Directive 4 (CRD 4) which aims to strengthen the capital requirements for counterparty credit risk exposures arising from derivatives, repos and securities financing activities. Specifically, the proposal recommends making the qualitative requirements for stress testing more explicit and revising the model validation standards of the CRD. The proposed changes to CRD 4 also reinforce the existing incentive for institutions to use CCPs for OTC derivatives as the proposed revisions would increase the assessed capital requirements against such exposures if completed on a bilateral basis rather than through a CCP.

In addition to the reforms proposed in CRD 4, the European Commission is moving to address other issues relating to derivatives. The Commission issued a proposal for comprehensive European Market Infrastructures Legislation (EMIL) which is expected to enter into force in 2012. EMIL would encompass CCPs, trade repositories and, if necessary, comparative static derivatives (CSDs). In particular, the draft legislation would introduce common legal frameworks for CCPs, and trade repositories. These would include requirements for their safety and soundness and authorization/registration to operate in the EU. The legislation would also address the recognition of infrastructures located outside the EU. In addition, the legislation may introduce the obligation to report all OTC derivatives transactions to trade repositories and to clear all transactions in standardized derivatives through CCPs.

The Commission will also review sections of the Markets in Financial Instruments Directive (MiFID) relating to exemptions for certain commercial firms dealing in commodity derivatives. Current MiFID provisions including authorization and operational requirements, and reporting and conduct of business rules, do not apply to such firms. The European Commission will also undertake a review of the Market Abuse Directive in 2010. The review will extend relevant provisions in order to cover derivatives markets in a comprehensive fashion and is expected to address position limits.

In February 2010, German MEP and Rapporteur to the Parliament's Committee on Economic and Monetary Affairs (ECON) Werner Langen issued a report that aims to exercise influence on the aforementioned legislative reviews and proposals within the European Commission. Specifically, the report supports mandatory clearing of standardized derivatives via 'independent' clearing between financial institutions, with the aim of trading a maximum number of standardized derivatives on organized markets. It also calls for risk management and transparency to be made the guiding principles in order to increase safety in financial markets without omitting the need for individual responsibility and demands that CCPs and their risk management systems are neither owned by users nor compete with each other.

The ECON Committee will discuss the draft report on March 22. The deadline for amendments to the report is March 24 and a vote in the committee is scheduled for May 4.

## **UK**

In December 2009, the Financial Services Authority (FSA) issued *Reforming OTC Derivatives Markets*, which raises objections to forcing "standardized" OTC contracts into clearing houses, as well as mandating that they be traded on exchanges and other electronic platforms. The paper emphasizes that both HM Treasury and the FSA do not support proposals to mandate CCP clearing for all standardized derivatives. It also notes "mandating the clearing of all standardized derivatives could lead to a situation where a [clearing house] is required to clear a product that it is not able to risk manage adequately, with the potential for serious difficulties in the event of a default."

Despite these objections, HM Treasury and the FSA continue to support moves towards greater "standardization" of OTC contracts, as well as greater use of clearing in such markets. The paper notes the increased use of CCPs will heighten their systemic importance so it is crucial that they are regulated to high standards, consistently applied in the major jurisdictions.

## US Developments

### House

The House of Representatives passed the *Wall Street Reform and Consumer Protection Act*, (H.R. 4173) on December 11, 2009 by a vote of 223 to 202. The House Financial Services Committee and the House Agriculture Committee merged their two differing packages on the floor, with the House Agriculture Committee seeming to “moderate” the bill more to the favor of end-users.

The Act requires clearable swaps to be traded on an exchange or swap execution facility, but it exempts end users that use swaps to hedge commercial risks. H.R. 4173 also would allow counterparties to request the segregation of collateral. The Act limits aggregate clearinghouse ownership, among swaps dealers, to 20%. H.R. 4173 empowers regulators by requiring all swaps dealers and major swap participants to register with the Commodity Futures Trading Commission (CFTC) and the Securities Exchange Commission (SEC).

The House bill divides jurisdiction over swaps between the CFTC and SEC. The SEC will oversee activity in swaps that are based on securities like equity and single-name or narrow-based index credit-default swaps. The CFTC will oversee all other swaps, including those based on interest rates and currencies. The title requires the registration and regulation of swap dealers and major swap participants. Capital requirements for swap dealers and major swap participants must be set at greater than zero, and the regulators are directed to set margin levels for counterparties in transactions that are not cleared, except when one of the counterparties is not a dealer or major swap participant. The bill imposes position limits and seeks to harmonize regulation of the swaps markets with similar markets overseas.

CFTC Chairman Gary Gensler noted “the bill comprehensively regulates swap dealers and major swap participants and lays out a framework for the use of clearinghouses and transparent trading facilities.” The House bill essentially retains all or most of current CFTC jurisdiction over commodities futures trading. The CFTC also announced a public hearing for March 25, 2010 to examine position limits in commodity positions.

### Past House Legislation

The House Agriculture Committee approved a bill (H.R. 977) introduced by Rep. Collin Peterson (D-MN) that would require most OTC derivatives to be settled through a registered clearinghouse. The bill would also grant the CFTC the authority to suspend trading in CDS, subject to the president’s veto power, and grant the CFTC criminal prosecutorial powers with respect to violations of the Commodities Exchange Act. The bill has been deferred to the House Financial Services Committee indefinitely.

The Derivative Trading Accountability and Disclosure Act (H.R. 3300) was introduced by Michael McMahon (D-NY) in July 2009. The legislation proposes the creation of the Office of Derivatives Supervision (ODS) in the Treasury Department which would coordinate the development of derivatives regulation by the SEC and CFTC and would grant the office veto power over derivatives regulations that do not promote consistency of regulation of equivalent financial products. The bill would also direct the SEC and the CFTC to jointly determine which derivatives will be required to be exchange traded, cleared and traded over the counter.

### Senate

In November 2009, Senate Banking Committee Chairman Chris Dodd released a comprehensive financial regulatory reform bill, the *Restoring American Financial Stability Act*, which establishes a presumption of clearing for derivatives transactions and mandates exchange trading for cleared transactions. It grants the SEC and CFTC limited authority to exempt transactions from clearing requirements. The bill creates a strong presumption of clearing of all swaps subject to the ability of the regulatory agencies to create rules to exempt swaps from clearing and exchange trading under limited circumstances. The Dodd draft provides a definition of “major swap participant” based on potential credit losses of other market participants and

does not provide an exemption for hedging. It also would also impose higher capital and margin requirements on end-users, even for transactions that aren't cleared, than what would be required by two separate bills in the House.

### **Past Senate Legislation**

Prior to the Dodd discussion draft, Senate Agriculture Committee Chairman Tom Harkin (D-IA) introduced legislation (S. 272) which sought to ban OTC trading of derivatives and force them to be traded exclusively through exchanges. Sen. Carl Levin (D-MI) introduced legislation (S. 447) relating to OTC energy derivatives that would allow the CFTC to impose position limits and regulate foreign operated electronic trading platforms in OTC derivatives markets operating in the US and offshore. In October 2009, Senator Jack Reed (D-RI) introduced the Comprehensive Derivatives Regulation Act, S. 1691, which requires standardized derivatives transactions to be cleared, but does not mandate exchange trading for cleared transactions. S. 1691 requires all OTC transactions to be reported to trade repositories, and it does not call for shared regulatory jurisdiction (SEC and CFTC).

## **Asian Developments**

### **Korea**

Leaders at the September G20 summit reached an agreement to build trading infrastructure for over-the-counter (OTC) derivatives. In line with such efforts, Korea developed the following plans for an OTC derivatives market: the Financial Services Commission's (FSC) Capital Market Division will form a task force to draw up specific plans to introduce trading infrastructures for OTC derivatives and revise related laws and regulations. Necessary revisions will be made to the Financial Investment Services and Capital Market Act (FSCMA) to provide legal grounds for a CCP which specify a definition of clearing, conditions of establishing a CCP, and measures to secure public interest. For CCP clearing purposes, OTC derivatives such as IRS, CRS and CDS will have to be standardized.

The National Assembly of Korea approved a New Product Approval Bill (NPA) that would require certain over-the-counter (OTC) derivative products to be reviewed and pre-approved by the "New Product Approval Committee". The approval process will be required for any new OTC derivatives product that is referenced to credit, natural/environmental or economic risks as well as any new OTC derivatives product offered to "general investors" as defined in the Financial Investment Services and Capital Markets Act (FISCMA). The Korea Financial Investment Association (KOFIA), which has been tasked to oversee the committee, has not determined the membership of the committee or how it will function. The bill will take effect in three months and sunsets December 31, 2011.

In January 2010, the Financial Supervisory Service (FSS) completed building the Integrated Derivatives Information System, with which it has commenced full systemic monitoring operations of derivative products. As a step to follow *Derivatives Market Supervisory Augmentation Plans* introduced in December 2008, the new system is a result of approximately a year of joint private-public Task Force efforts involving the Financial Supervisory Service (FSS), the Financial Services Commission (FSC) and others to achieve supervisory objectives in four main areas: 1) refurbishing monitoring operations of derivatives; 2) strengthening investor protection; 3) raising soundness of financial companies and preventing systemic risks; and 4) reestablishing the functions of both the financial supervisory authorities and the self-regulatory organizations.

*Risk Management Standards on FX Derivatives Transactions* came into effect in January 2010. The proposed measures are aimed at improving the system to enhance the soundness of foreign transactions and strengthen risk management competence of financial institutions and include:

- Fine-tuning the regulation on FX liquidity ratio
- New standards for FX liquidity risk management
- Mandatory minimum holdings of safe FX assets
- New standards for FX derivatives trading risk management
- Tightened regulations to increase mid- to long-term financing in foreign loan portfolios
- Promotion of reasonable FX hedge practices by asset management companies
- Clarification of rules over mandatory reporting of foreign exchange transactions
- Foreign asset limit (leverage ratio) to be further discussed

## **Japan**

In a regulatory blueprint released in January 2010, Japan's Financial Services Agency (FSA) called for reforms to Japan's OTC derivatives markets to avoid the risk of being unable to fulfill settlement due to the bankruptcy of a counterparty to a transaction. The blueprint called for the clearing of OTC derivative transactions of a certain turnover which are closely related to execution under Japan's legal system to be subject to the mandatory clearing at domestic CCPs. Furthermore, the blueprint promoted the introduction of regulations on major shareholders and regulations on capital for domestic CCPs.

The FSA blueprint also recognizes the importance of establishing a mechanism to require CCPs to provide information related to OTC derivative transactions that are centrally cleared and acquire bilateral trade information that are not centrally cleared. While a reporting requirement will strengthen the monitoring of OTC derivative transactions, it will also allow authorities to provide the market with partial information in order to enhance the transparency and predictability of the market.

## **China**

The People's Bank of China (PBoC) announced on March 11, 2009 that all financial institutions engaged in trading derivatives in the Chinese interbank market must sign a master agreement developed by the National Association of Financial Market Institutional Investors (NAFMII), a self-regulatory industry group supervised by the PBoC. Market players were given six months, until September 16, 2009, to negotiate new agreements, and they must submit the signed master agreement and its supplementary agreements to NAFMII for record purposes. As a result, many of the world's biggest banks are, in effect, locked out of China's derivatives markets after being unable to agree terms for new trading agreements with major Chinese institutions in the market.

*The Notice on Further Strengthening Risk Management for Derivatives Transactions between Banking Financial Institutions and Corporate Clients* issued on July 31, 2009, imposes restrictions on the ability of onshore banks to engage in derivatives transactions with onshore corporate clients together with significant ongoing administrative obligations on both the clients and banks. The Notice had immediate effect and required all onshore banks engaging in derivatives transactions to submit a report to the China Banking Regulatory Commission (CBRC) by October 31, 2009 outlining its plans for compliance with the Notice.

In November 2009, the PBoC sought industry comments to regulate interbank over-the-counter derivatives, including whether speculative trading should be permitted. Until now, trading has largely been for legitimate hedging purposes, because without PBoC guidance on what was allowed and between whom, dedicated government agencies took an overly cautious stance.

At the end of November 2009, China launched a new body to centralize settlement and clearing of financial products traded among the country's banks. The PBoC said the Shanghai-based clearing house will clear local- and foreign-currency financial markets. The clearing house has signed a cooperation agreement with Deutsche Börse, which owns the Eurex derivatives trading platform and operates clearing houses for exchange and over-the-counter products.

There are indications that China may be moving towards a close-out netting legal regime, but the timing of any move is uncertain. Regulators want to make it enforceable, but there are still difficulties ahead and netting may only apply to financial institutions.

On February 20, 2010, Chinese securities regulators approved rules for trading the country's stock index futures. The China Securities Regulatory Commission (CSRC) approved the trading contracts and the revised trading rules submitted by the China Financial Futures Exchange (CFFEX), where the index futures will trade.

## **India**

In August 2009, the Reserve Bank of India (RBI) reintroduced interest rate forwards to the market and in September 2009, it issued draft guidelines on repos for corporate bonds.

On November 12, 2009, the RBI introduced draft guidelines on *Over the Counter (OTC) Foreign Exchange Derivatives and Hedging Commodity Price Risk and Freight Risk Overseas* for public comment. The important changes proposed in the draft guidelines are as follows:

- Importers and exporters having foreign currency exposures in trade transactions are being permitted to write covered call and put options both in foreign currency-rupee and cross currency and also receive premiums.
- Authorized Dealers (AD) Category 1 banks are being permitted to offer plain vanilla cross currency options to persons resident in India (other than AD Category 1 banks), who transform their rupee liability to a foreign currency liability.<sup>1</sup>
- Since importers and exporters are being permitted to write covered call and put options, both in foreign currency rupee and cross currency and also receive premiums, the facility of zero cost structures/cost reduction structures is being withdrawn.

## **Other Developments**

Each Asian jurisdiction has its own set of regulations that restrict CDS activity. In most Asian markets CDS activity related to Asian obligors is limited to the offshore markets and the bulk of the volume is in CDS on indices rather than on single names. The exceptions are Australia, Hong Kong, Japan, New Zealand and Singapore, but the volumes are low.

Efforts to set up a regional CCP for CDS in Asia are still in their infancy. Singapore and Hong Kong are beginning to advocate for a regional CCP in their market, however, they would need to capture volumes from other markets, which will be difficult. Japan has the only CDS market of sufficient size for a domestic CCP to attract high enough volumes to achieve the necessary economies of scale. In the meantime, it is likely Asian transactions will be booked through a European CCP, particularly between global participants.

## **G20/IOSCO Developments**

### **G20**

At the Pittsburgh summit in September 2009, G20 leaders agreed that all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by the end of 2012 at the latest. OTC derivative contracts should also be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. The FSB and its relevant members will be tasked with regularly assessing implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and

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<sup>1</sup> A list of AD Category 1 Banks in India can be accessed [here](#)

protect against market abuse. The Financial Stability Board, for example, has recommended that “Market participants should act promptly to ensure that the settlement, legal and operational infrastructure underlying OTC derivatives markets is sound.”<sup>2</sup> The G20 also reiterated its call for reform of the derivatives markets in the September 25th Leaders’ Communiqué.<sup>3</sup>

## **IOSCO**

The International Organization of Securities Commissions (IOSCO) Task Force on Unregulated Financial Markets and Products issued a final report in September 2009 which recommends regulatory actions to assist financial market regulators in introducing greater transparency and oversight with respect to the credit default swaps (CDS) markets, and improving investor confidence.

The report offers the following specific recommendations to the industry to stabilize the CDS market: provide sufficient regulatory structure, where relevant, for the establishment of CCPs to clear standardized CDS; encourage financial institutions and market participants to work on standardizing CDS contracts to facilitate CCP clearing; facilitate appropriate and timely disclosure of CDS data relating to price, volume and open-interest by market participants, electronic trading platforms, data providers and data warehouse; and support efforts to facilitate information sharing and regulatory cooperation between IOSCO members and other supervisory bodies in relation to CDS market information and regulation.

IOSCO’s Committee of Payment and Settlement Systems plans to revise a previously issued report, *Recommendations for Central Counterparties* in June 2010 and issue a draft of revised standards for payment clearing and settlement systems by January 2011.

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<sup>2</sup> Report of the Financial Stability Forum, October 10, 2008, *Enhancing Market and Institutional Resilience: Follow-up on Implementation*.

<sup>3</sup> [http://g20.org/Documents/pittsburgh\\_summit\\_leaders\\_statement\\_250909.pdf](http://g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf)