EVENT REPORT

EUROPEAN CAPITAL MARKETS INSTITUTE

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Over the past five years, over-the-counter (OTC) derivatives markets have received heightened regulatory attention with a view to improving the robustness, safety and resilience of this market segment. The audience was briefed by a high-level group of panelists on the current state OTC derivatives trade reporting, central clearing and trade execution and the many challenges ahead.

Speakers:

- **Stephen O'Connor**, Chairman, International Swaps and Derivatives Association (ISDA)
- **Michael Davie**, CEO, LCH.Clearnet
- **Alexander Broderick**, CEO and President, Deriv/SERV, Depository Trust & Clearing Corporation (DTCC)
- **Uzma Wahhab**, Member of Secretariat, Financial Stability Board (FSB)
- **Nicolas Gauthier**, Policy Officer, Financial Markets Infrastructure Unit, DG Internal Market and Services, European Commission
- **Stephen Taylor**, Vice President, Head of Market and Product Development, NASDAQ OMX NLX
- **Diego Valiante**, Head of Capital Markets Research, ECMI and CEPS [moderator]

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Stephen O'Connor (ISDA) expressed the industry's concerns with regard to the margin requirements for non-centrally cleared derivatives, trade execution rules and market fragmentation. On the importance of the non-clearable products, he argued that without these instruments, corporates, insurance companies, pension funds, governments, smaller financial institutions and other entities may experience greater earnings volatility or be unable to offset the interest rate, inflation, maturity or foreign exchange risks. Consequently, ISDA developed and proposed to BCBS-IOSCO a standard initial margin model ("SIMM") estimated to reduce the costs for the market participants and also significantly lower the impact on liquidity. According to the most recent ISDA survey, the end-users community considers the application of new trade execution rules as being conducive to greater transparency, but having a less positive impact on price, liquidity and ease of use. In addition, almost 50% of respondents see the market fragmenting along geographic lines as the result of new regulations being put in place.

Michael Davie (LCH.Clearnet) indicated that LCH.Clearnet is looking into expanding the reach of its clearing capabilities across the non-clearable IRD segment (14% of total OTC derivatives markets) with some of the inflation swaps and options to be roll out by the year-end and next year, respectively. He then acknowledged that the increasingly widespread use of trade compression services has brought more efficiency in the clearing process. When it comes to access of pensions funds to CPPs, he stated that while some already began clearing, CCPs will remain unwilling to accept non-cash (equity, bonds) variation margin as it hugely complicates the valuation of the exposures. The proposed solution was to allow clients direct access to repo markets. Either way, there is also the option of a higher customer protection through full physical segregation of assets, but this is more costly. With regard to CCP default management waterfall structure, he backed up the "defaulter pays" model rather than mutualisation of risks. Furthermore, he outlined that LCH.Clearnet adopted the highest possible risk management and margin standards and conducts stress tests using substantial historical scenarios.

In the case of trade repositories, **Alexander Broderick (DTCC)** endorsed the "market utility" model, designed to satisfy multiple stakeholders, from submitters to policy makers, regulators and supervisors. He stressed the importance of greater standardisation in data fields/formats and connectivity of available TRs within and across jurisdictions in order to avoid inconsistencies, duplication, omission and other data errors and ensure the highest degree of clarity and insight into the market. From a systemic risk perspective, the real challenge remains in bringing all data together into a very sensible, digestible form and building/accessing a mature, harmonised global database. Data privacy and protection laws prohibiting reporting to TRs and regulatory access to data held in TRs may hinder this process. He also mentioned that DTCC engages in an open and continuous dialogue with the regulators and the market community, currently being embarked on a global awareness campaign about the advantages of having one global TR.

Stephen Taylor (NASDAQ OMX) said that privately-negotiated derivatives are often criticised for their opaqueness. Moving these trades on exchanges or electronic trading platforms, on the condition they are sufficiently standardised with a suitable degree of liquidity, would serve the goal of increasing transparency. He argued that further innovation in the clearing and trading environment could bridge the OTC and exchange-traded worlds. In his view, there is no zero-sum game. New, simple, good for many purposes products could be developed by combining features of both bespoke and listed derivatives. In addition, he stated that the horizontal model, in comparison with the vertical silo model, supports greater market competition and contributes to driving down the trading costs.

Uzma Wahhab (FSB) indicated that the jurisdictions need to move forward with the implementation of the remaining commitments areas. However, this should be done in a form flexible enough to respond also to cross-border issues, especially clarifying the options for equivalence, substitute compliance, mutual recognition regimes. Apart from some unilateral and bilateral actions (US, EU), she mentioned work being undertaken on a multilateral basis by the OTC Derivatives Regulators Group (ODRG) and additionally by standard-setting bodies, e.g. IOSCO's Task Force on Cross-Border Regulation. Both ODRG and IOSCO will publish final reports ahead of the November 2014 G20 Leaders' Summit. On the resolution and recovery of FMIs, including CCPs, final reports prepared by FSB and CPSS-IOSCO will be published in the coming months. With respect to enforcement, currently this is the primary responsibility of each individual jurisdiction. Nonetheless, in the future it may be the case for the IOSCO or FSB to play a more active role in ensuring effective compliance and somehow mirror the work done by the BCBS for the enforcement of the Basel III requirements.

Nicolas Gauthier (European Commission) briefed the audience on the EU's progress in the follow-up to the G20 commitments (EMIR, MiFID II, CRD IV) with trade reporting having just started in February, CCPs currently being authorized and potentially triggering the phase-in of clearing obligations once relevant technical standards are published (Q4 2014) and approved, ESMA advancing a letter to the EC with the intention to ease certain frontloading requirements, trade executions rules to be adopted and coordination taking place among ESAs for finalising margining requirements for non-centrally cleared derivatives. He stressed the importance of achieving meaningful international convergence in order to prevent regulatory arbitrage, liquidity fragmentation, and ultimately the build-up of systemic risk. In his view, CCPs are becoming more and more systemically important. Recovery and resolution rules are needed to deal with the most extreme events when the default waterfall may prove to be insufficient and ensure the continuity of the core services. There are still a couple of open questions with regard to the optimum toolbox, the switch from recovery to resolution, the role that the different authorities will have to play or the access to central bank liquidity. EC is currently working closely with CPSS-IOSCO on these issues. On the temporary clearing exemptions for pension funds, he said that the EC is preparing a report evaluating the preparedness of the industry to facilitate the access to CCPs that should be finalised this summer.

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