



# OTC derivatives market

November 14, 2011

Update on current regulatory initiatives

- In 2009, G-20 leaders agreed that all standardised OTC derivatives should be cleared through CCPs, non-centrally cleared contracts should be subject to higher capital requirements and all OTC derivatives should be reported to trade repositories by the end of 2012.
- Now, OTC derivatives regulations in the EU and the US are taking shape.
- Elsewhere in the G-20, the process to introduce OTC derivatives regulation has just started with rule-makers apparently waiting for US and EU rules to set the benchmarks.
- Regulatory initiatives in the US and the EU come with a lot of similarities and only few differences.
- For non-financial companies extensive exemptions have been defined.
- Overall, regulations seem to be shaped in a sensible manner but will nonetheless affect the financial industry substantially.

## Introduction

Derivatives have a long-standing history as financial instruments for managing financial risks stemming from changes in macroeconomic conditions. They thus represent important risk management tools for companies, authorities and financial institutions as they can be used to manage exposure to interest rate, currency, commodity price or other risks. Globally, the OTC derivatives market volume amounts to USD 600 trillion; nearly 85% of the world's outstanding derivatives market volume is accounted for by OTC derivatives.

Derivatives range from fully standardised to tailor-made products: fully standardised derivatives are usually traded on exchanges, whereas customised contracts are traded over-the-counter (OTC). Thus, as OTC derivatives markets are generally characterised by flexible and tailor-made products, satisfying the demand for bespoke contracts customised to the specific risks that a user wants to hedge, OTC derivatives often comprise privately negotiated contracts, with only the participants having access to detailed information. In contrast, exchange-traded derivatives, which are by definition standardised contracts, leave a transparent trail in terms of positions, prices and scale of exposures while OTC derivatives markets have historically been largely unregulated with respect to the disclosure of information even though operations in these markets were executed by supervised entities. As a result, information available to market participants and supervisors has long been limited.<sup>1</sup>

The financial crisis has brought to light many weaknesses in OTC derivatives markets, such as their intransparency, inherent counterparty risks, or the danger of contagion.<sup>2</sup> These problems were highlighted by the near-collapse of Bear Sterns, the default of Lehman Brothers and the bail-out of AIG.

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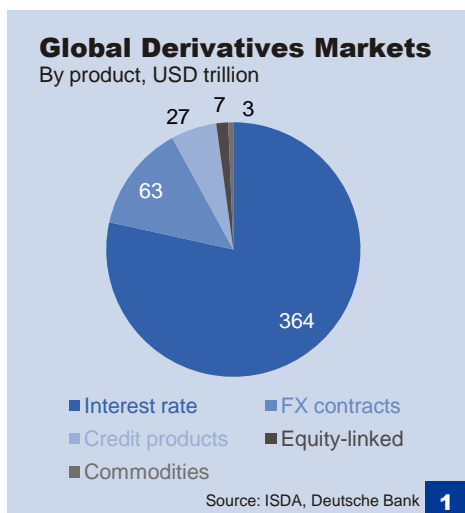
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<sup>1</sup> Chlistalla (2010).

<sup>2</sup> Contagion describes the risk of a default of one firm spreading through the financial system.



**EMIR is the main part of European OTC derivatives market reform**

To mitigate such risks, collateralisation and counterparty risk management are essential practices, which were already in use prior to the crisis.

In reaction to the financial crisis, there has been an international effort to increase stability in financial markets – including OTC derivatives markets: In 2009, G-20 leaders agreed that all standardised OTC derivative contracts should be cleared through Central Counterparties (CCPs) by the end of 2012 at the latest, while non-centrally cleared contracts should be subject to higher capital requirements. Furthermore, all OTC derivative contracts should be reported to trade repositories. These changes are set to improve the efficiency and transparency of OTC derivatives markets with a view to reducing counterparty and operational risk involved in these markets as well as overall systemic risk.

The regulatory initiatives currently undertaken follow the commitment made by G-20 leaders in September 2009.

**OTC regulatory update**

At the global level, OTC derivatives regulation is being undertaken by CPSS and IOSCO and focuses on efforts to update and strengthen standards for CCPs, CSDs, payment systems and the treatment of trade repositories. The revised Principles of the group were published earlier this year for public consultation and it is anticipated that they will be finalised in late 2011.

At the national level, initial proposals regarding OTC derivatives market regulation have been initiated in 2010, especially in the US and in Europe. 2011 will now see the finalising of these proposals and partial implementation in the US. In 2012, many of the final rules will then be implemented globally.

**OTC derivatives regulation in Europe**

OTC derivatives regulation in Europe is implemented through four different legislative initiatives. While the European Markets Infrastructure Regulation (EMIR) certainly constitutes the main part of Europe’s OTC derivatives market reform, regulations relevant to derivatives markets are also found in the MiFID Review, the short selling and CDS regulatory initiative and the CRD IV.

ESMA, the strengthened supervisor of market infrastructures, will be responsible for the implementation of the new rules and the supervision of OTC derivatives markets. Specifically, it will be responsible for interpreting the new legislation and determining which financial instruments and market participants will be covered.

*EMIR*

On September 15, 2010, the European Commission published its final legislative proposal for a Regulation on OTC derivatives, central counterparties and trade repositories: EMIR. Consistent with the G-20 commitment, the proposal stipulates rules for central clearing and risk mitigation and aims to increase stability within OTC derivatives markets. More precisely, the regulation introduces reporting obligations for OTC derivatives, clearing obligations for eligible OTC derivatives, measures to reduce counterparty credit risk and operational risk for bilaterally cleared OTC derivatives and rules on the establishment of interoperability between CCPs. It also includes requirements for CCPs, post-trade interoperability and requirements for trade repositories.

**Latest Council draft regulation**

The European Council's draft regulation calls for reporting of all derivative contracts – instead of OTC derivatives only as proposed by the Commission and supported by Parliament – to trade repositories and the clearing of standardised OTC derivative contracts through CCPs. Which contracts will be subject to this clearing obligation would be determined by ESMA. If a contract is not eligible for clearing by a CCP, the contract would be subject to additional collateral and capital requirements. Trade repositories would have to publish aggregate positions by class of derivatives.

ESMA would also be responsible for the surveillance of trade repositories – which would have to publish aggregate positions by class of derivatives – and for granting and withdrawing their registration. A CCP would be required to have a mutualised default fund to which members of the CCP would have to contribute. CCPs would be authorised and regulated by national regulators, although CCPs from third countries would have to be formally recognised by ESMA as meeting certain conditions.

The compromise proposal further allows room for technical work on how to negotiate and bring into force arrangements with third countries.

The obligation to clear OTC derivative contracts through a CCP and report them to trade repositories would apply to financial firms, while non-financial firms would only be subject to these rules if their OTC derivatives positions reached specified information and clearing thresholds or if they were considered to be systemically important. The thresholds will be set by ESMA and the Commission.

Pension schemes would be exempt from the clearing obligation for a period of three years, extendable by another two years through a review clause.

Source: The Council of the European Union

**Assessment of clearing eligibility**

In assessing an OTC contract's clearing eligibility, ESMA will mainly consider levels of standardisation, liquidity, systemic risk and pricing. Contracts that would e.g. not be suitable for CCP clearing are highly bespoke, illiquid, OTC derivative contracts.

It is thus recognised that not all OTC derivatives are suitable for CCP clearing. Consequently, some OTC trading will continue bilaterally, albeit with more stringent reporting and prudential requirements.

EMIR is now in the middle of the EU legislative process: on June 7, 2011, the European Parliament published its latest report on the Commission's proposal. On October 4, 2011, the Council reached agreement on the measures to regulate derivatives markets, thereby setting out its position on EMIR. Now, negotiations between the Parliament and the Council will start. The key points under discussion are what exemptions there might be for clearing obligations, whether or not clearing for OTC derivatives should be introduced retroactively and the degree to which interoperability should be allowed between CCPs without further review. Amendments were also made regarding the scope: the Council proposed to include an extension of clearing obligations to all derivative contracts – and not only to OTC derivative contracts.

As the EMIR text is still under legislative negotiation and the European Parliament and the European Council have just started joint discussions, it is expected that legislation will come into force by the end of 2011 or early 2012. It is envisaged that existing CCPs will have two years from that date to apply for recognition. Trade repositories will have to apply for recognition during 2012. As the regulation might come into force during 2012, implementation may therefore extend beyond the G-20 target of end-2012.

*Eligibility of contracts*

Generally, there will be no definition of the classes of derivatives that will be subject to the mandatory clearing provisions. Instead, EMIR lays down a *process* for determining whether a contract is "eligible" and therefore subject to the clearing obligation. "Clearing eligibility" can then be determined through two distinct approaches: a bottom-up approach or a top-down approach. In the bottom-up approach, the decision as to which contracts to clear is made by a CCP and approved by ESMA. In the top down approach, ESMA identifies the classes of OTC derivatives contracts to be cleared.

When assessing which approach is more suitable, one finds that on the one hand, eligibility of products for central clearing should be determined by the members of the CCP who are mutualising the risk, having considered key characteristics of the product class in question, the capability of the CCP, and the ability of major market participants to support the default process. CCPs should thus not be forced to clear a product if they are unable to manage the risk of doing so. On the other hand, the ability of CCPs to accept contracts for clearing is a necessary but not a sufficient condition for clearing eligibility, and therefore decisions as to what contracts should be cleared should not be left to the CCPs alone. Those CCPs that are commercial for-profit entities<sup>3</sup> might be driven by revenue and commercial considerations, which may not necessarily be aligned with the core purpose of a CCP, i.e. risk reduction. A CCP might thus not want to clear a contract even though this could enhance risk reduction in derivatives markets. Thus, involving regulators, such as ESMA, in the decision of the eligibility of contracts generally is sensible. By doing so, regulators should also have the possibility to decide that a product is not eligible for clearing if they are not comfortable with the overall risk management processes available in the CCP.<sup>4</sup> Regulators and relevant market participants should thus be working together to decide which products are eligible for clearing. A mixture of both approaches, the bottom-up and the top-down approach, thus seems plausible – even though in a conflict

<sup>3</sup> These are e.g. subsidiaries of publicly listed exchanges.

<sup>4</sup> FSA and HM Treasury, 2009.

situation ESMA decides whether a class of derivatives meets the eligibility criteria.

#### *Frontloading*

Generally, the degree to which frontloading should be introduced is debatable: on the one hand, it enables better oversight of outstanding contracts. On the other hand, the concept of frontloading is retrospective and it would thus be possible that agreement between parties on the clearinghouse to use may not be possible for existing trades. This would make it difficult to fulfil any clearing obligation. Normally, parties would agree on the clearinghouse at the time of trade. Thus, frontloading with regard to clearing requirements might be problematic, while frontloading with regard to reporting requirements is relatively uncomplicated.

Until now, there is a “frontloading language” in the Council’s text which provides that the clearing obligation would apply to trades executed after EMIR comes into force but before the clearing obligation takes effect. Reporting obligations would apply to contracts entered before EMIR enters into force and are still outstanding and to contracts entered after EMIR enters into force.

#### *Exemptions for non-financials*

### **Non-financials use derivatives to manage business risk and smooth out cash flows over time**

Generally, non-financials use derivatives to manage business risk and smooth out cash flows over time, thereby reducing the probability of financial distress and the funding risk for investment projects in low cash flow periods. Variability in cash flows is costly and might result from business’ operations, e.g. from exchange rate variations on fixed-price contracts with foreign customers or from changes in the interest rate on company debt. Due to the importance of derivatives for non-financial firms, the question of how non-financials will be affected by the new regulatory framework is highly important.

By and large, the question as to whether exemptions from regulations should be allowed is controversial: on the one hand, complete coverage is desirable as this is clear, easy to monitor and leaves less room for loopholes. Also, in general the “same risk, same rules” approach should apply. On the other hand, if participants are rather small in terms of having a small market share, exemptions might still be sensible from an efficiency point of view as risks emanating from these market participants to the financial system as a whole are negligible.

The share of non-financials in OTC derivatives markets, in terms of the notional amount outstanding, was around 13.5% between 1998 and 2007, and has declined slightly since the crisis. Thus, non-financials compose a relatively small share of the market.

Regulatory initiatives regarding OTC derivatives markets should thus consider the trade-off: while the contribution of non-financial market participants to systemic risk, in aggregate, can probably be considered small, the counterparty risk mitigation techniques employed by CCPs, and in particular the need to meet daily collateralisation of exposures in cash, make the use of a CCP rather costly. Thus, the price of the benefit of being protected against a default of the counterparty – resulting from the fact that all other participants face strict margin requirements – is the funding cost for one’s own margin.

Exemptions for non-financials in OTC derivatives markets regulation may thus be justified as long as market participants are small and



**Exemptions for non-financials may be justified as long as they do not pose a systemic risk**

do not pose a systemic risk. However, there clearly is a need for an appropriate and effective mandatory mechanism to check, at any point in time, whether non-financial market participants have become large enough to constitute a source of systemic risk.

In EMIR, exemptions from clearing and reporting requirements for non-financial firms are foreseen and can be summarised as follows:

- Reporting requirement
  - Contracts between two non-financial firms where neither firm exceeds an “information threshold” do not have to be reported to a trade repository.
  - All other contracts, including all contracts between non-financials and financial firms need to be reported.
- Clearing requirement:
  - Contracts by non-financial firms below a “clearing threshold” do not have to be cleared through a CCP, i.e. non-financials are subject to the clearing requirements if the clearing threshold is exceeded for a continuous period of one month.
  - Commercial hedging activities (i.e. when a firm uses OTC derivatives to hedge risks related to its activities) will be subtracted from the firm’s overall position, i.e. they do not count towards the threshold set for clearing obligation. These activities do not need to be cleared.

Not yet clear is how a “commercial hedging activity” will be defined and how these activities can unambiguously be distinguished from others. In the end, ESMA might have to decide on whether an activity is solely carried out for the purpose of commercial hedging or not.

**Thresholds will decide about the need to report or clear**

The thresholds will be set by ESMA, ESRB and other relevant authorities who are responsible for drafting the technical standards. Consequently, the thresholds are not included in the Commission’s legislative proposal. When setting the thresholds, ESMA will take into account the systemic relevance of the sum of net positions and exposures by counterparty per class of derivative. Furthermore, it is envisaged that the clearing and information thresholds will be different for different asset classes and might be different even within an asset class.

*Interaction between EMIR and CRD IV*

Next to EMIR, Basel III will be an important determinant for the capital requirements established for banks/dealers as the capital requirements for counterparty credit risk on OTC trades will be determined by the CRD IV. EMIR requires financials/non-financials that are active in OTC derivatives market either to clear those derivatives through a CCP or, if this is not possible, to hold collateral to back the risks associated with the derivatives that are not cleared through a CCP. The CRD IV takes into account that contracts that continue to be risk-managed bilaterally would be subject to appropriate requirements in terms of risk mitigation techniques. The capital the financial institution needs to hold with regard to one regulation can thus be counted towards the requirements of the other regulation.

**OTC derivatives regulation in the US**

On July 15, 2010, the US Senate passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act); it was signed by President Obama on July 21, 2010. The Dodd-Frank

### In the US, Title VII of the Dodd-Frank Act is the core of OTC derivatives market reform

#### CFTC's priorities for the rest of 2011

Next rules under consideration

- Clearinghouse core principles;
- Position limits .

Final rules on entity and product definitions will be tackled jointly with the SEC in Q4 2011.

#### Latest news from the SEC

On October 12, 2011, the SEC proposed a rule on the registration of security-based swap dealers and major swap participants. This rule would require the SEC to register dealers and major traders of security-based swaps.

Dealers would need to fill in forms similar to those that stock brokers already submit to the SEC. A dealer would also need to have a knowledgeable senior officer on hand who can attest to the firm's financial, operational and compliance capabilities.

The CFTC has proposed a similar rule for dealers and major participants in other types of swap.

Mary Schapiro, SEC Chair, said she expects to propose the last of the Dodd-Frank derivative rules in the near future as well as a proposed approach to address cross-border security-based swap transactions.

Act covers a broad range of issues ranging from systemic supervision, changes to the regulation of investment advisors and the regulation of OTC derivatives to measures aimed at improving consumer protection.

More precisely, Title VII of the Dodd-Frank Act, entitled the "Wall Street Transparency and Accountability Act of 2010", establishes a new framework for regulatory and supervisory oversight of the OTC derivatives market. Essentially, all derivatives will be affected by the new regulation, with a few exceptions.<sup>5</sup>

Generally, the Dodd-Frank Act itself provides little detail of important definitions. Instead, much of it is devoted to setting guidelines, basic parameters and standards. Defining terms and establishing how these regulations are going to work in practice has been left to the CFTC and the SEC. However, the rule-making is well underway.

Topics affecting (OTC) derivatives in the Dodd-Frank Act include:

- Registration of swap dealers and major swap participants;
- Push-Out Rule;
- Swap clearing and execution;
- Swap reporting;
- Margin;
- The Volcker Rule, which is in Title VI.

As derivatives in the US will be regulated by both the SEC and the CFTC, there is a differentiation between "swaps"<sup>6</sup> (regulated by the CFTC) and "security-based swaps"<sup>7</sup> (regulated by the SEC). Enforcement authority thus lies with the SEC and the CFTC. If a market participant engages in both activities, he or she is also regulated by both authorities.

The detailed rule-making to implement the Dodd-Frank Act is envisaged to be completed in early 2012, with the phasing-in of implementation planned for 2012 and most requirements intended to be in place for the G-20's end-2012 deadline.

#### Clearing requirements

Title VII of the Dodd-Frank Act requires all swaps (i.e. security-based swaps and swaps) designated by the CFTC and SEC as clearable and accepted by a clearinghouse for clearing to be cleared through a derivatives clearing organisation regulated by the CFTC, through a securities clearing agency regulated by the SEC or through a derivatives clearing organisation that is exempt from registration. Exemptions from the mandatory clearing requirement include the following:

- There is an "end-user exemption" stipulating that any counterparty that a) is not a financial entity, b) is using swaps to hedge or mitigate commercial risk and c) notifies the CFTC or the SEC as to how it generally meets its financial obligations associated

<sup>5</sup> Subrahmanyam (2011). The US Treasury Department proposed to exclude foreign exchange swaps and forwards. In the EU, this issue is still being determined.

<sup>6</sup> "Swaps" are defined as options, contingent forwards, exchanges of payment or transactions that are based on an underlying financial product or a contract that becomes known as a swap in the market. Furthermore, interest rate swaps, currency swaps, foreign exchange swaps, total return swaps and credit default swaps are explicitly defined as "swaps".

<sup>7</sup> A "security-based swap" is defined as a swap which is based on a narrow-based security index, a single security or loan and the occurrence or non-occurrence of an event relating to a single issuer of a security.



with entering into non-cleared swaps is not required to clear.<sup>8</sup> Thus, non-financials using derivatives to hedge business risks will generally get exemptions but will be subject to monitoring, with penalties for violation of hedging norms.

- The CFTC and SEC can also exempt from the mandatory clearing requirement certain depository institutions, farm credit institutions and credit unions with total assets of USD 10 bn or less<sup>9</sup> through a rulemaking.
- The Act does not require swaps entered into prior to the application of the mandatory clearing requirement or prior to the passage of the Dodd-Frank Act to be submitted for clearing. Nonetheless, like in the EU, these swaps will be subject to reporting requirements.

#### *Reporting requirements*

Furthermore, the Dodd-Frank Act requires each party that enters into any kind of swap to report such swap to a trade repository, the CFTC or the SEC – regardless of whether the swap is cleared or uncleared. The CFTC and the SEC have adopted rules requiring reporting of swaps that were in existence before July 2011.

Further issues covered in the Dodd-Frank Act regarding derivatives include:<sup>10</sup>

- Capital and margin requirements with higher requirements to be imposed on uncleared swaps;
- Mandatory execution of swaps subject to the clearing requirement on swap execution facilities (SEF), designated contract markets or exchanges;<sup>11</sup>
- Prohibitions on certain swap activities for insured depository institutions;
- Public access to swap transaction volume and pricing data.

#### ***Differences and similarities between US and EU regulation***

There is significant commonality in the approaches adopted by the European Commission's formal proposal and the Dodd-Frank Act, but there are also some differences.

Commonalities include the following: Both regimes aim to impose clearing and reporting on a broadly defined class of (OTC) derivatives and give regulators the ultimate decision on when the clearing obligation applies. Furthermore, there will be a centralised repository containing wide-ranging information on all OTC derivatives positions, the use of CCP clearing will be significantly increased, bilateral clearing practices will be improved and OTC derivatives contracts will become more standardised. Additionally, both regulatory initiatives seek to allow cross-border clearing by allowing the recognition/exemption of non-domestic CCPs. Moreover, margin and capital requirements as well as authorisation/registration and business conduct requirements apply both in Europe and in the US.

<sup>8</sup> The end-user exemption does not exempt such entities from margin requirements.

<sup>9</sup> Except for those whose primary business is to provide financing related to the activities of its parent or holding company affiliate.

<sup>10</sup> An open question is whether major end-users of swaps outside the US will be required to register with the SEC or CFTC because they trade in swaps with US banks or other dealers.

<sup>11</sup> Exceptions: swaps that are not subject to the clearing requirement or if the SEF or exchange does not list the swap for trading; cf. Dodd-Frank Act Sec. 723 h.

*Main difference: treatment of non-financials*

One of the main differences probably lies in the treatment of non-financial counterparties: Even though both approaches have exemptions from the clearing obligation for transactions of end-users, the scope of the definition differs. In the US, the clearing obligation falls on everyone who trades an eligible contract; also non-financial entities are obliged to clear but may qualify for exemption for transactions hedging commercial risk ("opt-out" rule). In the EU, the clearing obligation applies to financial counterparties when dealing with other financial counterparties; non-financial counterparties only become subject to clearing obligations when their positions exceed a specified clearing threshold ("opt-in" rule). While both regulations envisage registration and conduct of business rules for dealers, the reporting obligation in the US applies to all OTC transactions, thereby extending registration further, i.e. to "major swap participants"<sup>12</sup>, whereas a reporting obligation in the EU only applies to non-financial counterparties when they exceed a certain information threshold.

*Another difference: the EU uses a set of regulatory initiatives*

Also, the Dodd-Frank Act addresses some issues relating to the regulation of (OTC) derivatives not addressed in EMIR, such as the requirements for trading of derivatives through organised trading platforms, trading and transparency of transactions in OTC derivatives and the registration of OTC derivatives dealers. However, in the EU these issues are addressed by other regulatory initiatives. In a further effort to eliminate operational risk, and to increase market transparency, the European Commission is e.g. proposing amendments to MiFID that would require that all derivatives trades that are eligible for clearing, are sufficiently liquid and not subject to any relevant exemption to be traded on an organised trading venue such as an exchange or electronic platform.<sup>13</sup>

*Position limits*

Another issue that will be tackled by the MiFID Review is the one of position limits, i.e. the number of contracts any one trader can hold will be limited. The adoption of position limits aims to address risks to overall stability or settlement, especially in physical commodity markets. In the EU, trading platforms which have admitted commodity derivatives or emission allowances to trading can either apply position limits or take equivalent measures, such as position management.<sup>14</sup>

**OTC derivatives regulation elsewhere in the G20**

In Canada and Asia, regulatory efforts are at an early stage with unofficial proposals published by the CSA (Canada) and initial public policy intentions and 2012 targets announced in several markets

**Issues not addressed in the EU but US**

Wider issues addressed in the Dodd-Frank Act, such as the "Push-Out Rule", restricting the extent to which banking entities can trade in OTC derivatives, currently has no counterpart in the EU regulatory framework. However, political currents might lead to similar proposals at a later stage.

Also the "Volcker rule" restrictions on proprietary trading by banking groups or the provisions allowing regulators to restrict bank ownership of CCPs do not yet have a counterpart in the European regulatory framework.

<sup>12</sup> A „major swap participant“ is any entity who meets any of the following: 1) maintains substantial position in any major swap category, 2) outstanding swaps create substantial counterparty exposure or 3) any financial entity not subject to capital requirements, with substantial position in swaps and is highly leveraged.

<sup>13</sup> The MiFID proposals are subject to negotiations between the European Parliament and Member States at the moment. MiFID is not expected to enter into force until 2014 at the earliest.

<sup>14</sup> In the US, the SEC and the CFTC impose individual instrument and aggregate position limits in commodity markets. The latest rule foresees to limit the number of commodity contracts a trader could hold in 28 commodity derivatives markets. Basically, it expands existing position limits in agricultural futures markets to OTC derivatives and energy and metal markets.

(e.g. Japan, Korea, Hong Kong<sup>15</sup>). Also, several new clearinghouses are in development for the clearing of derivatives. Generally, the Asian derivatives regulations are more focused on clearing than on transparency.

### Evaluation

OTC derivatives market regulation aims to increase transparency and standardisation and to decrease risk. These objectives are generally worth being promoted.

#### Benefits of CCP clearing

Generally, CCP clearing has three benefits:

1. It improves the management of counterparty risk;
2. it allows the CCP to perform multilateral netting of exposures and payments, which can minimise imbalances in the market and
3. it improves market transparency by allowing for central collection of high-frequency, market-wide information on market activity, transaction prices and counterparty exposures and thereby making market activity and exposures available to regulators and the public.

Source: Chlistalla, 2010.

#### Moving to CCP clearing is sensible...

As CCP clearing seems to be an effective and efficient means to address counterparty risk in OTC derivatives markets, moving from bilateral collateralisation to a wider use of CCPs to mitigate counterparty credit risk is sensible in principle.

CCPs interpose themselves between the two counterparties to a transaction with the purpose of managing risk arising from a default by one of the participants. Thus, CCPs allow risk mitigation by introducing multilateral netting, by allowing novation/open offer as well as by robust margining procedures and other risk management controls performed by the CCP. Furthermore, CCP clearing may have a positive effect on market liquidity. Also, central clearing reduces interconnectedness between counterparties by interposing itself as counterparty to every transaction and may thus reduce disruptive information problems by mitigating uncertainty.

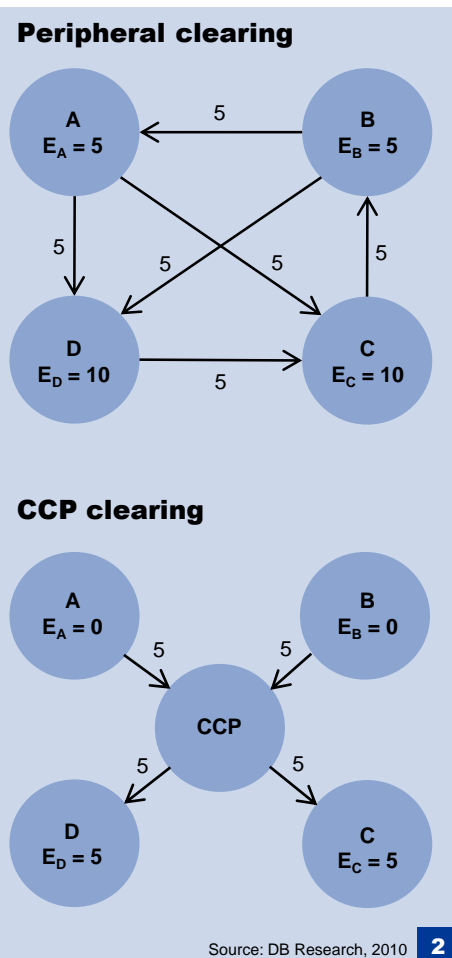
#### ... however, high risk management standards will be necessary

The downside is the risk of failure as the clearinghouse itself might pose a systemic risk. By transferring counterparty risk to the CCP, the bank or broker is thus assuming a new type of risk: mutualisation risk. This refers to the possibility that in case of a default where the defaulting member's initial margin turns out to be insufficient, the clearing house is forced to draw on its other members' default fund and in extreme cases to allocate contracts to its non-defaulting members.

Having said that, as systemic relevance is linked to the respective policy objective, it may be desirable in some cases to have institutions assuming a systemically relevant role as this increases the stability of the system. As such, CCPs are meant to reduce complexity in the OTC market and thereby enhance the stability of the system. Since counterparty risks are concentrated in each CCP itself, the central mechanisms should then be subject to high risk management standards, and be effectively regulated and supervised. Also, sufficient collateralisation, e.g. full collateralisation of the largest exposures, and capitalisation of the institution will be needed to accommodate for systemic risk and survivorship of the CCP needs to be assured.<sup>16</sup>

#### Interoperability of CCPs

As interoperability is an essential tool to achieve effective integration of the post-trading market, interoperability arrangements between two or more CCPs might become necessary. Interoperability agreements enhance cooperation between two or more CCPs and involve a cross-system of transactions. However, risk associated with such



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<sup>15</sup> In October, the Hong Kong Monetary Authority (HKMA) and Securities and Futures Commission (SFC) issued a joint consultation paper on the proposed regulatory regime for Hong Kong's OTC derivatives market.

<sup>16</sup> Weistroffer (2011).

an arrangement must be managed effectively. These risks include: structural differences, different approaches to risk management and risk protection that might vary across different CCPs.

### ***Exemptions for non-financials***

Exemptions for hedging transactions for non-financials make sense as long as the market participant is not systemically important. Central clearing should thus not be mandatory for all standardised derivatives as certain counterparties do not pose a systemic risk. Bilateral risk management techniques will be sufficient in these cases.

### ***Regulation of all derivatives vs. OTC derivatives only***

In Europe, it seems to emerge that under EMIR mandatory clearing will only apply to OTC derivatives.<sup>17</sup> In contrast, the Dodd-Frank Act clearing requirements apply to all derivatives.

To extend coverage to *all* derivatives would be preferable for two reasons: first, since the purpose of clearing derivatives is to reduce systemic risk, it is not clear why a derivative would need to be cleared when traded off-exchange but not if traded on an exchange; and second, as clearing involves the obligation to post collateral and this involves costs, linking requirements to trading venues, one type of venue would be given a competitive advantage. This discrimination between trading venues could thus lead to unfair competition and arbitrage. Surely, typically, exchange-traded derivatives are cleared anyway. However, this argument ignores the possibility of creating business models that do not include clearing for a trade executed on an exchange.

Accordingly, the European Commission seems set to propose the clearing obligation for listed derivatives in the MiFID Review which is still under legislative negotiation at the moment.

### ***International coordination is a must***

In order to prevent geographic regulatory arbitrage between jurisdictions, frameworks for CCPs and risk management standards should be consistent globally. CCPs should not compete on those standards, but rather on the quality of the service offered. Furthermore, to ensure consistency in implementation, and avoid overlaps, gaps, and conflicts in legislative and regulatory frameworks that may risk compromising reform objectives, attention should be drawn to the fact that a level playing field is maintained and multilateral coordination between jurisdictions takes place as rules are finalised and implemented. The difference in implementation timeframes between Europe and the US may e.g. create an uneven competitive landscape.

### ***Overall, progress in OTC derivatives regulation is only modest***

The latest FSB progress report on the implementation of OTC derivatives market reforms says countries need to push forward aggressively to meet the G-20's deadline at the end of 2012 to centrally clear and report OTC derivatives and trade standardised contracts on organised venues. Even though it is only a year to go until the end-2012 deadline, only few FSB members have the legislation or regulation in place to provide the framework for operationalising the commitments. As it seems, especially some

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<sup>17</sup> So far, the European Council has proposed to cover all derivatives, regardless of their venue of execution; by contrast the Commission's original (and Parliament's) proposal covers OTC derivatives only.



smaller countries are waiting to see what rules emerge in the US and the EU before developing their own regulation. However, to act quickly once rules are finalised in these two large OTC derivatives markets, it would be necessary that all jurisdictions advance development of their legislative and regulatory frameworks as far as they are able before finalisation of the US and EU regimes. Also, the market requires clarity on the specific requirements as well as sufficient lead-time to comply with before implementation deadlines.

### Future prospects: changing landscapes?

One question is the potential impact of the OTC derivatives market reform on businesses, i.e. will the landscape in the derivatives market change due to the new clearing regulation and models? Potential prospects include consolidation across the world of clearinghouses and exchanges and potentially also large dealer banks, emergence of global transparency platforms and services related to processing of new data on derivatives transactions and positions, transition of end-user hedging demand to centralised platforms and exchanges, and separation of market-making and proprietary trading/asset management positions in large financial institutions.

Another issue is that the reform could result in a significant increase of algorithm use. When more trading is done electronically and bid/ask spreads are compressed, dealers will be less able to differentiate themselves on prices. Greater automation might then provide a path for differentiation as dealers might focus on providing their clients with effective, convenient access to the market.

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