Shanghai Derivatives Market Forum

Distinguished Speaker Forum

OTC Market and Investor Protection

Derivatives markets, like the rest of the financial sector, are moving through the most significant regulatory reforms in living memory. To find a similar period of upheaval it is necessary to look back to the New Deal legislative programme of 1930's America.

Then, like now, reform was driven by economic crisis. While Herbert Hoover tried to revive the economy largely through public-private cooperation initiatives, it is widely acknowledged that the regulatory response to the Great Depression began in earnest during the seminal first 100 days of Franklin D. Roosevelt's Presidency, starting on 4th of March, 1933. By analogy, it can be said that the regulatory response to the current financial crisis began in Pittsburgh on 25th September, 2009, with agreement at the G20 Summit to a broad programme aimed at re-establishing economic stability, initiating radical financial sector reform and protecting investors.

The pace of legislative action was often swift in Roosevelt's times – with some measures passing through Congress in a single day. In today's world, reform takes much longer – certainly more than 100 days, not least because of the effects of globalisation and the emphasis on international coordination and harmonisation, of which the G20 itself is the visible embodiment.

That said many of the Dodd-Frank reforms in the US are either now live or will be shortly, with the CFTC recently approving detailed rules determining how buyers and sellers must trade credit-default, interest rate and commodity swaps in the $633 trillion global market.

In Europe the European Markets Infrastructure Regulation, otherwise known as EMIR came into force last August, but aspects of it are being phased in over 12 months from the 15th March 2013, when the European Securities Market Association put their technical standards into force.

In Asia, according to the Celent consultancy, the OTC Derivatives market is mainly centred around FX, which accounts for 75% of Asian turnover. The market is also highly variable by country, with Australia, Hong Kong, and Singapore playing the biggest roles and other more conservative jurisdictions being content to create barriers which serve to protect the local market and encourage trading in more exotic instruments elsewhere. Not every financial centre in Asia is trying to attract global banking business.

In this context, as one would expect, different Asian countries have responded differently to the proposed changes, ranging from India, which has agreed to and already implemented many of the proposed changes, to Malaysia, which feels its market is not sophisticated enough to require substantial regulatory change.

In the main, our perspective on regulatory reform is that the direction of travel is right. We passionately believe in fair, open, transparent, liquid and well-regulated markets which are orderly, efficient and free from abuse.

And we passionately believe that our industry must work together to restore trust, as trust is at the foundation of how markets work.

At their heart, the derivative markets have a fundamental economic purpose of providing an effective risk transfer mechanism for the businesses and individuals in the real economy who need to manage price risk in an increasingly uncertain world.

We believe those needs are best served by a market that is given the freedom to foster competition, innovation and choice, in which the role of policy makers and regulators is to intervene only when there is a demonstrable market failure.

It is absolutely right for policy makers to require appropriate standards of safety and prudence in the way in which business is conducted. It is also right for them to prohibit and take actions against abuses which can result in financial loss and damage to market confidence and trust.

However, we believe it is wrong for them to try to design the shape and structure of the industry itself. This would put a strait jacket on market-driven solutions which would only serve to stifle innovation and choice.

It's fair to say that most of the financial reforms which are being pursued today meet the test of addressing demonstrable market failures. In most cases, policy makers have identified a clear market failure, have carefully assessed the costs and benefits of different policy options and have determined a policy response based on that considered assessment.

For example, it became crystal clear during the financial crisis that a significant amount of OTC derivatives activity was being conducted within a structure that put individual institutions and the system as a whole at risk of financial collapse. The murky pricing and unclear ownership of OTC positions led to massive uncertainty and risk contagion. As a result, the US and EU authorities have taken legislative action to implement the G20 mandates that were agreed in Pittsburgh in 2009, which are designed to increase price transparency through extending the application of trading disciplines, reduce systemic risk through centralised clearing services and improve standards of business conduct.

Through initiatives like these, the policy makers are rightly addressing demonstrable market failures and helping to make the financial system safer and more resilient for customers in the real economy, for market participants and for tax payers.

As a timely reminder of the need for such regulatory change, we have had 13 headline grabbing scandals in the last 2 years, or basically 1 public scandal every 8 weeks. One need look no further than the recent review by British regulators into sales of interest rate hedging products to small businesses where they found that more than 90% of 173 sales to non-sophisticated customers did not comply with at least one or more regulatory requirement.

In contrast, some other items have made their way onto the regulatory reform agenda without having passed the test of addressing a demonstrable market failure. Those items pose considerable dangers for the system as a whole because they run the risk of imposing damaging and costly restrictions on the free market on the one hand, without addressing any manifest weaknesses or failures in the operation of the market on the other.

These items include proposals mandating access to EU listed trading venues and central counterparties (“CCPs”) by unaffiliated facilities for all futures contracts. Such provisions might seem superficially attractive from an egalitarian or competition perspective, but they have the capacity to undermine the continued ability of proven market infrastructures to manage financial risk at the clearing level and to maximise liquidity at the trading level.

This is significant from a macro-prudential perspective because futures markets have been a much needed stabilising factor during the various stages of the financial crisis, remaining liquid throughout. Whereas liquidity in many other venues dried up, futures markets continued to allow risk to be transferred between end users, financial intermediaries and others in a multilateral, open and transparent environment. The positions created as a result of that trading activity continued to be valued, risk managed and collateralised on a daily basis by the relevant CCPs in a prudent and professional manner.

While the more recent MF Global case raises separate issues, when insolvencies occurred – such as the default of Lehman Brothers in September 2008 - the CCPs managed the financial consequences without recourse to the finances or resources of other clearing members or government bodies.

It should therefore be a matter of concern to all market participants, their customers and tax payers that these proven infrastructures could be undermined by proposed reforms which, whilst well-intentioned, are not based on any evidence of market failure and which could undermine the G20's principal aim of improving systemic risk management.

So if we broadly believe that regulators are moving in the right direction and their actions are now beginning to become reality, what impact will we see in future?

The Romanian playwright Eugene Ionesco said that “You can only predict things after they have happened” and Albert Einstein said “I never think of the future - it comes soon enough". With those proviso’s, I will make a few remarks.

Given standardised OTC derivatives will be required to be cleared by a CCP, we can expect the proportion of OTC business that is cleared to dramatically increase over time. International banking and securities regulators within Basel and IOSCO recently estimated that central clearing mandates will reduce the gross notional value of uncleared derivatives by 46%. Interest rate and equity derivatives are expected to exhibit the largest declines (53% and 56% respectively), whilst foreign exchange and other derivatives are expected to experience smaller declines (13% and 21%).

Credit Suisse have also made some interesting statements on the magnitude of change. In their research note of 2 May, they suggested that about 80% of interest rate swaps will be guaranteed by clearing houses and traded on Swap Execution Facilities ("SEF"). Assuming this is true, the post Dodd-Frank world will usher in an irreversible blurring of the boundaries which previously separated the OTC and exchange-traded worlds. We will likely see a gradual switch from bilaterally traded swaps to on-exchange futures that will in turn translate into further product innovation and significant growth in futures volume. Our own Swapnote futures contract, which is referenced to the European interbank curve, is a good example of this growing trend.

Having said that, there are many exemptions from the clearing requirements. For pension funds; and corporates which fall below specific thresholds or which hedge their business rather than speculate. This means that much standardised OTC business will remain uncleared. Customisation to meet client needs will still be required and bespoke OTC transactions will also fall outside the clearing obligation. Where business remains uncleared, there will be higher capital charges, a requirement for the two-way exchange of initial margin between OTC counterparties, and the payment of variation margin on a daily basis.

Where a clearing obligation does apply, the products will also be assessed for their suitability to be traded on an organized trading venue of some kind – whether it be an exchange, a Swap Execution Facility ("SEF"), a Multilateral Trading Facility ("MTF") or an "Organised Trading Facility". Over the next few years therefore, we can expect the greater electronification of OTC trading to increase (in fact the "SEF in spirit" has already been operating for the last 18-months) a proliferation of trading venues of various types, seeking to capitalize on the equalisation of counterparty credit risk through the CCPs and other regulatory changes by creating competing pools of liquidity. Only the most innovative, cost effective and customer-focussed will survive in this competitive landscape, which means that proliferation will ultimately be followed by consolidation.

In the meantime, the industry will face three major challenges.

Firstly, the need for implementing infrastructure and technology solutions which facilitate connectivity between the plethora of clients, venues and ccps as well as deal with pricing fragmentation from new RFQ obligations and quote display rules. As we know from the evolution and electronification of the equities market, this is a huge undertaking, which simply cannot happen overnight. Additionally market users typically don't want a monopoly situation where they only deal with a single venue or central counterparty, but nor, at the other end of the spectrum, do they wish to deal with 20 or 30.

Accordingly the regulatory agencies need to strike a careful balance between making progress and creating new risk from driving change at too rapid a pace.

Secondly, coming to terms with how geographical regions will harmonise with each other on content of regulatory requirements and timing, something which is critical to minimise cost of cross-border trading and product issuance, as well as minimizing the risk of regulatory arbitrage. The assistant managing director at the Monetary Authority of Singapore, told the most recent annual International Swaps and Derivatives Association meeting in Singapore, that "The potential for overlapping, inconsistent, and worse, conflicting rules, cannot be ruled out"

On this point, many assume that EMIR is simply the European mirror image of the Dodd-Frank regulation currently being implemented in the USA, however there are some key differences that firms will need to consider and accommodate when implementing their solutions. As Rule Financial Consultants point out for example: Trade reporting for EMIR is inherently more complex, the number of fields required to be reported are far greater than those required by Dodd Frank and include more granular detail including the collateral and valuation associated with the transactions. Under EMIR all types of derivative contract must be reported including exchange traded derivatives and contracts not subject to the clearing obligation. Dodd Frank only requires the reporting of a subset of OTC derivatives.

Thirdly, it is important that we learn the lessons from other segments of our industry and avoid some of the unintended consequences that have stemmed from well-intentioned regulatory change. In the US equity markets for example, 2010's highly publicized flash crash, which wiped out $862 billion of stock value in 20 minutes, was compounded by interplay of a vast number of multiple electronic venues of different shapes, styles and sizes, under a structure that has become incredibly complex and confusing to the end investor and a fair few intermediaries. For sure, a balance must be found between off-exchange trading and public price discovery in order to maintain a healthy public market, but we also need to ensure complexity and confusion are kept at bay.

IN SUMMARY

We are at Day 1340 in the reform of the regulatory system. A little further on than Roosevelt's 100 days. But we are encouraged by the progress of most aspects of the reform agenda and can see that it will address a number of demonstrable market failures and thereby make the financial system stronger and more resilient for the future, as well as increase protection for investors. This is vital in restoring public trust and confidence.

As Roosevelt said in the depths of the Great Depression, confidence "thrives on honesty, on honour, on the sacredness of obligations, on faithful protection and an unselfish performance". We agree wholeheartedly with these sentiments and would also add that confidence and investor protection is further fostered by intellectual rigour and objective analysis of problems and the open and transparent discussion of options for their resolution. That is, we hope, a test to which all policy makers will aspire to in the days ahead.

Thank you.