

AN ENHANCED ROLE FOR INFRASTRUCTURES
A point about international regulatory initiatives

Banque de France

May 31, 2010

International Monetary Seminar

Market Infrastructures and Financial Stability



Gide Loyrette Nouel

A.A.R.P.I.

Moving Trade Settlements to CCPs “as far as possible”

- **A global trend**
 - At international level
 - At industry level
 - At national levels
- **A new religion ?**
 - An initial mystical experience
 - A dogma
 - A hope
 - Some doubts

A global trend

- At international level
 - G20 leaders' statement – London Summit April 2, 2009
 - “We have today pledged to do whatever is necessary to [...] strengthen financial regulation to rebuild trust”
 - “Confidence will not be restored until we rebuild trust in our financial system”
 - London summit “**Declaration on strengthening the financial system**”
 - Establishment of a new Financial Stability Board (FSB) replacing the Financial Stability Forum, with a strengthened mandate
 - Commitment to promote the standardisation and resilience of the credit derivatives markets through the establishment of CCPs subject to effective regulation and supervision
 - Call on the industry to develop an action plan on standardisation by Autumn 2009
 - G20 leaders' statement – Pittsburgh Summit Sept. 24/25, 2009
 - “We need tougher regulation of OTC derivatives”
 - “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**”
 - “Non centrally cleared contracts should be subject to higher capital requirements”



A global trend

- Jan. 2009 “**OTC Derivatives Regulators Forum**” (ODRF)
 - Providing mutual assistance among international regulators in carrying out their respective authorities with respect to OTC derivatives CCPs and to the broader roles and implications of these infrastructures in the financial system
 - Promote consistent public policy objectives and oversight approaches for OTC derivatives CCPs
 - Adopt, promote and implement consistent standards (such as IOSCO Recommendations for CCPs)
 - Coordinate and sharing information
- April 2010 FSB / IOSCO / CPSS / European Commission working group
 - Assessing and setting out options for promoting increased use of standardised products
 - Developing a clear process to implement at the global level the mandatory clearing and exchange or electronic trading G20 requirements
 - **Suggesting to the FSB politic options by the end of October 2010**
- FSB has set up an Implementation Monitoring Network to monitor implementation by member jurisdictions of the G20 recommendations

A global trend

- May 2010 IOSCO and CPSS just issued a Consultative “**Guidances on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC derivatives CCPs**”.
 - Nov. 2001 Recommendations for securities settlement systems
 - Recommendation 4 called for the benefits and costs of a CCP to be evaluated
 - No detailed or comprehensive standards for CCP risk management
 - Nov. 2004 Recommendations for central counterparties
 - An identical review to that led by CESR for its own 2008 Recommendations, one year ago
 - **Consultation closing on June 25**

A global trend

- At industry level
 - March 11, 2009 ISDA letter to Commissioner Mc Greevy on behalf of 9 main world's leading dealing firms in CDS which undertake to have their CDS cleared in one or more European clearing houses before July 31, 2009
 - G14 major derivatives dealers and buy-side institutions commitment joint letter of March 1, 2010
 - Expanding central clearing in both credit and interest rate derivatives markets
 - Evaluating levels of standardisation in credit, equity and interest rate derivatives products
 - Extending the set of counterparties eligible to clear via a CCP and extending clearing access for buy-side constituents
 - Developing best practices in collateralising bilateral OTC derivative trades
 - Number of **ISDA** initiatives, including Big and Small Bang Protocols standardising credit events processing
 - **CCPs clearing for the standardised part of the CDS market has also come into operation - March 29, 2010 Launching by LCH.Clearent SA of its offer on Euro denominated index CDS**

A global trend

- At national levels
 - In the US
 - OTC derivatives CCPs clearing CDS have been introduced
 - Jan. 2010 Federal Reserve Bank of New York Perspectives on OTC derivatives markets infrastructures
 - The House of Representatives has passed the “Wall Street Reform and Consumer Protection Act” on December 11, 2009
 - The Senate has passed the “Restoring American Financial Stability Act” on May 21, 2010
 - Both give the CFTC and the SEC jurisdiction over OTC derivatives
 - House legislation specifically requires that all “clearing-eligible” (i.e. standardised) OTC derivatives transactions between dealers and “major swap participants” (i.e. anyone that maintains a substantial net position in swaps exclusive of hedging for commercial risk or whose positions create such significant exposure to others that it requires monitoring) be cleared through regulated CCPs and traded on exchanges or alternative swap execution facilities
 - Senate legislation requires a larger share of derivatives to pass through clearing or exchanges
 - Non cleared transactions must be reported to TRs and will be subject to more stringent capital requirements than those cleared through a CCP
 - Reconciliation of the bills currently in process – Conference committee starts on June 9

A global trend

- In the EU
 - **Dec. 18, 2008** Governing Council of the European Central Bank communication
 - Recommends the introduction of European CCP for credit derivatives
 - Ask for its location to be in the Eurozone (access to Central bank money)
 - Demands high risk management standards consistent with existing ones
 - Appropriate regulatory capital treatment for cleared derivatives
 - **Feb. 25, 2009** Recommendation 8 of the de Larosière Report
 - Creation in Europe of at least one well-capitalised CCP for OTC CDS
 - Need for CDS simplification and standardisation
 - Supervision of the CCP by CESR and the relevant monetary authorities and notably the ECB (80% of the CDS market in Euro)
 - **March 31, 2009** CESR Consultation on the revision of the 2008 CESR/ESCB "**Recommendations for securities clearing and settlement in the European Union**", for CCPs clearing derivatives
 - Consultation closed on April 17, 2009
 - **Same process as IOSCO's**

A global trend

- July 3 and Oct. 20, 2009 EC two Communications to Parliament on future policy actions in the area of derivatives
 - Harmonised legal framework for CCPs
 - Mandatory requirement to clear standardised contracts
 - Mandatory supply of initial and variation margins
 - Substantial differentiation of bilaterally cleared and CCP cleared transactions
 - Legislation on, and mandatory registration of OTC trades with, TRs
 - Possible revision of the operational risk requirements under CRD to foster standardisation
- Feb. 2010 EU Parliament ECON Langen report on derivatives market reforms
 - EU Parliament ECON position on EC proposal
 - Exclusion from regulation of hedging activities of non financial institutions
 - Framework should avoid any competition between CCPs on risk management
 - Expected date of adoption June 2, 2010

A global trend

- EC has committed to coming forward with a legislative proposal on “European Market Infrastructures” (EMIL / EMID)
 - Common legal framework within the EU for CCPs and TRs
 - Harmonized risk management standards (margins, clearing fund, operation, governance, etc.)
 - Mandating clearing of “standards” derivatives and reporting of OTC trades
 - Scope of an end-users’ exception still under consideration
 - Introducing a framework for interoperability
 - **Timing : proposal in the Summer – Adoption before year end**

A global trend

- In the UK
 - Dec. 2009 FSA and HM Treasury Report “**Reforming OTC Derivatives Markets – A UK perspective**”
 - But recent concerns by the House of Lords on whether the EU can afford a CCP and opposition to any blanket clearing requirement !
- In Canada
 - In-depth research of the Canadian OTC derivatives markets has been undertaken in the first quarter of 2010
 - Regulatory framework proposal developed in parallel to ensure changes harmonised with the details of US and EU legislation
- In China
 - The Shanghai Clearing House was incorporated in Nov. 2009 and will gradually provide CCP clearing service for OTC derivatives
 - The China Banking Regulatory Commission expected to issue soon draft guidelines on maximum leverage
- **In India**
 - *I am gladly referring you to Mr. Siddharta Roy's next presentation !*

A global trend

- In Japan
 - The Financial Services Agency (J-FSA) presented to the Diet in March 2010 a draft bill that will introduce mandatory CCP clearing, data storage and reporting
 - Discussion ongoing to launch CCP services for OTC derivative transactions in 2010
- In Russia
 - The Russian government is considering a draft federal law that sets out the concept of CCP and formulates the requirements for supervision and regulation of its risks
- In South Africa
 - Proposed amendments to the Security Services Act, including proposals to shift derivatives onto a CCP, have been finalised
 - To be submitted in Parliament in the second half of 2010

A new religion ?

- An initial mystical experience

- The banks collapse of Spring 1933 and **President Franklin Delano Roosevelt's statement on government and capitalism of Sept. 30, 1934**

*"We are bringing order out of an old chaos with a greater certainty of the employment of labor at a reasonable wage and of more business at a fair profit [...] Men may differ as to the particular form of governmental activity with respect to industry and business, but nearly all are now agreed that private enterprise in times such as these cannot be left without assistance and without reasonable safeguards lest it destroy not only itself but also our processes of civilisation [...] **We are facing new questions for the solution of which the old reliance upon the free action of individuals wills, appears quite inadequate** [...] I still believe in ideals. I am not for a return to that definition of liberty under which for many years a free people were being gradually regimented into the service of the privileged few. I prefer that broader definition of liberty under which we are moving forward to greater freedom, to greater security for the average man that he has ever known before in the history of America."*

- We are living nothing less but a complete inversion of the 30 years old political and economic Thatcher / Reagan deregulation paradigm
- Tensions between public and private interests characterize the evolution of derivatives clearing and the current proposals are rooted in this shift



A new religion ?

■ A dogma

- Hardly debated : OTC Derivatives are dangerous products (“time bombs” !) responsible for the crisis – or “at best” its magnitude

■ A hope

- G20 Pittsburgh Summit : *“we shall turn the page on an era of irresponsibility [...] meet the needs of the 21st century global economy [...] the greatest challenge to the world economy in our generation ”*
- The EC communication *“we believe that a paradigm shift must take place away from the traditional view that derivatives are financial instruments for professional use, for which light-handed regulation was thought sufficient, towards an approach where legislation allows markets to price risks properly [...] and will shift derivatives markets from predominantly OTC bilateral to centralised clearing and trading”*
- Moving Trade Settlements to CCPs will solve the system and restore the confidence in the markets

A new religion ?

- Some doubts
 - Are derivatives digestible for a CCP ? CESR says so and that there is little to do... But derivatives clearing has many aspects that differ from those of payment and securities clearing
 - If only simple, liquid and standardized derivatives can be cleared, and if those derivatives (as opposed to the complex or structured AIG insured CDOs and synthetic securitizations) are for nothing in the crisis, then how come CCPs could help?
 - CCP membership cannot be open to all... So what impact will mandatory clearing have on concentration and competition ?
 - Are we sowing the seeds of a future crisis ? CCPs serve good purposes but does not solve the counterparty risk. Risks entailed by the concentration inherent to CCPs are worsened when we talk of derivatives. A CCP doing derivatives clearing becoming itself a member of the market, its own failure creates a systemic risk and most probably a breakdown of the market.
 - **IOSCO and CPSS Consultative report May 2010** : *"Although a CCP has the potential to reduce risks to market participants significantly, it also concentrates risks and responsibilities for risk management"* and that *"a risk management failure by a CCP has the potential to disrupt the markets it serves and also other components of the settlement systems [which] may spill over payment systems"*
 - **Is "too big too fail" really meaningless for CCPs ?**



Are we ready for mandatory clearing ?

- There is need for further research into the business case around CCP clearing for OTC derivatives and its actual global legal needs to function properly
 - The legal framework
 - Definition of its material scope of application
 - Is “standardisation” the right criteria – Shouldn’t it be liquidity and easy pricing ?
 - And what is “standard” ?
 - Each CCP to decide / Governmental decision
 - Definition of its personal scope of application
 - An end-users exception – Yes / No (Option 1 or 2 of the EC discussion paper of April 7, 2010)
 - What is an end-user and when does it creates a systemic risk ?
 - Primary screen (credit and collateral tests) + secondary assessment (governance tests) v/ digital activity investigation and clearing thresholds
 - Location of the CCP
 - Access to central bank money
 - Governing law
 - Segregation
 - Banking secrecy

Are we ready for mandatory clearing ?

- Harmonization and controls (Not simply a US / EU issue...)
 - **There is currently no agreement on how CCPs should be supervised and regulated !**
 - As regulatory reform proposals for OTC derivatives markets proceed in different countries, divergences are becoming evident which gives room for regulatory arbitrages and market fragmentation
 - Quantification of increased capital charges on customized products and control of their impact
 - Little has yet been done in terms of standards of regulation and oversight of **cross border clearing activities and interoperability**
 - Need for more sophisticated market sensitive risk management procedures, margining and collateral arrangements **designed, implemented and supervised by the regulators**
- Model / Ownership / Governance
 - How many CCPs in the world ?
 - **Utilities v/ Businesses**
 - A hot topic in the context of NYSE Euronext's declaration of its intention to run its own clearing service and stop its long established relationship with LCH.Clearnet SA
 - **Doesn't what regulators try to achieve through mandatory clearing, precisely request that it is provided by utilities, trusts or independent quasi-utilities and not by businesses or the markets themselves ?**

Présentation par

Alban Caillemer du Ferrage, Avocat Associé

acf@gide.com

Gide Loyrette Nouel

Association d'avocats à responsabilité
professionnelle individuelle

26, cours Albert 1er

75008 Paris - France

Tél. +33 (0)1 40 75 60 00

Fax +33 (0)1 43 59 37 79

www.gide.com



Gide Loyrette Nouel

A.A.R.P.I.

Abu Dhabi

Alger

Belgrade

Bruxelles

Bucarest

Budapest

Casablanca

Dubai

Hanoi

Hô Chi Minh Ville

Hong Kong

Istanbul

Kiev

Londres

Moscou

New York

Paris

Pékin

Prague

Riyad

St-Pétersbourg

Shanghai

Tunis

Varsovie