Topic 3: Regulation of OTC Derivatives

Introductory presentation – Howard Wetston (first speaker) and Fernando Restoy

The OTC derivatives regulatory regime in most jurisdictions is likely to have a degree of extra-territoriality. This is somewhat inevitable because of the global nature of the OTC derivatives market. Mutual recognition of CCPs is one solution to address extraterritorial issues in relation to the mandatory clearing requirement. Another solution is to develop common standards for mandatory clearing requirements and cooperative regulatory oversight and information sharing agreements to facilitate recognition of CCPs. How do you see the different regulatory views around the world would eventually converge on this very important issue?

(5-6 minutes each)

SPEAKING NOTES

Introduction

The G-20 has committed to reduce risks to the global financial system by having all standardized OTC derivatives contracts cleared by central counterparties by the end of 2012. The use of CCPs with proper risk management controls reduces systemic risk by centralizing counterparty risk – thereby making its management more uniform and transparent – and by lowering system-wide exposures to counterparty risk through multilateral netting and risk mutualization.

International regulatory reforms to increase the clearing of OTC derivatives are contributing to the development of global CCPs that are, or will become, critically important market infrastructure to multiple jurisdictions. In addition to a CCPs home country regulator(s), authorities from jurisdictions whose market participants utilize a CCP or where a CCP offers products linked to a foreign jurisdiction, will have a crucial interest in that CCPs operations particularly in a crisis situation.

Due to the international nature of many large CCPs a globally coordinated approach to oversight is essential. Effective oversight can only be achieved with broad supervision that takes into account how a CCP affects and is affected by its various jurisdictional participants.

The recently published CPSS – IOSCO Principles for Financial Market Infrastructure (PFMIs) are a key step forward in this regard. The Principles set international standards which require CCPs to meet stringent risk management standards and also provides the framework and road map for cooperative oversight arrangements. Importantly, the

PFMIs call for each jurisdiction to adopt common standards on CCPs and this will increase harmonization and help to minimize any regulatory inconsistencies between jurisdictions.

Approaches to cross-jurisdictional oversight

The topic for discussion in this panel is the form international regulatory coordination should take and how to balance the need for jurisdictions to ensure that their domestic interests are being met by global CCPs without creating unnecessary or duplicative regulation.

There are a wide range of models for oversight of financial market infrastructures operating in multiple jurisdictions that can be distinguished based on the level of deference afforded to the home country regulator.

Local oversight approach

At one end of the spectrum, every market regulator in the world could require global CCPs to go through full recognition processes and ongoing oversight in each of their jurisdictions. This would address the individual oversight responsibilities of each jurisdiction and ensure that each jurisdiction's interests are adequately represented. However, this approach would arguably be overly burdensome on the handful of OTC global CCPs and would likely result in overlaps and the possibility of conflicting legislation.

Adherence by jurisdictions to internationally agreed upon standards such as the PMFIs could mitigate these effects somewhat if requirements on global CCPs were harmonized. However, due to the potential number of jurisdictions involved it is not optimal to have this level of oversight.

Mutual recognition

On the other hand the most deferential system is that of mutual recognition. Mutual recognition involves a foreign jurisdiction recognizing the adequacy of a CCPs home regulation and permitting the CCP to operate within its borders without complying with local regulations. This typically requires reciprocity for the foreign jurisdiction's own market infrastructures from the home regulator. This option is the least cumbersome for global CCPs as all non-home regulators would defer oversight to the home regulator of the CCP.

There are various terms used to describe this general model including "reliance", "equivalence" and "substituted compliance". However, in reality these terms may be more similar than different. The differences are around the edge of what requirements would still be applicable from a third party country regulator to a CCP in a home regulator jurisdiction.

A recent example of an approach to mutual recognition is the EU Regulation with respect to the use of credit ratings issued from rating agencies located in non-European countries. The regulation permits the use of these ratings within the EU provided that the credit rating agency established in the third country is authorized or registered, and is subject to supervision, in that third country. The EU must also confirm that the standards of regulation in the non-European country are "equivalent" to the EU Regulation and an appropriate cooperation agreement must be in place. (*Note that there is a distinction to be made between the importance of a credit rating versus a systemically important CCP*)

Issues relating to mutual recognition

The problem with mutual recognition is that local market regulators must have and retain the authority to act to protect their local markets and market participants. The G20 commitments require participants in those markets where local CCPs do not exist to use global infrastructure. This creates a very problematic scenario if the market regulators in those same jurisdictions are then asked to delegate oversight of their markets to a foreign regulator.

It is possible that in many jurisdictions, market regulators may not have the statutory authority to completely delegate such important fundamental market oversight to other regulators outside of their jurisdictions. Therefore, full mutual recognition in this vital regulatory space is not a viable option.

Most of the market regulators in the world whose market participants' transactions are cleared at global CCPs will require agreements with the home market regulators of the global CCPs to enable them to carry out their statutory duties in their local jurisdiction. Foreign regulators cannot be relied upon to oversee all local interests.

There are a number of reasons why regulatory authorities in different jurisdictions may have a local interest in a cross-border CCP that would differ from the home regulators interests.

For example, the CCP may have systemic significance outside of its jurisdiction of establishment or its home regulatory jurisdiction because of:

- direct foreign participants
- indirect foreign participants
- implications for major foreign currencies or reference entities underlying derivatives contracts processed by the CCP, or
- direct implications for the financial stability of foreign financial markets served by the CCP.

An example of a situation that may be of potential systemic significance to a local jurisdiction could be a default of a major participant that, while not effecting the safety and soundness of the CCP, would represent a significant local interest to a particular

jurisdiction (e.g. Royal Bank of Canada going into default).

Proposed hybrid model

Accordingly, a third option needs to be considered. A combination of mutual recognition for day to day oversight combined with cooperative oversight agreements including information sharing. This will involve CCPs having to bring recognition applications in all interested jurisdictions.

However, as day-to-day oversight would be delegated to the home jurisdiction, once the initial application burden is passed, it should not be overly burdensome on the CCPs themselves. In a crisis scenario, there may be local regulator involvement but that will be dealt with through the cooperative arrangements with the home regulator and the recognition conditions with the CCP.

How would the cooperative process work?

The CPSS-IOSCO Principles for Financial Market Infrastructures (PFMIs) in Responsibility E (cooperation with other authorities) includes a roadmap to implementing this approach.

An actual or proposed operation of a cross-border CCP in an authority's jurisdiction should trigger cooperation among authorities which commences with the home country regulator informing other relevant authorities that they may have an interest in the CCP following the PFMIs.

Efficient and effective cooperative arrangements between authorities should be put in place for normal operating circumstances with sufficient flexibility for crisis situations with respective roles and requirements of the home country regulator and any third country regulator clearly defined.

These agreements should be done through formal arrangements - bilateral or multilateral MOUs, protocols, etc. The cooperation models could range from information sharing on an informal basis to a more formal supervisory group that may interact regularly.

Standard setters and individual regulators are turning their attention to what a cooperative oversight arrangement would look like. The UK FSA, for example, has put together a draft cooperative oversight arrangement for LCH and is considering what type of information and access would be needed by different regulators and participants.