FSB FINANCIAL STABILITY BOARD

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ISDA Annual General Meeting

Reforming derivatives markets: a stocktake

Remarks by Svein Andresen, Secretary General, Financial Stability Board

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Good morning, and thank you for inviting me.

I will cover three issues: First, our take on the emerging evidence about the effects of the G20 over-the-counter (OTC) derivatives markets reforms. Secondly, I'll look ahead to the FSB's derivatives-related work for the next year or so. Thirdly, I'll say a few words on the importance of international regulatory and supervisory cooperation.

Ten years on from the financial earthquake, regulation of the global financial system has strengthened substantially – leaving a safer, simpler, and fairer financial system that can support open markets and inclusive growth. So far, our assessment of the effects of reforms in building a more resilient system is overwhelmingly positive.

At the international level, policymaking for derivatives markets to implement the post-crisis reforms is largely complete, with guidance on central counterparty (CCP) resilience, recovery and resolution to be published this summer, and data harmonisation efforts well underway. Our focus now is turning to implementation and assessing the effects and effectiveness of the global reforms.

To that end, the FSB, in close collaboration with the standard-setting bodies and informed by work carried out by its members and other stakeholders, is completing the development of a framework for the post-implementation evaluation of the effects of the G20 financial regulatory reforms.

The framework aims to guide analyses of whether the G20 core financial reforms are achieving their intended outcomes, identify any regulatory gaps, remaining or emerging risks, and material unintended consequences that may have to be addressed, without compromising on the objectives of the reforms.

The framework will apply to individual reforms, as well as to the interaction, coherence and combined effects of those reforms. The development of the framework and subsequent policy evaluations will be a transparent process. The main elements of the framework are currently under public consultation, and we have received thoughtful input from private sector participants and academics. Application of the framework will begin over the coming years, with a process in place for consultation on those evaluations.

Reforms to global derivatives markets

As perhaps the most global and least regulated of all financial markets before the crisis, the post-crisis reforms to OTC derivatives markets have been substantial.

Those who experienced the crisis from September 2008 onwards need no reminder of why these reforms were necessary. But for those who did not, weaknesses in OTC derivatives contributed materially to increase systemic risk and to the damage caused by the crisis.

The stated objectives of the reforms were to mitigate systemic risk, in part by increasing central clearing; to increase transparency of these markets; and to protect against market abuse.

So where are we today? Although the reforms are still being implemented, authorities are increasingly able to observe progress toward meeting the G20 Leaders' objectives.

- Clearing rates have increased significantly in recent years, mainly for interest rate derivatives and credit default swaps, leading to a corresponding reduction in bilateral counterparty risk exposures and a simplification of the complex network of relationships between dealers, banks and end-users in those markets.
- Many authorities with access to trade repository data are using or beginning to use the data to identify and monitor systemic risk and for a range of other purposes, including oversight of markets, trading venues, financial market infrastructures and market participants; analysing product and market structure developments, developing policies around central clearing; and conducting event studies.
- Higher capital charges for non-centrally cleared derivatives have been put in place in nearly all jurisdictions, and margin requirements for non-centrally cleared derivatives are beginning to come on-line.
- Finally, platform trading frameworks and requirements are being rolled-out, increasing market transparency and straight-through processing, and reducing operational risk.

Some metrics to demonstrate the extent of progress, starting with central clearing:

- The share of the stock of global outstanding OTC interest rate derivatives that is centrally cleared is estimated by the Bank for International Settlement (BIS) to have almost tripled between end-December 2008 and end-December 2016 to at least 61%. The rate of clearing in new transactions is even higher.
- The availability of CCPs continues to grow, with 30 CCPs now authorised to clear OTC derivatives in the FSB jurisdictions, with many of these authorised to offer services in up to 13 FSB member jurisdictions.

Turning to trade reporting, through 34 trade repositories and trade repository-like entities, FSB member authorities collectively now have access to around 30 million reports on outstanding OTC derivatives contracts across the five major asset classes, and comprehensive trade reporting requirements are now in force in 19 of 24 FSB member jurisdictions, with this number expected to increase to 23 by the end of next year.

Frameworks for mandatory platform trading are in force in 12 jurisdictions, and six jurisdictions have mandatory requirements for specific products to be traded on platforms. Mandatory trading requirements are due to be implemented more widely, for example through MiFID 2 in the EU, starting in 2018. We have seen electronic trading rates increase markedly in some asset classes, notably in standardised interest rate swaps, in credit dedault swaps indices, and FX forwards, options and swaps asset classes, as reported by the BIS in 2016.

The minimum margin requirements and higher capital charges for non-centrally cleared derivatives were designed to contain counterparty risk in non-cleared trades and to provide incentives to centrally clear derivatives.

Since the crisis, the proportion of collateral relative to current exposures for OTC derivatives has increased markedly, by our calculations from around 52% in 2007 to well over 80% in the three years to end-2014, relying on BIS and ISDA margin survey data. Recent US Office of the Comptroller of the Currency (OCC) figures show collateralisation rates continuing to climb steadily for many counterparty types, possibly in response to margin changes.

We are encouraged by the large increase in jurisdictions, in Europe and Asia, implementing margin requirements since September last year, and acknowledge the very large effort on the part of industry, both buy and sell side, to come into compliance through amendment of contract terms.

We urge stakeholders to make full use of standardised documentation where appropriate, in order to finalise the repapering exercise before the 1 September end of transitional relief periods, where applicable. We also urge jurisdictions that haven't fully implemented the margin requirements to redouble their efforts in this regard.

Challenges and work underway

Against this backdrop of progress, important challenges have also been identified, and work is underway internationally or at the jurisdictional level to address or better understand these issues. These include work to improve the resilience, recovery planning and recoverability of CCPs and to harmonise trade repository data and improve data quality, and remove legal barriers to reporting and accessing such data.

CCPs

With CCPs an increasingly important part of the financial system it is vital that CCPs do not themselves become a new source of too-big-to-fail risk.

To coordinate international policy work on CCP resilience, recovery planning, and resolvability, a workplan was agreed by the Basel Committee on Banking Supervision (BCBS), the Committee on Payments and Market Infrastructures (CPMI), the International Organization of Securities Commissions (IOSCO) and the FSB in April 2015.[1] Two progress reports have been published and the work is nearing completion.[2]

As part of this workplan, in February the FSB published a consultation on guidance for CCP resolution and resolution planning which authorities should consider when developing frameworks for resolving failing CCPs. The final guidance will be issued in late-June, together with the workplan update and guidance on resilience and recovery planning from CPMI and IOSCO.

The FSB will be undertaking further work on financial resources for CCP resolution and it will determine by end-2018 whether it should develop further guidance on this issue.

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1 BCBS–CPMI–FSB–IOSCO (2015), *Chairs' 2015 CCP Workplan (15 April 2015)*, September; available at: http://www.fsb.org/wp-content/uploads/Joint-CCP-Workplan-for-2015-For-Publication.pdf.

2 BCBS–CPMI–FSB–IOSCO (2016) *Progress Report on the CCP Workplan*, August; available at: http://www.fsb.org/wp-content/uploads/Progress-Report-on-the-CCP-Workplan.pdf.

Understanding interdependencies between CCPs, clearing members, clients and other parties involved in this ecosystem is key to assessing financial stability risks. Central clearing has generated increasingly important nodes in the financial system. When they work well, as they did in the crisis, they are effective shock absorbers and circuit breakers.

But authorities need to know more about how shocks of various kind could travel through this ecosystem and affect the rest of the financial system. As part of the CCP workplan, a joint study group was established to identify, quantify and analyse the network of interdependencies between CCPs and key CCP participants. A summary of the findings will be published in June 2017.

Trade respository data challenges

Further work is required for authorities and the industry to realise the full benefits from trade repositorydata.

Efforts to improve the data quality and harmonise the reporting requirements continue at both domestic and international levels. CPMI-IOSCO are working on recommendations for harmonisation of key OTC derivatives data elements that are reported to trade repositories and are important for the aggregation of data by authorities. Guidance to authorities on a global Unique Transaction Identifier (UTI) was published in February 2017.

Work continues on a global Unique Product Identifier (UPI) and other critical data elements, and the FSB is developing options for governance of the UTI and UPI. Some of you in the room may have been at a recent consultative roundtable the FSB convened in Amsterdam, focused specifically on how governance arrangements for these unique identifiers can be fashioned to appropriately reflect stakeholder interest.

On legal barriers to reporting, authorities reported last year to the FSB on their planned actions to address the identified barriers by 2018; the FSB will publish a further progress report ahead of the G20 Summit in July 2017.

ISDA's work with the authorities

I'd like to pause here to acknowledge the work of ISDA, and many industry participants in this room, for the efforts you have made to advance these reforms and to interact with authorities in ensuring we are as well-informed as we can be about market developments.

This has not been limited to OTC derivatives. One of the aims of the FSB's work has been to end taxpayer bailouts of failing financial institutions. Developing effective recovery and resolution regimes for global systemically important banks (G-SIBs) is a key element of this reform. ISDA together with the International Capital Markets Association and and the International Securities Lending Association. have played an important role in this work by providing a forum to agree the ISDA Resolution Stay Protocol. The Protocol improves the effectiveness of cross-border resolution actions and in 2015 the associations worked to extend the coverage of the Protocol to securities finance transaction master agreements.

To extend the protocol regimes to the broader market, ISDA has been developing Jurisdictional Modular Protocols that reflect the requirements in the particular jurisdictions. Such modules have been adopted for Germany, Japan and the UK. The protocol is an important element of ensuring that it is possible to operationalise resolution plans. Its effectiveness hinges on wide adoption and therefore requires actions both by ISDA and its members as well as authorities. Jurisdictions need to accelerate their efforts to adopt stay regulations that promote adoption by the broader market.

Another area where ISDA has been working with the official sector is in the area of major interst rates benchmarks, including analysis of alternative risk-free rates and of contractual fallbacks in case major IBOR benchmarks are not offered. Here ISDA has convened currency area working groups who are doing valuable and demanding work which the FSB remains closely engaged in.

Broader effects of the OTC derivatives reforms

Regarding financial market infrastructures (FMIs) the reforms have resulted in an increase in the number of CCPs offering clearing of OTC derivatives, including those that operate on a cross-border basis. Electronic trading platforms are becoming widely available, particularly in the larger OTC derivatives markets.

The reforms have also stimulated developments in post-trade services that support risk mitigation, including expanded portfolio reconciliation, compression and valuation services, and improved documentation practices.

The main market structure changes relate to increased rates of participation in central clearing. However, market intelligence suggests that smaller firms may be facing challenges in accessing clearing arrangements, noting that some CCP clearing members are withdrawing services to clients or imposing prohibitive minimum revenue thresholds.

Some also point to aspects of the capital regime such as the leverage ratio, or at least the way national regimes apply the leverage ratio and embed it within stress testing and other aspects of supervision, as exacerbating issues around client clearing and collateral transformation. These are areas that authorities are watching closely and which will be looked at in some further work I will touch on shortly.

And there remain concerns about geographic market fragmentation in certain markets due to differences in the scope and timing of national or regional rules. Authorities are sensitive to possible impacts of any fragmentation, for instance the impact on liquidity and trading costs for market participants, and remain committed to identifying and addressing cross-border challenges in implementing the reforms.

Many of these issues were discussed at a recent FSB-industry roundtable on OTC derivatives reforms at the Commodity Futures Trading Commission headquarters in Washington on 20 April, kindly hosted by Chris Giancarlo, kindly hosted by Chris Giancarlo, with ISDA represented by Scott O'Malia, together with a number of ISDA members on the sell side and buy side, and key global FMIs. At the roundtable, no one advocated rolling-back derivatives reforms. But industry and authorities are looking for more effective and efficient implementation to achieve the levels of resilience, transparency and effective markets the reforms intended at lower compliance and economic costs than presently.

In this regard, both the industry and the official sector are loking to benefit from FinTech innovations to assist in this endeavour. As part of work on FinTech, FSB members are also looking into RegTech applications.

We will continue to engage closely with our members, ISDA, and all other stakeholders to ensure that, as far as possible, legitimate concerns are addressed and unnecessary compliance costs are minimised – without compromising on the objectives set forth by the G20 for an open and resilient financial system that supports sustainable growth and development.

Looking ahead

Let me briefly summarise other important items on our agenda.

In June, we will be publishing the key findings of our ongoing review on derivatives markets reforms in our third annual report on the effects and implementation of reforms, along with our twelfth regular update on implementation, and the follow-up review on FSB members' progress in removing legal barriers to trade reporting. We expect these reports will stimulate discussion and also point authorities and academics to some issues that merit further investigation.

As one example of further work, before next year's G20 Leaders' Summit in Argentina, authorities will look again at whether the reforms achieve the appropriate balance in incentivising standardised derivatives to be centrally cleared, but non-standardised instruments to remain non-centrally cleared, including for dealers and non-dealers. This study may be the first under the framework for post-implementation evaluation of the effects of the G20 financial regulatory reforms, which we also expect to publish in mid-year. We will be reaching out to some of you with data requests in due course on this issue, and will be working with the Basel Committee and other relevant standard-setters to coordinate this effort. So there will be quite a lot of activity around these topics shortly.

And we will continue to engage with ISDA members and other stakeholders as we design the governance arrangements for the UTI and the UPI.

International Cooperation

I'd like to end with a few words on international cooperation. Those in the derivatives markets, perhaps more than others, understand the importance of global consistency and the dangers of fragmentation. Significant regulatory differences across jurisdictions reduce the risk-sharing capacity that the global market is capable of, and increase the costs of doing business. Should there be setbacks instead of progress in recognition of different supervisory and regulatory regimes, the risk for financial institutions is that they have to operate an increasingly fragmented business model with the increased capital and other costs that this involves.

It's critical, therefore, that authorities continue to act and coordinate at the global level.

International standards agreed among national authorities are a critical underpinning of a globally integrated financial system. Without international cooperation, or if international standards are not fully implemented, or set too low a common bar and thus encourage gold-plating, we risk fragmentation of the global system.

Rather than enhancing financial resiliency across jurisdictions, markets and institutions, this would cause financial system vulnerabilities to remain unaddressed and new weaknesses to arise.

To avoid the potential risk of fragmentation, it is important that the private sector speaks up about the risks, and continues to make a clear case for the benefits of effective international standards.

In conclusion, authorities are nearing the end of the international policy development work to address the fault lines of the crisis. This work has made significant progress in putting in place the underpinnings that a globally integrated system requires. While the reforms to derivatives markets have been slower than first anticipated, we are now seeing real progress being made, with more in the pipeline.

As a result of the reforms, we now have a financial system that is better able to dampen economic shocks, not amplify them. As a result of the reforms, we now have a financial system that is better able to dampen economic shocks, not amplify them. The FSB's focus in the years ahead will centre on effective and efficient implementation of the core G20 reforms through evaluation of their effects, while remaing alert to unintended consequences and evolving risks, and taking action as necessary.

Thank you.