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Regulation in Derivatives Markets

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New Landscapes New Players New Rules

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I am delighted to be back in Singapore, and in such prestigious company, to contribute – and learn from – this important conference: *New Landscapes, New Players, New Rules*.

This is indeed a timely conference and debate. Just yesterday morning on CNBC I heard President Obama describing the derivatives markets as billions of dollars sloshing around in the system, trading under the cover of darkness. From all around the world there has come a call for greater light to be shed on the trading of derivatives and Governments are considering and reflecting on the best way to do this.



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This week has shocked the world with the dislocation caused by a volcano in Iceland. Suddenly planes are halted and the plans of millions are thrown into disarray.

The global financial crisis hit many in the same way. It seemed to come out of a clear blue sky. It left them reeling with shock, unable to take in their losses. Some will suffer from the aftershocks for the rest of their lives. For all of us, one way or another, the financial landscape changed forever.

One of the differences between a global financial crisis and a volcanic eruption is, of course, that we remain unable to predict these natural eruptions or to blame others for them. Financial crises, on the other hand, prompt an immediate search for human agency and blame.

It is only now that the first shock has subsided that the most challenging question has come into focus: what do we need to do in order to prevent such a meltdown occurring again?

The regulatory response to the crisis must be one that encourages thriving, transparent, deep liquid markets, and does not reduce innovation in those markets. It must be based on appropriate research and data, and evidence of the potential impact regulatory intervention is likely to have.

It should also be calibrated and refined through consultation with market participants, particularly those whose businesses would be most closely affected.

Derivatives trading markets have been targeted as a prime scapegoat for the global financial crisis. In fact, over the last couple of decades there has been as much distrust of derivatives as there has been enthusiasm. In 2002, one of the US's richest men and most successful investors, Warren Buffett, observed that derivatives were time bombs both for the parties that



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dealt in them and the economic system: “financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.”¹

These observations were made before the global financial crisis hit. Since then, both the blame and the rebuttals have been more vociferous.

Derivatives Markets

Hedging of positions has been a common way of managing risk for a very long time. They were developed to manage and lower risk, and crude versions of derivatives have been in use for centuries. Derivatives began being sold off-exchange in the early 1980s. Today, they account for vast sums of money – the [Bank for International Settlements](#) estimates the total outstanding notional amount at \$684 trillion (as of June 2008).²

Derivatives certainly bring legitimate business benefits. The use of derivatives to hedge positions in business and to offset risk is well understood and an important business tool.

The Basel Committee on Banking Supervision has pointed out that credit risk protection through collateral pledged against potential losses in derivatives transactions is a cornerstone of risk management.³

Unfortunately, though, the crisis demonstrated that derivatives trading can also concentrate and heighten risk. Some commentators have demonised derivatives as a product class. I do not agree with this analysis. Nevertheless, a misunderstanding of derivatives can expose market participants who use them to significant risk. The global financial crisis highlighted

¹ Berkshire Hathaway Inc 2002 Annual Report <http://www.berkshirehathaway.com/2002ar/2002ar.pdf>

² Bank for International Settlements Quarterly Review, June 2009 <http://www.bis.org/press/p090608.htm>

³ Consultative document: International framework for liquidity risk measurement, standards and monitoring, 16 April 2010 <http://www.bis.org/publ/bcbs165.pdf>



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the counterparty risk, where, even though the instrument might well have been sound, the counterparty could not pay.

The International Organization of Securities Commissions' (IOSCO) report on the subprime crisis published in May 2008⁴ highlighted the fact that a number of structured products relying on leverage magnified both risks and returns.

A January 2010 report from the Joint Forum⁵ made up of the financial sector's international standard-setting bodies, including IOSCO, reminds us that "one of the factors contributing to the crisis was the inadequate management of risks associated with various types of products designed to transfer credit risk. This resulted in severe losses for some institutions. These products transfer risks within and outside the regulated sectors."

My view is that derivatives trading contributed to the global financial crisis, but was not the main cause. Like poor valuations, mis-selling of products, misuse of off-balance sheet vehicles and poorly understood securitisations, they were a contributor. Some derivatives destroyed value because of significant opacity in pricing valuation, and because many were traded over the counter rather than in regulated exchanges, and therefore there was an absence of transparency in relation to positions.

As Gary Gensler of the US Commodity Futures Trading Commission has observed,⁶ the crisis demonstrated that OTC derivatives added leverage to the financial system, with more risk being backed up by less capital.

⁴ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD273.pdf>

⁵ Review of the Differentiated Nature and Scope of Financial Regulation: Key Issues and Recommendations
http://www.iaisweb.org/_temp/Review_of_the_Differentiated_Nature_and_Scope_of_Financial_Regulation_January_2010.pdf

⁶ Remarks of Chairman Gary Gensler, Commodity Futures Trading Commission OTC Derivatives Reform, Chatham House, London, 18 March 2010
<http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opagensler-35.pdf>



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Derivatives markets continue to grow in size, product range and complexity, with complex trades making up an increasing proportion of new over-the-counter – and, therefore, unregulated – transactions.

Some hedge funds and financial institutions that trade derivatives do so using very small amounts of their own capital and very large amounts of borrowed money. The effect of all this is to make these derivatives extremely risky, while often obscuring that fact.

A global push for regulation

I firmly believe that, if we are to build a framework that will assist us in avoiding future financial crises in global markets, we must be prepared to work together to build an effective regulatory framework for OTC derivatives – one that will function alongside the regulatory frameworks for securities and on-exchange derivatives.

Twenty-first century financial markets are no longer geo-political islands. Money moves around the world and back again at the touch of a mouse, and regulatory frameworks must be just as agile at leaping borders.

Regulatory reform must be thorough and it must be international. Nothing less will do.

This is what G20 leaders believe. Last year in Pittsburgh⁷ they agreed that, by 2012, all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, and cleared through central counterparties. Non-centrally cleared contracts, they said, should be subject to higher capital requirements.

The Basel Committee's March 2010 report

⁷ Leaders Statement: The Pittsburgh Summit, 24-25 September 2009
<http://www.pittsburghsummit.gov/mediacenter/129639.htm>



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The Basel Committee on Banking Supervision recently published the findings of its stock-take of legal and policy frameworks for cross-border crises resolution.⁸ It said the crisis revealed that, although large financial institutions' cross-border derivatives activities could be internationally beneficial, they brought with them significant risks of cross-border contagion.

The committee said policymakers could encourage more use of risk mitigation mechanisms and strengthen legal frameworks to ensure their enforceability. This would help reduce interdependencies among individual market participants, better insulating them from the failure of individual financial institutions. This would also reduce systemic risk and make financial or market functions more resilient during a crisis.

It recommended greater standardisation of derivatives contracts, migration of standardised contracts onto regulated exchanges and the clearing and settlement of such contracts through regulated central counterparties, and greater transparency in reporting for OTC contracts through trade repositories.

The committee noted progress over the last two decades, with legal reform adopted in most major jurisdictions. It saw less progress in some emerging market jurisdictions, and said further convergence and strengthening of national frameworks was strongly desirable.

IOSCO work

IOSCO was quick to react when the subprime crisis hit. It had identified concerns and decided to initiate work as early as November 2007, and its report on the subprime crisis was released in May 2008.

⁸ <http://www.bis.org/publ/bcbs169.htm>



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The report noted the risks posed by some collateralized debt obligations (CDOs). By relying on leverage, investors in such CDOs would magnify returns but at significant risk. It made recommendations to better protect public markets from the spillover effects caused by activity on private markets.

Early this year, the Joint Forum released a review on regulation requested by the G20 through the Financial Stability Board. It analyses and makes recommendations on key issues arising from differential regulation in the international banking, securities, and insurance sectors, focusing on unregulated or lightly regulated entities or activities where systemic risk is high.

The issue of credit risk transfer associated with derivatives was addressed by the Joint forum in 2005 and later in 2007.

In November 2008, IOSCO initiated a review of the scope of financial markets and in particular unregulated financial markets and products. This resulted, after extensive consultation with industry, in a final report in September 2009.⁹

This report examines ways to introduce greater transparency and oversight in unregulated financial markets and products. It aims to improve investor confidence in, and the quality of, these markets. Financial market regulators are urged to implement its recommendations, especially as regards securitisation and credit default swap markets, which are of particular systemic importance. This will help introduce greater transparency and oversight with respect to securitisation and CDS markets, and improve investor confidence and the quality of these markets.

IOSCO recommends the provision of sufficient regulatory structure, where relevant, for the establishment of CCPs to clear standardised CDS. This includes requirements to ensure:

⁹ IOSCO Technical Committee Report: Unregulated Financial Markets and Products – Final Report. September 2009 <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD301.pdf>



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- appropriate financial resources and risk management practices to minimise risk of CCP failure;
- CCPs make available transaction and market information that would inform the market and regulators; and
- cooperation with regulators;

Financial institutions and market participants are encouraged to work on standardising CDS contracts to facilitate CCP clearing. Updating the CPSS-IOSCO Recommendations for Central Counterparties will take into account issues arising from the central clearing of CDS. Facilitating appropriate and timely disclosure of CDS data relating to price, volume and open-interest by market participants, electronic trading platforms, data providers and data warehouses is another important recommendation. Equally important are efforts to facilitate information sharing and regulatory cooperation between IOSCO members and other supervisory bodies in relation to CDS market information and regulation.

IOSCO also encourages market participants' engagement in industry initiatives for operational efficiencies. Jurisdictions should now assess the scope of their regulatory reach and consider which enhancements to regulatory powers are needed to support these recommendations in a manner promoting international coordination of regulation.

IOSCO believes that the recommendations relating to CDS might be used, or tailored, to inform general recommendations for other unregulated financial markets and products, in particular, standardised and non-standardised OTC derivative products where these products may pose systemic risks to international finance markets or where regulation could contribute to restoring investor confidence. IOSCO recognizes that further work in this area, taking account of industry initiatives, may be necessary.

In February 2010, the Committee on Payment and Settlement Systems (CPSS) and IOSCO's Technical Committee announced a comprehensive review of their existing standards for



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financial market infrastructures such as payment systems, securities settlement systems and central counterparties.

A working group from the Committee on Payment and Settlement Systems and the Technical Committee of IOSCO is reviewing standards for financial market infrastructures, including central counterparties, for over-the-counter derivatives.

A draft of the broader standards will be published in early 2011, but the standards specific to central counterparties clearing OTC derivatives are expected to be published for consultation later this month.

What the regulatory framework might look like

In the first place, all dealers in derivatives should be regulated, this includes any entity making markets in OTC derivatives such as banks, non-banks and algorithmic or high-frequency traders. They should be subject to capital and margin requirements.

Dealers must take on more of the risk themselves. They should be obliged to stick to firm standards in order to protect market integrity and regularise documentation. They should be required to keep strict records, and ensure information on cleared and uncleared transactions is passed on to the appropriate bodies, thus ensuring regulator access to all transaction details. Because of the cross border nature of many transactions, a reporting protocol common to all jurisdictions will be essential so that this information can be shared between regulators around the world.

When it comes to promoting public transparency and lowering risk, OTC derivatives should be traded through a regulated exchange or other regulated trading venue. They should be cleared through a regulated clearing house. These act as umpires, ensuring the rights and obligations of both parties to a transaction are upheld.



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The issue of bespoke derivatives needs to be isolated, quantified and addressed. Even if a bespoke derivative is too complex or difficult to standardise, such trades should be reported to the regulator and to an exchange to ensure the transparency of the position, and may require more capital. The issue of standardisation of contracts can be separated from the issue of transparency of trading.

Many argued, pre-crisis, that OTC derivatives were too customised to trade on exchanges or to be centrally cleared. If it was once true, it is not any more. Gary Gensler cites a Wall Street CEO as believing that 75-80% of such transactions are standardised enough to be cleared.¹⁰

I believe we will see an increasing proportion of transactions heading in this direction, and that it will bring wide benefits, in terms of price discovery and liquidity. It may also reduce costs over the longer term.

Exempting some derivatives trading from regulation

Many corporations and financial firms argue that OTC derivatives contracts signed up with corporate end-users should be exempt from regulation. They claim that such contracts represent only a fraction of the market. The Bank for International Settlements reports that 9% of transactions are between dealers and corporate end users. If that argument were extended to dealers and their financial customers, that “fraction” would rise to 57%. The BIS figures suggest dealer-to-dealer transactions are at most 40% of the market.¹¹ Depending on

¹⁰ Remarks of Gary Gensler, Commodity Futures Trading Commission, FIA’s Annual International Futures Industry Conference, Boca Raton, Florida, 11 March 2010

<http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opagensler-33.pdf>

¹¹ Cited in Gary Gensler, Commodity Futures Trading Commission, Remarks to American Bar Association Committee on Derivatives and Futures Law, 29 January 2010

<http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opagensler-26.pdf>



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the extent of any end-user exemption, this may leave around 60% of standardised transactions unregulated.

To leave such a large proportion of the derivatives market unregulated – and therefore less transparent and more exposed to risk – is not where the public interest lies.

To quote Gary Gensler again, “What’s good for Wall Street is often not what’s good for the American public.”¹² A statement just as true when applied internationally.

Self-regulation

My answer to the question of whether some form of self-regulation would be workable and/or acceptable is that it depends what you mean by the term.

If the question means, should the industry and its self-regulating trading platforms be left entirely to their own devices, the answer must be a clear no.

If, however, self-regulating industry segments and trading platforms can show they are working appropriately to enhance transparency and reduce risk, then yes – that is exactly what regulators are looking for.

Regulation and growth

Will OTC derivatives market regulation stifle market growth? I believe not. In fact, it’s likely the reverse will be true.

Regulated exchanges and clearing houses proved themselves during the crisis. They allow the netting of both buyers’ and sellers’ positions, thus reducing the cost of posting collateral

¹² Ibid.



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and minimising clearing members' exposure. Exchanges and clearing houses are supervised by regulators.

Conclusion

Never again should the shock of a financial crisis hit us like a volcanic eruption, out of a clear blue sky.

Few of us relish change. We much prefer to go on taking our familiar landscape for granted. Some of us would prefer also to keep the benefits that opacity and the arbitrages inherent in that opacity have provided for us.

However, the world has changed. The "Heads I win, tails the tax payer loses" philosophy, is now outmoded. The global financial crisis has shaken financial institutions and markets to their foundations. Rebuilding is already underway, and there is no point in rebuilding the same shaky structures we have seen fall down around us. We must do better.

A sound regulatory framework for the OTC derivatives market is over-due. To be as effective as we all need it to be, however, national regulators must work together at the international level. To be proactive and workable, regulation must be based on relevant research, data and analysis that is shared globally.

Transparent derivatives markets would benefit us all. They would be more liquid and competitive, thus lowering the costs of hedging risks for companies that need to do so, lowering the risk of OTC products for all parties, and reduce the risk of derivatives as a class being demonised by commentators.

It is something I call on you all to support.