Nout Wellink: Towards an international dispute resolution facility for the financial markets

Speech by Mr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the expert round table, World Legal Forum, Den Haag, 25 October 2010.

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Ladies and gentlemen, it is a great pleasure to address you in this magnificent venue. The Peace Palace is a symbol of peace that – at the time of its opening in 1913 – was acclaimed to be a "dream palace as big and mighty as the idea of world peace itself". The ambitions of world peace were embodied by contributions of numerous nations in the form of works of art, furniture and building material that today still decorate this building. This is a striking entourage to discuss new initiatives aimed at maintaining another global ambition, the ambition of financial stability.

Financial innovation, advantages

Over the past decades we have witnessed a huge growth in complex and innovative financial products, including in the over-the-counter (OTC) derivatives markets. According to the latest BIS estimates, the notional value of outstanding OTC contracts exceeded the staggering amount of 615 trillion USD by the end of 2009[1]. I believe that financial innovation has brought us real benefits. Financial products like credit derivatives have increased the possibilities to spread and manage risks. And indeed, the financial system proved to be better capable of absorbing shocks, as was demonstrated when the dot.com bubble burst or after 9/11. However, clearly, financial innovation has not prevented the financial crisis from happening. In fact, financial innovation is often pointed out as one of the root causes.

Risks associated with financial innovation

The risks associated with financial innovation are real. First of all, not only size, but also complexity in the markets for sophisticated financial products increased rapidly. This came at the cost of transparency. At the outset of the financial crisis, hardly anyone seemed to know what the true risks and value of complex financial products were and who would in the end bear the losses. In many cases, this was even true for the parties who created them in the first place. Risk management systems of financial institutions could hardly keep up with product innovation. Furthermore, the increased interconnectedness of financial markets made that not only gains, but also losses were transmitted through the system easily, hardly hampered by time or national borders. Although the system was less vulnerable to shocks, it turned out that it was at the same time prone to large accidents and sudden loss of confidence. By implication, the risks associated with financial innovation is nowadays a topic of heated debates among policy makers, market participants and academics worldwide. However, consensus exists that OTC derivatives markets have to become safer, more resilient and more transparent.

[1] Regular OTC Derivatives Market Statistics 11 May 2010.

Derivatives can pose systemic risks

One of the key risks associated with OTC derivatives is counterparty risk. Counterparty risk depends on a complex set of factors including the underlying value of the asset, the creditworthiness of the counterparty, and the interaction between the two. Optimal models that can properly assess these risks remain under construction. Furthermore, the lack of transparency of these markets plays an important role. With the strong growth of derivatives a complex network of bilateral dependencies has been created, opening up a web of inter-linkages and contagion channels. This lack of transparency also makes it complicated to properly assess counterparty risk.

Legal certainty supports financial stability

Furthermore, OTC derivatives do form part of a sometimes highly complex legal framework. Over the last decades various branch organisations have undertaken the standardization of derivatives contracts, which is a means of diminishing legal risk of transactions. An international dispute resolution facility could in my view be a logical next step in these standardization efforts. It can lead to a further improvement of legal certainty and thereby – at least in an indirect way – support financial stability.

Improvement of stability through legal certainty

How would legal certainty be achieved? The fact that the same contractual terms are used across the world implies that a decision in a dispute between two parties may have implications that go beyond their specific contractual relation. The interpretation of a local court of a standard contract term might differ significantly from what the parties involved and the market would expect. The result: legal uncertainty for other transactions. This would also be true for disputes regarding transactions for which a court in another jurisdiction is competent; in the end, the same contractual terms are at stake. Therefore, the standardization efforts in the globalised markets can be partly hampered by decentralized and non-coordinated dispute resolution and interpretation of contractual terms. One universal court with judges and arbitrators specialised in this specific subject matter could reduce legal risks.

But what should such a universal financial court look like? And how should it function to promote financial stability? These specific legal issues obviously are not the core business of a central bank, but I am happy to share some thoughts on this matter. The basic idea behind this is actually quite simple: legal certainty.

Tribunal of public or private nature?

The first question is: should this international dispute resolution facility be of a public or private nature? Full standardisation of the dispute resolution process in the financial markets could only be reached if states would transfer part of their jurisdiction to an international court on the basis of a treaty. At this moment there is no initiative to prepare a treaty like this, nor is there any indication that enough states would be willing to adhere to it. I will therefore focus on the standardization of the judicial process by private initiative. There are four features that an international dispute resolution facility should have from the perspective of stability.

Swift and final end to disputes

First of all, dispute resolution should be quick and final. Legal proceedings that last for years can be a burden to legal certainty. That does not only affect the parties to a dispute, but also

the market as a whole. The fast resolution of disputes can for example prevent other institutions from engaging in litigation on the same standard contract terms. Therefore, a court decision can prevent procedures from being duplicated. Although arbitration procedures are not necessarily faster, the procedural rules could be shaped in such a way that parties can be forced to proceed swiftly. Between two parties engaged in the arbitration, a decision will normally mean an end to the dispute. An arbitral decision will also be recognised in most states under the New York Convention of 1958. A more challenging aspect is the voluntary nature of arbitration. No-one can be brought before the court without consent, implying that other parties cannot easily be joined in the same litigation.

Responsiveness to party and market expectations

Second, decisions should meet justified market expectations. Disputes on derivative contracts differ from other disputes for the reason that standard contracts are used across many jurisdictions worldwide. Parties to a contract may have agreed on its terms without having contemplated the economics or the history behind them. In some respects, the interpretation of such standard terms resembles statutory interpretation. To mitigate the risk of unexpected decisions, an international dispute resolution facility should consist of arbitrators with extensive knowledge of the specific market environment in which the transactions take place.

Insight in conflict of law issues

Third, financial markets are global, but their legal frameworks are of a regional or even national nature. This may make it hard to establish which jurisdictions apply in each case. Arbitrators would need to have a very good understanding of the conflicts of law this brings about. Therefore, it would be desirable to involve arbitrators with different legal backgrounds, depending on the matter at hand. In this way, the legitimacy of the court would be ensured, both towards the market and public stakeholders.

Public availability of awards

A last important feature is the public availability of judgements. The creation of a body of decisions on standard terms used in financial transactions would improve legal certainty, thereby enhancing the stability of the derivative markets. Yet, this goal would only be reached if the market would get to know the outcome of disputes and if the decisions rendered by the tribunal would be public. Any reluctance of market parties to go public with their disputes can be taken away by making the court decisions anonymous. Of course, different laws may be applicable to the relevant master agreements, and the regulatory regime in which the transactions take place may differ. However, if they are of a high quality and well motivated, the decisions may *de facto* be authoritative across the world by the power of persuasion of their content and the stature and prestige of the institution by which they are rendered.

Other initiatives: central counterparties

The idea of an international dispute resolution facility for the financial markets fits well in a rapidly changing environment. Both in the United States and in Europe, central counterparties [CCPs] for the central clearing of derivatives have been launched. ICE Clear Europe for instance clears credit default swaps and SwapClear is a CCP for interest rate swaps. This is a significant development, since for instance SwapClear claims to clear currently more than 40% of the global interest rate swap market, with a total notional principal of 229 trillion USD. Central clearing by CCPs not only mitigates counterparty risk,

but also minimises the cash flows between counterparties. In addition, a CCP increases transparency, as it registers all transactions. Also, CCPs require daily collateralisation of open derivative positions which reduces the leverage in the financial system and contributes to financial stability.

Legislative initiatives

It is not surprisingly, therefore, that the G20 leaders committed in September 2009 that all standardised OTC derivatives should be cleared through CCPs by end – 2012 at the latest. Also, it decided that OTC derivatives contracts should be reported to trade repositories. In the US this resulted in the Dodd-Frank Wall Street Reform and Consumer Protection Act. In the EU, the European Commission recently proposed a Regulation that creates a framework for the regulation of CCPs and trade repositories. Both the EU and the US regimes aim to impose clearing and reporting obligations on a broadly defined class of derivatives. There are differences though at a more detailed level. In the US there is only a narrow exemption from the clearing obligation for non-financial entities that enter into certain hedging transactions. In the EU the clearing obligation applies to financial counterparties when dealing with other financial counterparties; non financial counterparties only become subject to the clearing obligation when their positions exceed a certain threshold.

Nevertheless, an obligation to clear eligible derivatives through CCPs can only mitigate part of the risk associated with derivatives. After all, there will always be a need for bespoke contracts that cannot be standardised. By implication, there will be an OTC derivative market for tailor made or more complex products. Therefore, improvements of risks management systems are desirable, also for institutions outside the banking sector. Requirements to register derivatives contracts in central repositories, especially those that are not cleared through central counterparties, will contribute to transparency. Also, national authorities will have to cooperate closely and share relevant information in order to assess where systemic risk might be building up.

Certain capital requirements / BASEL III

Another recent initiative to mitigate counterparty risk in the derivatives markets is a proposal of the Basel Committee for Banking Supervision. The basis idea is straightforward: the capital weight for derivatives that are bilaterally cleared will be higher than those for derivatives cleared through CCPs. In this way, the additional risk for these trades can – at least – to some extent be taken into account. It also provides an incentive to clear derivatives through CCPs. The costs associated with the use of a CCP might be a lesser burden if capital needs to be reserved for bilaterally traded derivatives. In addition, the requirements for banks to use internal models for calculating capital requirements for derivatives will be tightened. This proposal also includes a reconsideration of the zero risk weight for CCPs, even when the CCP complies with international standards. CCPs will become systemically important, as more and more derivatives will be cleared through CCPs. There will be a concentration of risks on CCPs. Therefore, the Basel Committee also proposes to increase the capital charge for exposure on CCPs [the current charge for CCPs is 0%]. The capital charges will be calibrated in such way that the incentive to use CCPs will be preserved.

The establishment of an international dispute resolution facility that contributes to legal certainty in the OTC derivatives markets, fits well in a broad range of initiatives to enhance financial stability. DNB therefore welcomes this initiative.

Conclusion

I started by saying that this is an inspiring place to discuss an international dispute resolution facility for the financial markets. It might even be worth to consider establishing this facility

just here as well. Although the concept of a world financial tribunal is of greater importance than the question of where it is located, I believe the tribunal would find a perfect home in The Hague. The first world peace conference was held in 1899 in The Hague and resulted in the establishment of the Permanent Court of Arbitration. The idea of adding private dispute resolution in the financial markets to this landmark decision would fit perfectly in The Hague's international judicial tradition.