Benoît Coeuré: Four years after Pittsburgh – what has OTC derivatives reform achieved so far

Speech by Mr Benoît Coeuré, Member of the Executive Board of the European Central Bank, at the at joint Bank of France, Bank of England and ECB conference on OTC derivatives reform, Paris, 11 September 2013.

*   *   *

I wish to thank Patrick Föll for his contributions to this speech. I remain solely responsible for the opinions expressed herein.

Introduction

Ladies and Gentlemen

It is a great pleasure for me to speak here in Paris and to welcome you, on behalf of the ECB, to the conference on the OTC derivatives reform.

The over-the-counter (OTC) derivatives markets were at the heart of the financial crisis and several root causes on what went wrong were identified. Increasingly complex and opaque financial products, combined with a lack of transparency, were contributing factors, but also the failure of public authorities to appreciate and address adequately the risks building up in the financial markets. Not only did regulators and supervisors not keep up with financial innovation, but they lacked the tools to monitor the risks adequately. Regulation also failed to keep up with the dynamics in the OTC derivatives markets over the last two decades, which saw an explosion in outstanding contract volumes. Post-trading infrastructures had become increasingly inadequate for coping with the growing volumes and complexity of such trades.

In an unprecedented act of international cooperation, the G20 leaders met in 2008 and 2009 in Washington, London and Pittsburgh to coordinate action and address the regulatory gap. As the crisis has shown, deregulation and reliance on self-regulation just do not work.

In the area of OTC derivatives, the objective was to have all standardised OTC derivatives contracts traded on exchanges or electronic trading platforms and cleared through central counterparties by the end of 2012. OTC derivatives contracts were to be reported to trade repositories, and non-centrally cleared contracts subject to higher capital requirements.

No doubt, a vast amount of technical work has been undertaken during the last four years, and substantial progress has been made in regulatory and supervisory reform in response to the financial crisis.

Just to mention some examples: the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) issued, in 2012, new and more demanding international standards for payment, clearing and settlement systems and trade repositories, and have also recently published guidance on authorities' access to data stored at trade repositories. The clearing and reporting obligation has been implemented in major jurisdictions. The CPSS and the Financial Stability Board (FSB) have issued guidance on the recovery and resolution of financial market infrastructures, including central counterparties. However, it should also be highlighted that little more than half the FSB jurisdictions have legislative frameworks in place that implement the G20 Pittsburgh commitments.

Other important reforms are still underway or have only recently been adopted and implementation is outstanding. Regulation implementing Basel III in Europe entered into force two months ago. Tomorrow the European Parliament will discuss the regulation establishing a Single Supervisory Mechanism, an important step towards a European banking union. Under the Single Supervisory Mechanism, one supervisor will have a complete overview of an entire large and interconnected banking group in the context of the single currency. Furthermore, work is being undertaken to address cross-border regulatory inconsistencies.

So where do we stand five years after Lehman Brothers and four years after Pittsburgh? Did we achieve the overall goal of improving transparency, mitigating systemic risk and protecting against market abuse in OTC derivatives markets? Are we now better placed to monitor risks building up in the financial system?

I will limit myself to three of the many issues covered by this conference: lack of transparency, the challenges remaining in central clearing and inconsistencies in cross-border application.

Transparency

First, I would like to reflect on one of the main root causes of the financial crisis: the lack of transparency relating to OTC derivatives in general. When I say "in general", I mean that there was not only a lack of transparency on OTC derivatives at the level of the market, but also at the level of individual institutions and counterparties.

There are two dimensions to the lack of transparency: lack of information due to a lack of reporting requirements, and data fragmentation making it difficult to connect the dots and see the full picture. Let me address them in turn.

The accounting treatment in many jurisdictions allowed such instruments to be reported off-balance sheet. Furthermore, different valuation methods were used to estimate the risks attached to these transactions.

Hence, information was either completely unavailable or incomplete and, even if available, it could not be compared across the sector and jurisdictions owing to different accounting assumptions and valuation methods. It was thus of little value to regulators and supervisors.

In addition, financial innovation and strategies that were intended to limit risk – especially securitisation and insurance through derivative products – dramatically increased the complexity of the financial system.

Unlike organised markets, such as stock exchanges, which were tightly regulated to protect against market abuse, insider trading, and other transgressions, and were required to disclose information on prices and orders, over-the-counter markets were not. At the height of the crisis, neither market players nor public authorities could monitor the market for corporate credit-default swaps. Hence market participants were unable to evaluate the counterparty risk appropriately. Risk mitigation failed, which ultimately resulted in a drying-up of the whole market.

Since that time, many jurisdictions have implemented regulatory frameworks ensuring that counterparties report OTC derivatives trades to trade repositories. In Europe, all derivatives contracts, not only OTC derivatives, are subject to this reporting obligation.

In the United States, the reporting and public dissemination of publicly reportable swap transactions in all asset classes is already effective. The same in Japan, which has the most active OTC derivatives market in Asia and where the country's first repository was approved in March this year. In Europe, it is expected that the European Securities and Markets Authority will adopt a decision on the registration of trade repositories still this month and that counterparties will start to report all asset classes to the repositories as of January next year.

So, on the surface, it appears we have achieved our goal. But have we really? Does, for example, the supervisor responsible for the supervision of a large cross-border financial institution at the consolidated level have direct and immediate access to information on OTC derivatives transactions that encompass *all* transactions entered into by *all* entities of this group? Is the information accessible, in other words can it be easily aggregated across trade repositories and jurisdictions? My answer would be a clear no!

In the Single Supervisory Mechanism, the ECB, as I've already said, will be responsible for the supervision of such large banking groups, some of which are global systemically important financial institutions (SIFIs) with large derivatives businesses. The *access to data* relating to foreign (that is non-EU) subsidiaries of financial groups, where an authority – in this case the ECB – has supervisory responsibility at a consolidated level, is key to assessing the overall risk exposure of a given banking group.

Of course, access to data should always be in line with the authorities' mandate and with the CPSS-IOSCO guidance, issued last month, on authorities' access to trade repository data. However, even if this is warranted, privacy laws, blocking statutes and indemnification clauses which are in place in several jurisdictions restrict effective access to the detail of OTC derivatives transactions.

Another important issue is whether authorities will be able to aggregate data across trade repositories and jurisdictions. Where there is more than one authorised repository in a single jurisdiction, it will be necessary to aggregate data across repositories. This in itself will be challenging. If no central entity is responsible for such aggregation, it could well mean that a plethora of public authorities with an interest in accessing data will need to conduct this task. This would hardly be efficient.

It gets even more complicated if data, for example for all entities of a large financial group which is present in several markets, have to be aggregated across jurisdictions, as the level of information reported to repositories is different.

A lot of work has already been done to address these issues. The January 2012 CPSS-IOSCO report on OTC derivatives data and reporting and aggregation requirements identified the Legal Entity Identifier (LEI) as an essential tool for aggregation. Good progress has been made in the development and implementation of the Global LEI System. In order to promote the use of LEI at the start of the financial reporting obligations in the European Union, United States and other jurisdictions, an interim pre-LEI system has been agreed.

The same report also identified potential data gaps, such as the availability of collateral information which would be necessary to evaluate exposure, and therefore risks, appropriately. Here in the European Union, for example, entities are required to report collateral information, whereas in the United States no such requirement exists. So, even if access issues are standardised across the board, a lot of data issues will still remain.

In short, I see three main issues that have to be addressed. First, information gaps still exist, either due to a lack of or differences in reporting requirements. Second, data are fragmented across trade repositories and jurisdictions. And third, there are still obstacles impeding authorities' access to data.

In February 1999, in his report to the G7 finance ministers and central bank governors that led to the establishment of the Financial Stability Forum, Hans Tietmeyer called for "arrangements for the surveillance of global vulnerabilities, including the pooling of information available to the international financial institutions and the international regulatory groupings". This was almost 15 years ago and we are not yet there.

In fact, at the current stage, no authority has a complete overview of the risks in OTC derivatives markets or is able to examine the global network of OTC derivatives in depth. Hence, fragmentation of data, both at the data storage level and at the access level, is putting at risk the implementation of the overall objective of the G20. The good news is that the G20 leaders, who continuously monitor the implementation of the reform, are aware of this issue. The Financial Stability Board, assisted by the CPSS and IOSCO, has only very recently begun a feasibility study on various approaches to address these shortcomings and intends to issue a report in the first half of next year.

Central clearing

The second area I would like to concentrate on is central clearing.

A lot of progress has also been achieved in the area of central clearing. However, although legislation is in force in Europe, it may still take more than one year before the clearing obligation becomes effective. Actually, this Sunday (15 September), the deadline by which central counterparties in Europe have to apply for authorisation under EU legislation will expire. Within another six months – by mid-March 2014, at the latest – the authorisation process should be completed, after which the mandatory clearing obligation will be determined.

The good news is that the share of cleared contracts in relation to total OTC derivatives transactions outstanding has consistently increased over the last five years. In the case of interest rate derivatives, for example, the share of cleared transactions increased from 16% in 2007 to over 50% by the end of 2012. We expect this share will increase continuously as the clearing obligation comes into effect in many countries. Progress is, however, different among asset classes, and substantial scope still exists for further increasing central clearing.

A number of challenges still remain. Let me mention two key points in this regard.

First, I would like to recall that the introduction of mandatory clearing obligations raises new challenges in terms of the distribution and management of financial risk beyond the risk concentration in central counterparties.

Indeed, mandatory clearing implies that an increasing share of the risks arising from OTC derivatives transactions will also be concentrated in a few major clearing banks. This is because the mandatory clearing requirement implies that a larger pool of market participants will need to have access to central counterparties, while only a small part of this pool will be able to access the counterparties directly.

Indeed, central counterparties need to ensure that their direct members meet adequate standards in terms of financial soundness, technical and operational capacity, and product expertise. The enforcement of robust standards in this area is a critical first layer of defence against counterparty risk and ensures that central counterparties are able to swiftly manage a potential default situation. It is clear, however, that many market participants will not meet these stringent requirements and will therefore need to access central counterparties indirectly via a direct clearing member.

A number of risks are associated with this development. In particular, the systemic risk concentration in a small number of global financial institutions is further increased and an increasing number of foreign jurisdictions are exposed to risks arising from the potential default of those banks. This aggravates the risk that these financial institutions may act as contagion channels for financial disturbances and may become or be perceived to be “too big to fail”. In addition, as several countries outside the European Union and the United States have observed, an unfair cross-border distribution of the costs for central clearing could arise. Finally, corporate governance arrangements of central counterparties may not be sufficiently reflective of the interests of all stakeholders, particularly as regards indirect clearing members.

I am aware that several measures to control these risks are underway. Rules for central counterparties have been strengthened to ensure that they limit access restrictions to what is really necessary in order to manage the incurred risks and to ensure the central counterparties’ orderly default management processes. Similar governance rules now explicitly require central counterparties to adequately take into account the interests of clients and not only those of their direct members. Similarly, arrangements for the segregation and portability of client positions and collateral are being made. However, we will need to monitor very closely how these new requirements will work in practice, given the strong interest of global dealers in preserving their dominant position in the market. The aim of the new financial regulatory framework is to reduce risk in the global financial system, not to turn it upside down.

Furthermore, the measures adopted in this area are, in my view, not sufficient to capture the macro-prudential dimension of the problem. To this end it will be necessary to achieve, in addition to controlling the role of global dealers within each central counterparty, also a better understanding of the interdependencies between central counterparties. Indeed, even though OTC derivatives central counterparties are typically not interoperable, they are still closely linked owing to the fact that the major clearing banks typically participate in several of them at the same time. In order to be able to better identify and monitor the related contagion risks, we will need to significantly enhance information-sharing across central counterparties, including through access to relevant participant-level data, and conduct analytical work in this field.

However, it is not clear at this stage to what extent this analysis can and will be carried out. For instance, the European Market Infrastructure Regulation (EMIR) colleges focus on individual central counterparties. While major central banks of issue, such as the Eurosystem, could in principle support a horizontal risk assessment across central counterparties, given our participation across several EMIR colleges, it is still unclear what type of information we will receive and, in particular, to what extent this will include participant-level data. It will therefore be critical to ensure, in the context of the EMIR implementation, that information-sharing within the colleges will effectively address not only the micro-prudential concerns of authorities but also the need for appropriate macro-prudential analysis.

Second, another important concern regarding the institutional setting is the fact that global cooperative oversight arrangements for central counterparties are still lagging significantly behind what has been agreed in the CPSS-IOSCO Principles for financial market infrastructures.

Indeed, the respective gap between the EU level and the global level is striking in this regard. In the European Union, given the introduction of legally binding requirements for central counterparty supervisors to cooperate and consult with all relevant authorities – including central banks, supervisors of major clearing banks and supervisors/overseers of interoperable infrastructures – cooperative oversight arrangements for all EU central counterparties, in the form of EMIR colleges are currently being set up. At a global level, however, virtually no progress in cooperative oversight or even in terms of pure information-sharing has been achieved for several major global central counterparties outside the European Union.

This is a key concern especially in the field of OTC derivatives, given the global nature and interconnectedness of these markets. Indeed, if we want to ensure that the introduction of mandatory clearing is implemented in a way that ensures that central counterparties manage systemic risk effectively, it is not enough that they are supervised and overseen in their home jurisdiction. Instead, robust cross-border cooperative oversight arrangements are essential to ensure that they take fully into account the implications across jurisdictions and currencies in their on-going risk management, as well as in crisis situations, and that effective cross-border arrangements for the recovery or potential resolution of central counterparties in a crisis situation can be put in place. We should not wait for a potential emergency to remind us of the urgency of this problem. It would be too late to address it then, as the cross-border upheaval in the banking sector in the context of the 2008–09 financial crises amply demonstrated. And the consequences in the case of central counterparties would be even more devastating than what we have seen in the banking sector.

Cross-border application inconsistencies

Finally, let me briefly mention another area of concern: the cross-border application of different rules. I leave entirely aside the question of whether or not we are finished with the standard setting. There are areas where additional work would be beneficial: think of collateral transformation and settlement cycles, and of the success of Target2-Securities in fostering harmonisation around T+2 settlement in Europe. But this would require another conference and I will focus here on the application of existing rules.

It is clear to all of us that due to the global nature of the OTC derivatives markets, international coordination is absolutely indispensable to avoid inconsistencies, gaps or overlaps, or conflicting rules. At a more general level, the lack of a level playing field in the enforcement of the new financial standards has a potential to fragment the global financial system and to lead to a suboptimal allocation of capital of liquidity and to overconsumption of scarce resources, such as the safe assets used as collateral by financial market participants. OTC derivatives are a case in point.

I therefore strongly welcome the recent agreement reached between the European Commission and the US Commodity Futures Trading Commission (CFTC) on a common path forward regarding a number of measures on how to approach cross-border issues. In this context, the notion of substituted compliance is a useful tool, as it will help to reduce the risk of duplication and potential frictions of rules. Clearly, convergence at a very granular level may not be achieved. It may not even be desirable, as specific differences may reflect the specific institutional and regulatory frameworks in the jurisdictions concerned.

Nevertheless, it needs to be ensured that the outcome in all material aspects is similar. A key objective of the G20 mandate for OTC derivatives reform was to ensure effective systemic risk reduction in these markets. It is unlikely that we will achieve this objective by converging on the lowest common denominator rather than by achieving common best practices. However, this may be the result if substantive regulatory differences are not addressed and consequently, opportunities for regulatory arbitrage open up. The respective risk is pronounced, especially in view of the fact that most major OTC derivatives dealers are large cross-border banking groups that may be in a position to shift their OTC derivatives business to the most leniently regulated group entities.

As the European Commission and the CFTC noted in their recent statement on the "common path forward", one important open issue in this regard is the material difference in central counterparties' initial margin coverage between the European Union and the United States, for example in terms of confidence interval, procyclicality buffers and the scope for portfolio margining. I would like to add that different coverage requirements for central counterparties' financial resources, in terms of the liquidity and credit risk arising from the default of their largest members, are at least equally important.

In addition, it would seem helpful to broaden somewhat the attention concerning the global regulatory level playing field beyond the immediate concerns regarding EU-US divergence to all relevant jurisdictions.

Conclusion

It's time for me to conclude:

Yes, we have come a long way and a lot has been achieved since the Pittsburgh summit.

But as highlighted before, additional work will be required:

In the area of data and transparency we need to remove barriers to access and provide a mechanism to aggregate data across trade repositories and jurisdictions in order to be able to have a comprehensive overview of the risks in OTC derivatives markets. This is what the G20 leaders had in mind four years ago.

In the area of clearing we need to monitor the impact of mandatory clearing not only on central counterparties, in terms of capacity and risk management, but the focus should also be on whether an increase in indirect clearing changes the risk profile of the direct clearing members.

The reform will also have an impact on *collateral needs*, and we will hear more on this in tomorrow's academic session on the topic. However, authorities should monitor the availability of high quality collateral and related collateral management services. New risks that appear as a result of innovation, such as those relating to collateral transformation, need to be analysed and addressed. We should not wait for the next crisis to happen but need to be constantly vigilant.

Though substantial progress has been made, it is also true that only just over half of the FSB jurisdictions have implemented the reform agenda so far. Although these include the jurisdictions of the most important OTC derivatives markets, we need to be vigilant in order to avoid regulatory arbitrage – that is to say, business moving from jurisdictions that stick to the agreed agenda to others that lag behind.

Little over two weeks ago, the BIS published its macroeconomic impact assessment of OTC derivatives regulatory reforms. The results are promising. It concludes that the effects of (i) mandatory central clearing of standardised OTC derivatives, (ii) margin requirements for non-centrally cleared OTC derivatives and (iii) bank capital requirements for derivatives-related exposures will result in overall net benefits for economic growth.

I have spoken a lot about many technical issues. Let me therefore conclude by reminding you about the ultimate objective of this reform: to rebuild confidence in the financial system, which has been shattered in the recent years. Not only among market participants but in our societies as a whole, a good deal of trust has been lost. It is our shared responsibility that our societies regain this trust.

I wish you, for the rest of today and tomorrow, a successful and fruitful debate and exchange of views.

Thank you very much for your attention.