William C Dudley: Remarks at panel discussion on OTC derivatives reform and broader financial reforms agenda

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the 2013 OTC Derivatives Conference, Paris, France, 12 September 2013.

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It is a pleasure to be here. Who wouldn't want to be in Paris – anytime – let alone in September? My comments today will focus on how over-the-counter (OTC) derivatives reform fits in with the broader financial reform agenda and those aspects of the reform effort in OTC derivatives that could potentially fall short relative to those broader objectives. My short answer, which I will elaborate on in my remarks, is that the OTC derivatives reform effort fits in very well with the broader reform agenda, but there are significant risks that we will fall short in this arena relative to what we are likely to achieve elsewhere.

As I see it, the G20 reform effort for OTC derivatives has three broad goals:

- Reduce systemic risk with respect to OTC derivatives activities;
- Improve the ability to aggregate and analyze over-the-counter derivatives OTCD risk exposures across markets, institutions and product classes; and
- Improve competition and protect against market abuse.

Systemic risk is being reduced in a number of different ways. First, mandating the standardization, whenever possible, and central clearing of OTC derivative trades can reduce risk by transforming a complex web of bilateral firm exposures into a smaller set of net exposures between each dealer and the central counterparty (CCP). Given their role in fostering financial stability, robust financial market infrastructures (FMIs) that are properly risk-managed can serve as a source of strength in times of stress. Central clearing can also reduce systemic risk by requiring collateral from the participants. To the extent that the OTCD reform effort results in the greater use of collateral, that should also help make the system safer.

Second, increasing capital and liquidity requirements, improving governance, risk management, and resolution and recovery, as well as implementation of the Principles for Financial Market Infrastructures (PFMIs) promulgated by the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) should make FMIs more robust and resilient. FMIs performed well during the financial crisis, but with OTCD reform, we are asking FMIs to do even more, so the bar needs to be higher.

Third, firm-level risk management is being strengthened in a variety of ways such as requiring mandatory margin requirements for bespoke, non-cleared trades. Firms need to understand the risks associated with OTC derivatives activity and set aside capital and exchange margin to cover these risks. Moreover, authorities are developing supervisory approaches to oversee market infrastructures and participants to ensure compliance with evolving regulatory frameworks.

Activity in the OTC derivatives market is gradually being moved into clearer view. In particular, over time, mandatory reporting to trade repositories (TRs) and access to that data by regulators should facilitate the ability for supervisors and others to assess building risks in the global financial market more quickly and comprehensively.

Improving competition and protecting against market abuse are also important. These objectives are being accomplished by the increased use of electronic trading platforms and improving access to CCPs. This should lead to more competitive markets that will offer participants better liquidity and pricing and a greater degree of transparency.

In general, I think that the first two objectives of OTC derivatives reform fit in well with the goals of the broader financial reform effort undertaken in the wake of the financial crisis. I would characterize the goals of the broader effort as:

- Reducing the risk of failure of large systemically important financial institutions;
- Increasing the robustness of the system when such failures occur; and
- Obtaining better information more quickly about what is happening in the financial system so that the identification of incipient problems can be improved and the ultimate interventions – be they macroprudential or firm-specific – can occur earlier and with greater conviction.

Implementation of OTC derivatives reform should make the markets more resilient and should reduce the risk that they will be a source of contagion in stressed environments. Also, the risk of funding runs should be reduced by the increase in the quality of information on firm exposures that can be made available to regulators, and, in principle, through increased disclosure to market participants.

I also think that OTC derivatives reform is an important complement to the emphasis placed on strengthening individual institutions, which is part of the broader reform agenda. Financial stability is not just about individual institutions but also about how the entire system interacts. For example, are the incentives in the system appropriate and does the system amplify or dampen shocks? Thus, it is important that reform efforts not concentrate exclusively on the systemically important financial institutions, but also that these efforts focus on the market products and practices and the linkages among markets, market participants and infrastructures.

Despite the progress made to date, I do have some concerns about the OTC derivatives reform effort. My first concern is about pace. For example, it seems to me that we have made much more progress in strengthening individual institutions through higher bank capital and liquidity requirements than we have made in reducing risk in the OTCD space. Now some of this is inevitable because OTCD reform is harder and we are not as far along. It requires the creation of new institutions to clear such trades or to house the trade information. It also requires national legislation to be flexible enough so that it can work coherently on a global basis. The difficulty in harmonizing the regulatory treatment of cross-border OTCD activity is a good example of this. Parenthetically, I'd add that I am very pleased to see the breakthrough achieved between Europe and the U.S. this summer.

Regardless of the cause, because of the slower pace, we are not yet close to a harmonized, robust OTCD system. Thus, we can't ascertain whether we have achieved what we set out to achieve – that is, reducing the amount of risk in the system, making the infrastructure more secure, and increasing the flow of information so that regulators and others can develop a more coherent view of what is happening in the global financial system.

I'm also worried that even when we have finished revamping the architecture and regulation of OTC derivatives activities, reform may not go far enough in a number of respects. First, I am concerned that trades may not be standardized to the fullest degree possible. A preliminary analysis undertaken by the Financial Stability Board that compares the costs of clearing and margin requirements of standardized trades versus bespoke trades suggests that the economics with respect to costs favors standardizing OTCD trades whenever possible. However, the wider spreads that might be earned on bespoke trades, because of their greater opacity, could swing the needle the other way, with the higher profits on bespoke trades more than offsetting their higher costs. It is too soon to say yet, but we should be prepared to push harder for further standardization should the desired degree of standardization that we are striving for not materialize.

I also worry that implementation of the Principles for Financial Market Infrastructures could falter over time. This could happen for several reasons. In particular, we should recognize that there is a tension between the profit motive of for-profit CCPs and full compliance with the PFMIs. Put simply, some CCPs will prefer to avoid the full costs of compliance. In other words, there will always be a risk of a race to the bottom, which we must continually push against.

In this respect, the effort could also falter if countries were to fail to enact the relevant legislation and policies to put the PFMIs in practice. For the global system to be robust, the requirements for CCPs will need to be enforced across the different geographic regimes. I am also worried about fragmentation. In particular, I worry about the proliferation of TRs and CCPs geographically – in some cases in each of the major asset classes. In the case of CCPs, fragmentation would bring two costs. First, the netting benefits would be reduced and, second, the system would be more complex. In an ideal world, I would prefer very few, very robust CCPs, rather than a proliferation of many, less robust CCPs. But whether that is what we will get is unclear to me at this point.

Finally, I am worried that we are not going to achieve the full benefits from trade repositories. Regulators, market participants and TRs must continue to work together to ensure that comprehensive, and meaningful data are being reported to TRs and that authorities have the ability to access and analyze the data from the TRs. Although authorities currently receive data, the data are often fragmented and reported in different formats or are not comparable across TRs. This poses challenges for regulators and supervisors of market participants and global CCPs as well as authorities more broadly. Aside from the issues with TR fragmentation, data quality and regulatory access to data, we could be leaving considerable money on the table by not using the TR dataset to increase transparency into the marketplace more broadly.

Moving forward on all of these issues will require global coordination and continued efforts across all stakeholders. Authorities must continue to coordinate their oversight of global infrastructures*.* Where FMIs are "global," that is providing services across multiple jurisdictions and in multiple currencies, it is important for the relevant authorities to find efficient ways to cooperate with each other to effectively carry out their respective responsibilities. Additionally, where there are overlapping or contradicting regulations, authorities must provide clear guidance to the market on how regulation will be applied.

One final point: What matters is not the standardization of OTC derivatives, central clearing or the use of the trade repositories per se, but instead the results that flow from these efforts. These institutions are just devices to achieve an end – less risk, more robustness and greater transparency. In the end, we will need to assess our progress on OTCD reforms against those broader qualitative metrics.

Thank you very much for your kind attention.