Andreas Dombret: Global derivatives markets in transition

Guest contribution by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, published in the *Börsen-Zeitung* on 2 August 2013.

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The global derivatives markets are close to reaching a turning point. In future, the vast majority of risks associated with over-the-counter (OTC) derivative contracts will be shifted from market participants to central counterparties (CCPs). The aim of this regulatory change in market structure is to use CCPs as a tool to limit and cushion risks in the derivatives markets. The G20, comprising the 20 main industrialised and emerging market economies, agreed on this as long ago as 2009. Their decision has been followed by extensive legislative activity worldwide, with support being given by the Financial Stability Board (FSB). The recently found compromise between the US Commodity Futures Trading Commission (CFTC) and the European Commission on cross-border derivatives business should be seen as part of this regulatory convergence process. It is proof that, in the regulation of derivatives, policymakers around the globe are pulling together.

Worldwide, only a small percentage of OTC derivatives are at present settled via central clearing. For instance, a mere 13 % of credit derivatives are cleared through CCPs. The majority are subject to bilateral clearing agreements between the counterparties. Thus, the OTC derivative contracts that are traded around the world have led to a network in which a very small number of globally active banks play a major role. In the sub-market for credit default swaps, for example, the ten most important market participants are involved in more than 70 % of all transactions. Since the counterparties often cover only part of the counterparty risk associated with these transactions, these market participants in particular are a potential source of contagion risk.

Counterparty risks can be reduced by relocating them to CCPs, which continuously evaluate the open positions of the trading participants and demand a relatively high level of collateral. They can act as a risk buffer because of the extensive financial resources they have at their disposal; these comprise, among others, the clearing members' collateral, a clearing fund, obligations to make further contributions under additional margin calls, and the CCPs' own funds. According to the EU European Market Infrastructure Regulation (EMIR), in future CCPs will even have to be able to withstand the simultaneous default of the two largest clearing members.

Juggernauts of the financial system

At the moment, a requirement to clear derivatives with CCPs exists only in Japan and the United States. We expect mandatory CCP clearing to be introduced in the EU under EMIR from 2014 onwards. This means that the reforms are only slowly taking hold. Nevertheless, I am confident that the regulation will make itself felt in the foreseeable future and improve the structure of the derivatives markets.

However, we must be aware that these regulatory requirements will turn CCPs into "juggernauts" of the international financial system. For this reason, particular attention will have to be paid to the following points.

First, every CCP must have robust risk management structures in place. Competition among CCPs is growing more and more intense. This could lead to a race to the bottom, ie a situation in which CCPs undercut each other in terms of the size and quality of their margin requirements. It is up to the regulatory and supervisory authorities to prevent this from happening. Above all, it has to be assured that the CCPs' models for calculating margin requirements are sufficiently conservative.

Second, appropriate recovery and resolution regimes need to be available for CCPs in case of emergencies. The envisaged loss allocation rules are one core element in designing these regimes. The main problem with CCPs is that losses could only be distributed among clearing participants – a small group of market participants usually including, in particular, the globally active big banks –, giving rise to potential contagion risks and domino effects.

Risks through interoperability

Third, it must be ensured that central financial stability concerns do not take a back seat to issues of competition and efficiency. It would certainly be desirable from the derivative user's viewpoint if the CCPs became interconnected, ie interoperable. Market participants would then not need to join a number of different CCPs in order to settle contracts with counterparties that use other CCPs. However, in the interests of financial stability, I would warn against subscribing to the idea of CCP interoperability prematurely. We cannot yet say for sure that we would actually be able to handle the new dangers that interoperability would create – in particular because of the new channels of contagion that would arise.

Fourth, in the derivatives market we must beware of focusing exclusively on the function performed by CCPs. It is possible that a small number of banks, too, may in future accumulate high levels of risks. I refer here to banks which, as general clearing members (GCMs), are directly linked to CCPs, making them the "eye of the needle" through which CCP clearing must pass. The GCMs' central role has implications for financial stability on three accounts. They link the CCPs indirectly with each other, as in most cases they have connections with several CCPs; the default of one such bank would affect a number of CCPs simultaneously. Furthermore, the services provided by a GCM are crucial for its many clients; the question arises as to whether a GCM could be replaced. And finally, a bank acting as GCM faces additional risks, as it is liable vis-à-vis the CCP for the fulfilment of the obligations of its clients, who are indirectly linked to the CCP through the bank.

These points all serve to illustrate why supervisors will continue to keep a close watch on the future development of the derivatives markets. In Europe, EMIR in particular offers a good starting point for supervisory authorities to ensure that the change now under way helps achieve greater stability in the financial system.