

OTC Derivatives Market Reforms

Progress report on Implementation

In September 2009, G-20 Leaders agreed in Pittsburgh that:

All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.

In its October 2010 report on [Implementing OTC Derivatives Market Reforms](#) (the October Report), the FSB made 21 recommendations addressing practical issues that authorities may encounter in implementing the G-20 Leaders' commitments concerning standardisation, central clearing, exchange or electronic platform trading, and reporting of OTC derivatives transactions to trade repositories. At the November 2010 Seoul Summit, G-20 Leaders endorsed the FSB recommendations and asked the FSB to monitor OTC derivatives market reform progress regularly.

This is the first progress report by the FSB on OTC derivatives markets reform implementation. The body of this report is set out in two parts: (i) implementation by jurisdictions and progress in international bodies' workstreams; and (ii) overall observations on progress, including identification of issues meriting additional attention in the near term, and next steps.

The FSB notes that implementation is still in its early stages and that its next progress report (expected in September 2011) should provide greater insight into whether progress is on track. This report highlights a number of issues which will have a bearing on whether the G-20 commitments can be implemented in an internationally consistent manner by end-2012. The FSB notes its concern regarding many jurisdictions' likelihood of meeting the G-20 end-2012 deadline, and believes that in order for this target to be achieved, jurisdictions need to take substantial, concrete steps toward implementation immediately.

Implementation by jurisdictions and progress in international workstreams

January 2011 survey of FSB members

The FSB Secretariat conducted a survey in January 2011 of FSB members regarding their OTC derivatives market reforms implementation efforts. The responses show substantial variation across jurisdictions in the pace of implementing the recommendations in the October Report and the resulting progress toward achieving the G-20 commitments on standardisation, central clearing, exchange or electronic platform trading, and reporting to trade repositories.

In the largest, most developed OTC derivatives markets, major implementation projects are underway. In the United States, legislation has been enacted and implementing regulation is proceeding according to established timetables with respect to clearing, trading, and reporting to trade repositories (TRs); and in Japan, legislation has been enacted and implementing regulation is proceeding according to firm timetables with respect to clearing and reporting to trade repositories. In the European Union, legislation has been proposed and is expected to be adopted by end-2011 with respect to clearing and reporting to trade repositories, and is in the pre-proposal consultation stage regarding trading; while in Hong Kong the legal framework for a regulatory regime to govern an as-yet-to-be-established central counterparty (CCP) and trade repository is understood to be proposed during 2011.

In other markets with local or regional significance, there has been substantial policy analysis, but key legislative or regulatory next steps have yet to be taken. In Korea, the government has finalised plans for requiring mandatory central clearing, and a CCP is to be established by mid-2012. The government will propose legislation for approval by the Korean National Assembly in the second half of 2011. The Korean financial authority is also reviewing whether to establish a separate trade repository. In Canada, an inter-agency working group comprised of securities and prudential regulators, the finance ministry and the central bank has issued a report outlining key policy issues for the Canadian market; however, key decisions regarding whether to establish local infrastructure for clearing and transaction reporting or to rely on global infrastructure will be made in the course of 2011. Likewise in Australia, India, Mexico, Saudi Arabia, South Africa and Switzerland, financial authorities have embarked on an assessment of the derivatives markets operating within their jurisdictions and plan to decide upon future regulatory initiatives involving the implementation of the G-20 commitments in the course of 2011.

In some jurisdictions, while review of legislative and regulatory frameworks covering the spectrum of the G-20 commitments is ongoing, efforts have been made to introduce central clearing for OTC derivatives, but firm timetables for completion have not been established. In China, the central bank has required the use of standardised documentation and reporting to authorities of OTC derivatives transactions, and has promoted the establishment of a CCP to clear OTC derivatives. In Russia, legislation providing for central clearing of OTC derivatives was adopted in February 2011, while consideration of price transparency for OTC derivatives continues. The Indian central bank has developed the Clearing Corporation of India Limited to act as both CCP and trade repository in the Indian market, and has set up a working group to develop the modalities for a single-point reporting mechanism for all OTC interest rate and foreign exchange derivative transactions. It is intended to eventually clear all OTC derivatives transactions through the CCP. In Singapore, a preliminary industry consultation on the

regulatory regime and market structure is underway; meanwhile, the Singapore Exchange already offers central clearing for OTC commodity derivatives, and, as of November 2010, for interest rate swaps.

Some jurisdictions have regulatory regimes covering derivatives that have been in place for some time. In Brazil, for example, it is estimated that approximately 90% of all derivatives are standardised, exchange traded and centrally cleared; since 1994, all OTC derivatives transactions are required to be registered with trade repositories that are self-regulatory organisations. While work is taking place to improve the quality of information reported to trade repositories, the Brazilian questionnaire response indicates that authorities there do not see a need for a major legislative or regulatory initiative to achieve the G-20 commitments, given the highly standardised state of the market. In Argentina, bilaterally traded and settled derivatives comprise only about one-quarter of the market, as the other three-quarters of the market are centrally-cleared and either traded on exchange or on the Mercado Abierto Electrónico S.A. electronic platform, which is regulated by the Argentine market regulator.

In nascent markets, such as Indonesia and Turkey, consideration of approaches to implementing OTC derivatives market regulation is at an early stage.

FSB members also were asked whether the international workstreams underway covered the issues that need to be addressed to achieve full and internationally consistent implementation of the G-20 commitments by end-2012, and whether any emerging issues have been identified. While members were generally satisfied that the workstreams underway largely cover the appropriate issues, ongoing monitoring was seen to be key as implementation progresses further. The FSB considered the members' responses to these survey questions in developing the observations set out below.

International workstreams

In the October Report, the FSB recommended that appropriate international bodies with relevant expertise carry out needed work for the coordination of implementation of OTC derivatives market reforms in an internationally consistent and non-discriminatory way. Each of these international bodies has provided a report on progress achieved to date and its ongoing work.

The recommendations directed toward international bodies set out in the October Report are being undertaken through the following workstreams:

- BCBS work regarding the creation of incentives to centrally clear and higher capital charges for non-centrally cleared OTC derivatives (Basel III rule text published December 2010)¹ and the capitalisation of bank exposures to CCPs (consultative document published December 2010 and to be finalised during 2011)²
- CPSS-IOSCO review of standards for financial market infrastructures (consultation report published March 2011 and to be finalised by early 2012)³

¹ The Basel III rule text is available at: <http://www.bis.org/publ/bcbs189.pdf>.

² The consultative document is available at: <http://www.bis.org/publ/bcbs190.pdf>.

³ The consultative document is available at: <http://www.bis.org/publ/cpss94.htm>.

- CPSS-IOSCO report on derivatives data and aggregation requirements for reporting to trade repositories (consultation report to be published in July 2011 and finalised by end-2011)
- CPSS-IOSCO guidance, to be developed in consultation with the OTC Derivatives Regulators' Forum (ODRF), on sound cross-border oversight arrangements for financial market infrastructures including CCPs (no timetable set)
- IOSCO *Report on Trading of OTC Derivatives* (published February 2011)⁴
- IOSCO report on international standards to address coordination of central clearing requirements with respect to products and participants (and any exemptions from clearing requirements) (report expected January 2012)⁵
- ODRF fostering development of cooperative frameworks for information sharing and cooperation among relevant authorities concerning individual OTC derivatives market infrastructures (ongoing)⁶
- OTC Derivatives Supervisors Group (ODSG) development of a roadmap and commitments covering standardisation, among other things, by G-14 dealers and other major market participants (commitment letter delivered 31 March 2011)⁷
- ODSG, working with standard setters, BIS, and other relevant authorities and market participants, development of reporting metrics to measure to what extent the recommendations in the October Report and G-20 commitments are being met (by July 2011)

Observations and next steps

Drawing on its consideration of the survey responses and progress reports by international bodies, the FSB has a number of observations concerning implementation progress generally, and more specifically addressing standardisation, central clearing, organised platform trading, and reporting to trade repositories.

General

A great deal of work has been undertaken at national, regional, and international levels toward implementation of OTC derivatives market reforms. However, although it is still early to be assessing progress toward implementing the G-20 commitments across jurisdictions, it must be noted that there are a number of jurisdictions that have not yet taken threshold decisions regarding the shape of the regulatory framework for their respective markets. The FSB notes

⁴ The IOSCO Report on Trading of OTC Derivatives is available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD345.pdf>.

⁵ Recommendation 12 notes that to minimize the potential for regulatory arbitrage, IOSCO, working with other authorities as appropriate, should coordinate the application of central clearing requirements on a product and participant level, and any exemptions from them.

⁶ Recommendation 21 notes that ODRF, working with CPSS and IOSCO, should continue to foster development of common frameworks for effective cooperation and coordination on oversight arrangements and information sharing among the relevant authorities for individual trade repositories and systemically important OTC derivatives CCPs.

⁷ The commitment letter is available at: <http://www.newyorkfed.org/newsevents/news/markets/2011/an110405.html>.

its concern regarding many jurisdictions' likelihood of meeting the G-20 end-2012 deadline, and believes that in order for this target to be achieved, jurisdictions need to take substantial, concrete steps toward implementation immediately.

The FSB is concerned with the substantial variation across jurisdictions in the pace of implementation. Some jurisdictions expressed concern in their survey responses that implementation was proceeding too rapidly in some jurisdictions and too slowly in others. Another concern cited by some survey respondents was that the movement to central clearing was taking place before the issues related to the number and location of CCPs and TRs from a global perspective have been addressed. Some worried that the rushed pace of implementation might exacerbate, rather than mitigate, systemic risk.

The FSB believes a measured approach to consideration of new international workstreams to address emerging issues is warranted, as some fundamental work set out in the October Report recommendations is yet to be initiated or at a nascent stage. Accordingly, the FSB has specified below its observations on progress to date and the issues that are emerging as threshold issues or particularly timely.

Standardisation

The work that the ODSG has undertaken since 2005 was cited by several jurisdictions in their survey responses as key to increasing standardisation in the OTC derivatives market. Given the value of this work, authorities working with industry will continue to be crucial to achieving greater standardisation of contractual terms and operational processes.⁸ Therefore, whilst some have speculated that the ODSG's work in securing and monitoring commitments from G-14 dealers and buy-side participants may be unnecessary as regulatory regimes are established, the FSB supports the ODSG in continuing to work with G-14 dealers and other market participants, after establishing the 31 March 2011 roadmap, to ensure that targets set are achieved, and that future targets are developed as needed, consistent with regulatory frameworks established.

Central clearing

Different approaches to central clearing requirements appear to be emerging. The frameworks for central clearing in Japan, and United States and proposed in the European Union would provide for both "bottom up" and "top down" approaches,⁹ whilst some other jurisdictions have not yet decided whether to put in place a "top down" framework and currently rely on the "bottom up" approach alone. Monitoring efforts focused on the consistency of central clearing requirements will be critical. The IOSCO report on international standards addressing coordination of these requirements on the product and participant level, and any exemptions from clearing requirements, expected to be published in January 2012, will be important.

⁸ The ODSG work includes increasing both process and product standardisation through commitments for increased use of electronic processing and standard documentation. See http://www.newyorkfed.org/newsevents/otc_derivative.html.

⁹ The "bottom up" approach refers to a process through which contracts that a CCP proposes to clear are made subject to a mandatory clearing requirement by the relevant regulator. The "top down" approach means that the relevant regulator has the authority to identify OTC derivatives contracts that may be required to be cleared, irrespective of whether a CCP has yet proposed to clear them. Japan, the European Union and the United States have proposed frameworks that are not identical and differ with regard to particular constraints and authority that the relevant regulator has in taking regulatory actions.

Some jurisdictions also consider the issues around CCP interoperability and access to CCPs for smaller and cross-border market participants as threshold issues bearing on the achievability of the G-20 commitment to central clearing by end-2012, as well as on the appropriate structure of derivatives markets. Inefficient access to clearing may reinforce the role of global systemically important financial institutions (SIFIs). To help explore these issues and determine appropriate next steps, the CGFS, CPSS, and IOSCO held a forum in January 2011 and are organising follow-up work to promote expanding access to central clearing to a broader set of participants, and links between CCPs, without sacrificing the rigour of CCP risk controls. Among other things, CPSS and IOSCO will conduct a stocktaking of current participant requirements for OTC derivatives CCPs, and the CGFS has established a study group to consider the macro-financial implications of CCP access and links. Other issues relating to CCPs that the official sector will need to consider further include oversight arrangements, access to central bank liquidity and resolution regimes.

The FSB believes that ensuring fair and open access to CCPs, subject to sound risk management, is essential for the G-20 objectives for OTC derivatives market reforms to be achieved.

Exchange or electronic platform trading

In February 2011, IOSCO published its *Report on Trading of OTC Derivatives*. The report marks progress toward clarifying the G-20 commitment to exchange or electronic platform trading, where appropriate, of standardised OTC derivatives. The report concludes that it is appropriate to trade standardised derivatives products with a suitable degree of liquidity on organised platforms, and that a flexible approach to defining what constitutes an organised platform would maximise the number of standardised derivatives products that can be appropriately traded on these venues. Additionally, the report identifies characteristics that organised platforms should exhibit in order to fulfil the G-20 Leaders' objectives of improving transparency, mitigating systemic risk, and protecting against market abuse in the derivatives markets.

The FSB notes that while IOSCO task force members were in agreement on seven of eight characteristics of organised platforms, task force members were not in full agreement as to whether organised platforms must provide platform participants with the opportunity to seek liquidity and trade with multiple liquidity providers within a centralised system in order to meet the G-20 objectives for the derivatives markets. The report recognises that if jurisdictions choose to establish trading requirements that differ in this aspect, the resulting regulatory disparities have the potential to influence market participants' choice of venues in which to conduct business. The FSB has requested that IOSCO undertake further analysis on market use of multi- or single-dealer platforms.

Reporting to trade repositories

Unless jurisdictions take approaches to trade reporting requirements that are consistent with the recommendations of the October Report, the FSB is concerned that the data collected on OTC derivatives transactions may not be able to be readily aggregated on a global basis and that authorities may not have effective and practical access. Survey responses revealed that some jurisdictions will require market participants to report OTC derivatives transactions to

registered TRs, whilst others appear to consider reporting to governmental authorities, such as the central bank, sufficient.¹⁰

Survey responses also indicate questions regarding the depth and breadth of data that needs to be reported to trade repositories. Some have posited that a more limited data set is all that is needed for financial stability analysis. However, as discussed in the October Report, and confirmed by survey responses, authorities will rely on the data stored in trade repositories for a variety of purposes. These purposes include financial stability analysis, monitoring of the use of non-standardised products, post-trade transparency, and market surveillance.

For data to be useful and provide global coverage of the derivatives markets, it will need to be reported and stored in a form that can be readily aggregated within and across repositories. In this regard, the reports of CPSS and IOSCO on data reporting standards and aggregation (consultation to be published in July 2011), as well as on standards for financial market infrastructures (consultation published in March 2011, which addresses regulator access to trade repository data including on a cross-border basis), will be important.

Survey responses indicate that only a few jurisdictions have undertaken work to identify barriers to the collection and dissemination of trade data by repositories and begun to take steps to address them. The FSB is concerned with this because, as noted in the October Report, such barriers may be more widespread. The FSB believes jurisdictions should undertake work to identify any such barriers in their jurisdiction and address them as a matter of urgency. To this end, the FSB supports further analysis and assessment of this issue as part of the ODSG commitment process through leverage of the work that already has completed in connection with that process.

Overall assessment

Although many jurisdictions have yet to make key decisions regarding the shape of their regulatory framework for OTC derivatives regulation, differences in approaches are emerging. Implementation of the 21 recommendations set out in the October Report is needed to promote consistency of OTC derivatives market reforms across jurisdictions, and the relevant authorities, standard setters and other groups should continue to work together to achieve this. Recognising that ultimately there likely will be a range of jurisdictional approaches taken, the FSB recommends that the focus in assessing progress going forward should be on: (i) assessing the degree to which the commitments and objectives set by the G-20 are being met; (ii) highlighting areas where coordination of future steps toward achieving G-20 objectives are needed; and (iii) flagging where differences in approaches may foster or facilitate opportunities for regulatory arbitrage or subject market participants and infrastructures to conflicting regulatory requirements.

Next steps

As a basis for the FSB's next progress report in September 2011, the FSB secretariat plans to conduct a follow-up survey of FSB members in July. In addition to asking for a self-

¹⁰ Recommendation 18 in the October Report states that reporting to the relevant authority would be appropriate in exceptional circumstances if it is not possible to report a particular transaction to a trade repository.

assessment of whether progress is on track to achieve the G-20 commitments by end-2012, the survey will seek to elicit detailed information on potential emerging issues.¹¹

Future progress reports also will use the reporting metrics being developed under the leadership of the ODSG as they become available and are applicable to assess the extent to which the recommendations of the October Report, and more generally, the G-20 commitments to central clearing, exchange or electronic platform trading, and reporting to trade repositories, are on the way to being achieved.

¹¹ Based on the survey results and progress reports, the FSB has preliminarily identified potential emerging issues such as backloading of existing contracts and phasing in of requirements; coverage of clearing requirements by asset class; implementation of the “top down” approach to central clearing requirements; and organised platform trading on multidealer versus single dealer platforms.