Proposed regulatory changes to the treatment of derivatives

Ruth Frederick
Sidley Austin LLP

1. Introduction

Credit derivatives have received a great deal of attention due to their market size[1] and complexity, and the collapse or near-collapse of certain financial institutions that have substantial involvement in the credit default swap (CDS) market. While over-the-counter (OTC) derivatives were not in themselves the cause of the global financial crisis, the near-collapse of American International Group (AIG)[2] and Bear Stearns and the bankruptcy of Lehman Brothers – all heavily involved in the CDS market – have highlighted the extent to which the risks in the OTC derivatives market have gone undetected by both regulators and industry. This has revealed shortcomings in the management and regulation of counterparty credit risk, as well as a lack of transparency[3] in the OTC derivatives market, and has raised questions as to whether the OTC derivatives market should be allowed to continue to self-regulate.[4] These issues have led to derivatives regulation being at the forefront of debate in both the United States and Europe, and have prompted a global move to improve regulatory oversight and transparency in relation to the OTC derivatives markets.

This chapter examines the current proposals for the regulation of OTC derivatives in the United Kingdom and Europe, and the direction in which the regulation of OTC derivatives appears to be heading. However, as such proposals are constantly evolving, this chapter is not intended to be a comprehensive guide as to the current or future regulatory framework so far as OTC derivatives are concerned.

2. Counterparty risk and transparency risk

Broadly speaking, a derivatives contract is a financial instrument between two parties in which they agree to exchange cash or assets in amounts and on dates that are dependent on the occurrence of certain predefined future events, and is intended to assist parties in managing and sharing risk. One predominant risk associated with

1 According to statistics released by the Bank of International Settlements, as of June 2009 the value of unsettled OTC derivative contracts worldwide exceeded $600 trillion.

2 AIG had issued more than $400 billion of unhedged credit default swaps. When the value of those swaps started to decline and AIG suffered two downgrades, AIG's counterparties began calling for collateral to secure its payment obligations under those swaps, which led to AIG needing to be bailed out by the Federal Reserve to avoid further systemic consequences.

3 In that it appeared more difficult to see behind the bilaterally negotiated OTC derivatives contracts.

4 To date, the OTC derivatives market has been only lightly regulated, on the assumption that its key participants – professional investors – should be aware of the risks associated with OTC derivatives and should be in a position to effectively manage and hedge their exposures.

such an agreement is the risk of one party not fulfilling its obligation to pay cash or deliver assets. This risk is sometimes described as ‘counterparty risk’ or ‘default risk’. Counterparty risk is sometimes difficult to evaluate because the exposure of the counterparty to various risks is generally not public information, and this risk can be worsened if a counterparty enters into similar contracts with one or more other market participants. If a large financial institution has accumulated large positions with other counterparties and then defaults, such counterparties may also suffer substantial losses, which in turn may create systemic risk in the markets generally.

The momentous events relating to, among others, AIG and Lehman revealed the lack of transparency in the OTC markets, as neither the regulators nor the market was aware of the extent of the credit default swap exposures that AIG and Lehman had accumulated. This in turn raised the question of whether AIG’s true risk as a counterparty was reflected in the prices of, and risk controls (eg, collateral or margining arrangements) for, credit protection that market parties had purchased from AIG. These concerns led to a call by regulators for more robust counterparty risk management, greater transparency and more stringent reporting requirements.

3. Overview of current proposals

The push for reform of the OTC derivatives market has progressed at an international level. Regulators in Europe and the United States, in collaboration with the industry, are considering various regulatory reforms which are intended to address systemic risk and transparency issues.

3.1 Global perspective

During the 2009 G20[5] Summit, the G20 agreed on a commitment to “promote the standardisation and resilience of credit derivatives markets, in particular through the establishment of central clearing counterparties subject to effective regulation and supervision”.[6] Subsequently, at their meeting in Pittsburgh on September 25 2009, they made the following declaration:

> *All standardized 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 Financial Stability Board*[7] *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.*[8]

3.2 European perspective

The European Commission’s view is that there should be a shift from the viewpoint

---

5 The Group of Twenty Finance Ministers and Central Bank Governors (G20) is a group of finance ministers and central bank governors from 20 economies: 19 countries plus the European Union.

6 G20 Declaration on Strengthening the Financial System, London, April 2 2009.

7 The Financial Stability Board was established to develop and implement regulatory, supervisory and other policies in the interests of financial stability (www.financialstabilityboard.org).

8 Leaders Statement, The Pittsburgh Summit, September 24-25 2009 (http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf).

that light-handed regulation of derivatives is sufficient to a view that legislation is required to allow the markets to price risk appropriately. Accordingly, on October 20 2009 and following a public consultation, the commission published its proposals[9] for future policy actions for reform for the OTC derivatives markets, which it proposed to be implemented during 2010.

The commission's proposals focused on four key areas:

- Reducing counterparty credit risk – the commission concluded that the global financial crisis demonstrated that market participants had failed properly to price counterparty credit risk, and that such risk can be managed using either bilateral or central clearing.
- Reducing operational risk – the commission proposed to legislate for the use of data repositories to reduce operational risk and to encourage standardisation of the contractual terms for OTC derivatives contracts.
- Increasing market transparency – the commission proposed that legislation be implemented to require market participants to report on OTC derivatives contracts that are not centrally cleared through data repositories. It is anticipated that further legislation will regulate such data repositories by mid-2010. Proposals have also been made to legislate for the trading of standardised derivatives on exchanges and other trading platforms.
- Improving market integrity and oversight – with the view that trading in the CDS market is more liquid and less transparent, which could make it easier for dealers to conceal abusive activities, a review of the market manipulation provisions of the Market Abuse Directive during 2010 may extend the scope of such provisions to apply to derivatives and give regulators the ability to set position limits.

In recognition of the international nature of the OTC market and to avoid market participants structuring transactions with the aim of cherry picking the most lenient of the regulatory rules,[10] the commission proposed to develop comprehensive and wide-ranging policies for the OTC derivatives market as a whole rather than using a product-specific (eg, credit default swap only) regulatory approach, and stated that it would be desirable that any legislation should be consistent with non-EU markets and, in particular, the approach adopted in the United States. However, the commission did acknowledge that any proposals should take into account the specific nature of each asset class type of each derivatives product and the specific differences between financial and non-financial institutions.[11]

In recognition of the potential costs to market participants of implementing the proposed regulatory reforms, the commission has acknowledged the need to carry out impact assessments before finalising its proposals, to take into consideration the views of market participants on the costs and benefits of implementing them.

9 "Ensuring efficient, safe and sound derivatives markets: Future policy actions" (COM (2009) 563), published by the European Commission on October 20 2009.

10 Sometimes described as regulatory arbitrage.

11 Non-financial (eg, corporate) institutions use OTC derivatives to hedge, for example, the impact of movements in currencies, interest rates, commodities and other prices.

3.3 UK perspective

The commission's proposals are not binding in the United Kingdom, as any European-wide regulatory proposals will need to be implemented into the national law of each country. In the case of the United Kingdom, changes will need to be made to the prudential rules of the Financial Services Authority (FSA).

The FSA and Her Majesty's (HM) Treasury (together, the UK regulators) jointly released a discussion paper in December 2009[12] on the proposed reforms to the OTC derivatives market. Although fundamentally in agreement with the key proposals made by the commission as to the need to address systemic shortcomings in the OTC derivatives market, the paper challenges some of the proposals put forward by the commission. However, the UK regulators agree that regulatory reforms should be internationally consistent to maximise their impact.

Like their counterparts in the United States and the European Union, the UK regulators favour:

- more robust counterparty risk management tools;
- greater standardisation of OTC derivatives contracts;
- higher capital charges for firms conducting non-standardised transactions that adequately reflect the potential risks faced by the financial system;
- registration of all relevant OTC derivatives transactions in a trade repository;
- greater disclosure of OTC trades to the market;
- consistent and high global standards for central counterparties;
- greater transparency of OTC trades to the market; and
- on-exchange trading.

However, the joint paper also describes some of the measures that have been proposed elsewhere as being potentially damaging to the financial markets. For example, in relation to the proposal for the mandatory clearing of standardised contracts through central counterparties, the UK regulators are of the view that central counterparties should not be forced to clear a product if they are unable to manage the risks of doing so. In addition, standardisation should not be the sole criterion in determining whether a product is eligible for central counterparty clearing; other factors, such as the regular availability of prices and sufficient market liquidity, should also be considered. Other issues raised by the UK regulators in their joint paper should be reconciled with the US and EU approaches during 2010.

3.4 US perspective

Changes in derivatives regulation are planned in the United States, with numerous draft bills currently under consideration.

On May 13 2009 the Obama administration proposed a regulatory framework with the aim of promoting greater transparency and regulation to the OTC derivatives markets in the United States.[13] Broadly speaking, the US proposals to

12 *Reforming OTC Derivative Markets, a UK perspective*, Financial Services Authority and HM Treasury, December 2009.

13 Regulatory Reform Over-the-Counter (OTC) Derivatives, May 13 2009, tg-129 (www.treas.gov/press/releases/tg129.htm).

reform the regulation of the OTC derivatives market would require:

- the compulsory clearing of all standardised OTC derivatives contracts through regulated central counterparties;
- the movement of standardised OTC derivatives transactions onto regulated exchanges; and
- the promotion of transparency, giving regulators the power to require the reporting of trades on a regulated trade repository, increased margin requirements for derivatives contracts that are not centrally cleared and the imposition of position limits to limit speculation in commodity derivatives underlying assets.

Central counterparties and trade repositories will also be required to disclose information on open positions and trading volumes to the markets, and to disclose information on individual counterparties' trades and positions to US federal regulators. The US reform proposal also stipulates that OTC derivatives dealers that build up large exposures to counterparties should be subject to a regime of prudential supervision and regulation, which will include conservative capital requirements, business conduct standards and certain reporting requirements.

With the aim of implementing such proposals into law, numerous draft bills are currently under consideration in the United States. However, the extent to which such proposals will become law or will be allowed to be regulated by market participants and the scope of any reporting requirement to trade repositories remain the subject of intense debate in the US Senate.

4. Standardisation of OTC contracts

In the joint paper, the FSA and HM Treasury present the view that standardisation of OTC derivatives contracts is key to the realisation of many of the proposed regulatory changes, including facilitating the trading of OTC derivatices contracts on a central clearing platform as well as enabling better comparability between products and thus greater liquidity.[14] The UK regulators made the following statement: *"In aggregate these market developments would allow participants to trade, settle and monitor positions in a more straightforward way and it could encourage the use, where feasible, of simpler derivatives thereby reducing unnecessary complexity and facilitating more robust risk management"*.[15]

UK regulators believe there should be a move to greater standardisation of OTC derivative contracts irrespective of whether these products are then cleared or traded on an exchange. However, what will constitute "standardised" and "non-standardised" OTC derivative contracts has not yet been agreed. Consequently, UK regulators have called for an international agreement between regulators and market participants as to what standardisation means on an asset class by asset class basis.

---

14 Reforming OTC Derivative Markets, a UK perspective, by the Financial Services Authority and HM Treasury, December 2009, para. 3.3.

15 Reforming OTC Derivative Markets, a UK perspective, by the Financial Services Authority and HM Treasury, December 2009, para. 3.3.

4.1 Progress to date

Substantial progress has already been made by industry itself, with the support of The International Swaps and Derivatives Association (ISDA),[16] in standardising the terms of OTC derivative contracts. The main example is the launch by ISDA of the Big Bang and Small Bang Protocols for credit derivatives transactions.

(a) Big Bang and Small Bang Protocols

Many CDS contracts are settled physically by the delivery of bonds from one transaction participant to its counterparty. A large number of transactions that reference the same bond could result in the same bond being required to be transferred, for the purposes of settlement, multiple times within a given period. Not only would this prove operationally burdensome but the limited availability of the bond would render it far more expensive to settle. As a consequence of such a rise in operational difficulties and costs in the settlement of credit derivative transactions, during 2005, ISDA commenced publishing auction protocols for settlement of CDS. Market participants can agree that their CDS transactions be bound by this auction protocol.[17] Under the protocol, following the occurrence of a credit event with respect to a reference entity or asset, the relevant determinations committee[18] will decide by a majority vote whether to hold an auction. If an auction is to take place it will be conducted by a panel of dealers to establish a fair market price for the bonds which would otherwise have to be delivered, and then requires the net cash settlement of each transaction to take place at the agreed auction price. The auction protocol process had been adhered to and supported by a large proportion of the industry both on the buy-side[19] and the sell-side.[20]

This initiative lead to the auction settlement process being permanently built (or hard wired) into the ISDA documentation through the following protocols:

- On 12 March, 2009, ISDA published the 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement Supplement to the 2003 ISDA Credit Derivatives Definitions (the Supplement) and the 2009 ISDA

16 www.isda.org.

17 Certain transactions, such as fixed recovery transactions (i.e. where losses are set out at the inception of the CDS contract) are not suitable for the auction settlement process and so the settlement price for such transactions will still be determined by either cash settlement or physical settlement.

18 The Supplement provides for the formation of five different regional (namely the Americas, EMEA, Australia-New Zealand, Asia (excluding Japan) and Japan) committees of rotating ISDA members to make determinations regarding the details of a credit event. Each determinations committee will be comprised of eight global dealers, two regional dealers, five buy-side members, two non-voting dealers (one global, one regional) and one non-voting, buy-side member. Criteria for dealers to be included on a determinations committee will be based on trading volume. Non-dealer members that wish to be considered for inclusion in the pool of members in the non-dealer committee from which buy-side members of the determinations committee are randomly chosen must have (i) at least $1 billion in assets under management and (ii) notional single-name CDS trade exposure of at least $1 billion. The determinations committee will be responsible for determining, among other things, whether and when a credit event has occurred, the date on which the requirement to deliver a notice of publicly available information with respect to a credit event is satisfied, the date of receipt of a credit event notice and whether to hold one or more auctions with respect to a credit event.

19 Buy side is a term used in the financial services industry to refer to institutions concerned with buying, rather than selling, securities and may include for example, corporate entities, mutual funds, hedge funds and pension funds.

20 Sell side is a term used in the financial services industry to refer to firms that sell investment services such as broking, dealing, investment banking and investment advisory functions.

Credit Derivatives Determinations Committees and Auction Settlement CDS Protocol (the Big Bang Protocol).

- On 14 July, 2009, ISDA then published a further Supplement (the Restructuring Supplement) to the 2003 ISDA Credit Derivatives Definitions to extend the auction hardwiring provisions (implemented by the Big Bang Protocol) to restructuring credit events. The Restructuring Supplement can be hardwired into the confirmations of new CDS contracts and into existing CDS contracts through the 2009 ISDA Credit Derivatives Determinations Committees, Auction Settlement and Restructuring CDS Protocol.

Three of the key features of the amendments are to:

- add the concept of "Auction Settlement" to the 2003 ISDA Credit Derivatives Definitions and, therefore, allow parties to settle transactions through the auction settlement process;
- implement "60 day look-back"[21] provisions with respect to credit events, and "90 day look-back"[22] provisions with respect to succession events; and
- establish a credit derivatives determination committees for determining matters related to whether a credit event or succession event has occurred and to establish certain rules for each committee.

The changes introduced by the supplements and the Small Bang and Big Bang Protocols facilitate consistent determinations by a committee as to whether a credit event or succession event has occurred which should in turn provide greater liquidity to the market, reduce the amount of effort required to settle a credit default swap and ultimately support central clearing and greater transparency.

The settlement of OTC derivative contracts via the auction process is seen by industry to be a very successful settlement mechanism. It has worked as industry had intended with reduced net exposures across the market without the systemic risks that the market expected may occur following a credit event or collapse of a large financial institution. For example, following the bankruptcy of Lehman, a notional amount of $400 billion became payable to the buyers of credit protection against Lehman insolvency. However, as a result of the settlement auction that took place during September 2008 in relation to Lehman, counterparties were able to net

21 Prior to the Supplements taking effect, the term of protection (i.e. the period during which the occurrence of a credit event will obligate the protection seller to make a credit protection payment to the protection buyer) ran from the effective date of the CDS contract to the scheduled termination date (subject to any grace periods or potential credit events) so a transaction entered into in January could not be fully hedged by entering into a back-to-back transaction in December since the December transaction would not require the protection seller to make payments for any later discovered credit events that occurred during January. The Supplement changed the term of credit protection to 60 days preceding the present date so that all CDS that are subject to the Supplement will cover the same term of credit protection. The effective date for each transaction has become a rolling date as the current date less 60 days (for example, the effective date of a trade concluded on 22 June would be 22 April) then on 23 June, the effective date for that trade would become 23 April and so on). This compares with pre-Big Bang position in which the effective date is the day after the trade is executed and remains that date for the life of the trade. The advantage of this change is that counterparties can capture events that are not easily observable (for example, a payment being missed without the public noticing or a non-obvious succession event occurring) thus eliminating uncertainty.

22 A similar, albeit longer, 90-day look back period was created for Succession Event determinations.

amounts they owed against amounts owed to them, which resulted in $5.2 billion of credit protection payments being paid, a significantly reduced amount.

4.2 Further proposals

Although other steps have been taken by industry to move towards greater standardisation,[23] the Commission is considering incentivising further standardisation by implementing greater capital charges for non-standardised derivative contracts through the Capital Requirements Directive (CRD).[24] UK regulators support the Commission's objectives in this respect and have been working with CRD working groups to establish appropriate capital charges.

5. Central Clearing

One possible consequence of the global financial crisis and in particular the demise of Bear Stearns, Lehman and the near collapse of AIG, is that large financial institutions are no longer considered to be "too big to fail", which view is shared by industry and regulators alike. As a consequence, the Commission and the UK regulators see the use of CCPs as key to mitigating the perceived systemic impact of a default of a major counterparty to an OTC derivative contract and, therefore, intend to encourage a greater proportion of the OTC derivatives market to adopt central clearing. To this end the Commission will be proposing legislation during 2010 to establish consistent, Europe-wide regulatory and operational standards for all CCPs.

2.1 What is clearing?

Broadly, clearing includes all activities from the time two parties agree to enter into a transaction until that transaction is settled. The clearing process includes reconciliation of trades, risk margining and the management of credit exposures, to ensure that trades are settled smoothly in accordance with market rules. Reconciliation or trade matching will involve the matching of the terms of the transaction to ensure that they reflect each parties' records. Risk margining and the management of credit exposures may involve the provision of collateral and margin to secure a party's performance under the transaction. And finally settlement, which is the last step in the post-trade process, involves the transfer of cash or assets between the parties to satisfy their respective payment or delivery obligations under the transaction.

2.2 What is central clearing?

After two parties enter into a transaction, the transaction is novated to a central counterparty which takes on the sole credit risk by becoming the buyer to every seller and the seller to every buyer under two, new, back-to-back derivatives contracts25. If, for example, a bank that is counterparty to the transaction defaults, the CCP will

---

23 Such as the publication by ISDA of new master confirmation agreements for equity derivatives.

24 Directive 2006/48/EC of the European Parliament and of the Council of 14 June, 2006 relating to the taking up and pursuit of the business of credit institutions (OJ L 177, 30.6.2006, p. 1).