ISDA® Briefing Notes

Derivatives markets today: increased transparency and reduced counterparty risk

The Dodd-Frank Act: Five Years On

On July 21, 2010, US President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into US law. Quickly shortened to the Dodd-Frank Act or simply 'Dodd-Frank', the 848-page piece of legislation was intended to reduce the potential for future financial crises and end the perception that large financial institutions are too big to fail.

In doing so, it touched virtually all aspects of the US financial system, from bank resolution, derivatives regulation and bank structure, to regulatory oversight, executive compensation and investor and consumer protection.

Five years on, much of the framework envisaged by Dodd-Frank is in place. In particular, most of the requirements contained within Title VII – the section relating to derivatives – have been implemented, resulting in the launch of clearing mandates, trade execution requirements and reporting and transparency obligations.

Given this progress, now is the time to focus on ensuring regulatory regimes are consistent and harmonized across borders, and to ensure they support risk management that enables economic activity and growth.

This paper briefly summarizes the main milestones of the Dodd-Frank derivatives reforms over the past five years, and outlines some of the outstanding issues.

PROGRESS IN TITLE VII

Title VII Progress – At a Glance		
Issue	**Dodd-Frank Requirement**	**Progress**
Clearing	The Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission can mandate a derivatives class for clearing (the relevant authority depends on whether the derivative instrument is classed as a 'swap' or 'security based swap'), so long as it is accepted for clearing by an authorized derivatives clearing organization.	The CFTC's first clearing mandates came into force in 2013. Approximately three quarters of interest rate derivatives and credit default swap (CDS) index average daily notional volume is now cleared.
Trade execution	Cleared derivatives must be traded on a regulated exchange or a so-called swap execution facility (SEF), so long as those instruments are made available to trade by an exchange or SEF.	The first trading mandates under the CFTC's SEF rules were introduced in February 2014. More than half of interest rate derivatives and 65% of CDS index average daily notional volume is now SEF traded.
Reporting	Information relating to any derivatives transaction must be reported to an authorized swap data repository (SDR) for regulatory reporting. Certain pricing and transaction data also has to be publicly reported.	Under CFTC rules, all swaps involving a US person are now required to be reported to US SDRs, giving regulators full transparency down to the counterparty level.
Regulation of swap dealers (SDs) and major swap participants (MSPs)	Swap market participants must register with regulators if they meet the criteria for an SD or MSP. These entities are required to meet a variety of requirements relating to business conduct, capital and margin, reporting and record keeping.	104 firms have registered with the CFTC as SDs. Capital and margin rules are close to finalization.

Approximately 75% of interest rate derivatives and CDS index average daily notional volume is now cleared

Clearing

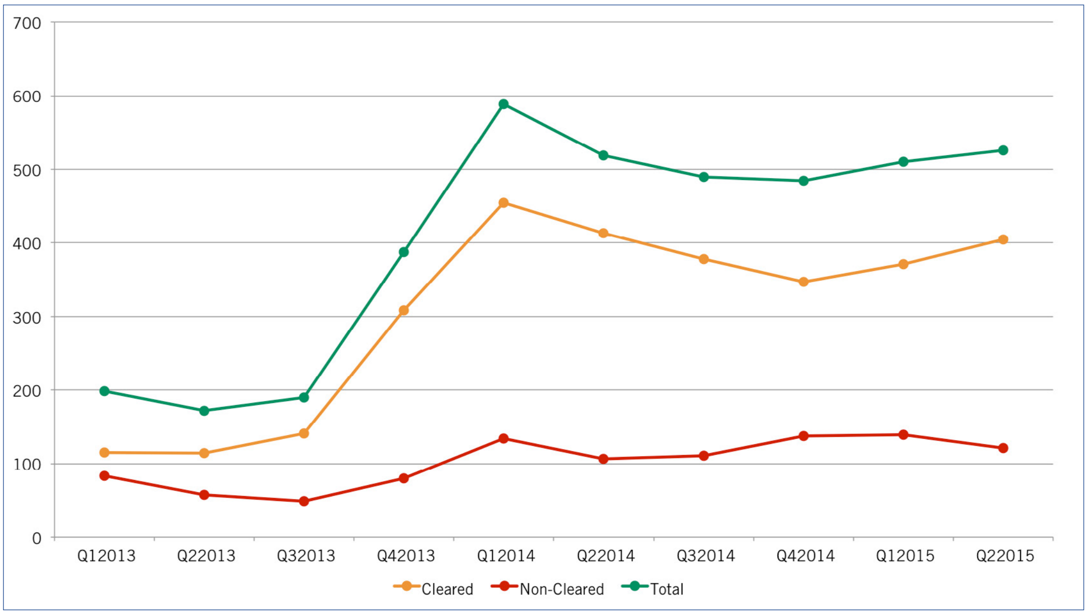
A large proportion of the interest rate derivatives and credit default swap (CDS) index market is now centrally cleared[1]. For interest rate derivatives, 76.5% of average daily notional volume was cleared over the whole of 2014, according to US swap data repository (SDR) information compiled by ISDA SwapsInfo.org (see Chart 1)[2]. That compares with 57.9% in the first quarter of 2013, before the US clearing mandates came into force. The high proportion of cleared trades has continued into 2015, with 72.5% of notional volume cleared each day on average in the first quarter of 2015, increasing to 77% in the second quarter.

The interest rate derivatives market is the largest derivatives asset class, comprising 80% of total derivatives notional outstanding, according to the Bank for International Settlements.

It's a similar story in the CDS index market. According to ISDA SwapsInfo analysis, 74.7% of daily average notional volume was cleared over the course of 2014 (see Chart 2). That proportion increased to 80.6% over the first three months of 2015, but fell slightly to 74.3% in the three months to June 30.

During the first half of 2015, 75% of average daily interest rate derivatives notional volume was cleared.

Chart 1: Interest rate derivatives average daily notional volume: total, cleared, non-cleared (US$ billions)



Source: ISDA SwapsInfo data (DTCC/Bloomberg SDRs).

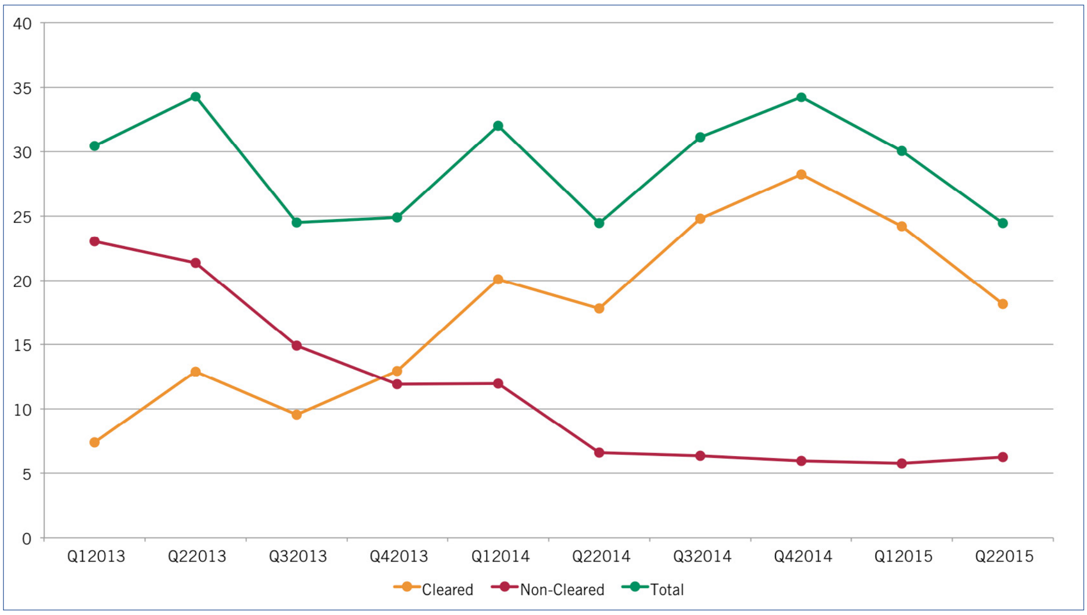
Please note: US reporting mandates came into force throughout 2013

[1] The first Dodd-Frank clearing obligations were introduced by the CFTC in 2013 for certain interest rate and credit derivatives classes

[2] ISDA SwapsInfo.org compiles data from the DTCC and Bloomberg SDRs

Chart 2: CDS index average daily notional volume: total, cleared, non-cleared (US$ billions)

During the first half of 2015, 78% of average daily CDS index notional volume was cleared.



Source: ISDA SwapsInfo data (DTCC/Bloomberg SDRs).

Please note: US reporting mandates came into force throughout 2013

The volume of cleared trades is likely to increase over time as clearing houses expand their product offerings and clearing mandates come into force in other jurisdictions[3]. Nonetheless, certain instruments are likely to remain outside of clearing. Regulators have said they will consider the depth of the market, availability of prices and number of clearing members when making clearing obligation determinations – criteria that may not be met for certain instruments, currencies and maturities. Exemptions to the clearing mandate also exist for commercial end users.

Dodd-Frank recognizes there is a place for customized, less liquid instruments to enable counterparties to closely hedge specific risks. As such, it acknowledges the need for non-cleared derivatives and requires regulators to set capital and margin requirements for them (see *Regulation of SDs and MSPs* section). Dodd-Frank also recognizes that the hedging and risk mitigation activities of commercial end users should not be caught by the derivatives reforms.

[3] The first European Union clearing mandates for certain interest rate derivatives are expected to come into force in early 2016. Other countries, including China, India, Japan and South Korea, have already introduced clearing mandates for certain products

Approximately 55% of interest rate derivatives and 65% of CDS index average daily notional volumes are now traded on SEFs

Trade Execution

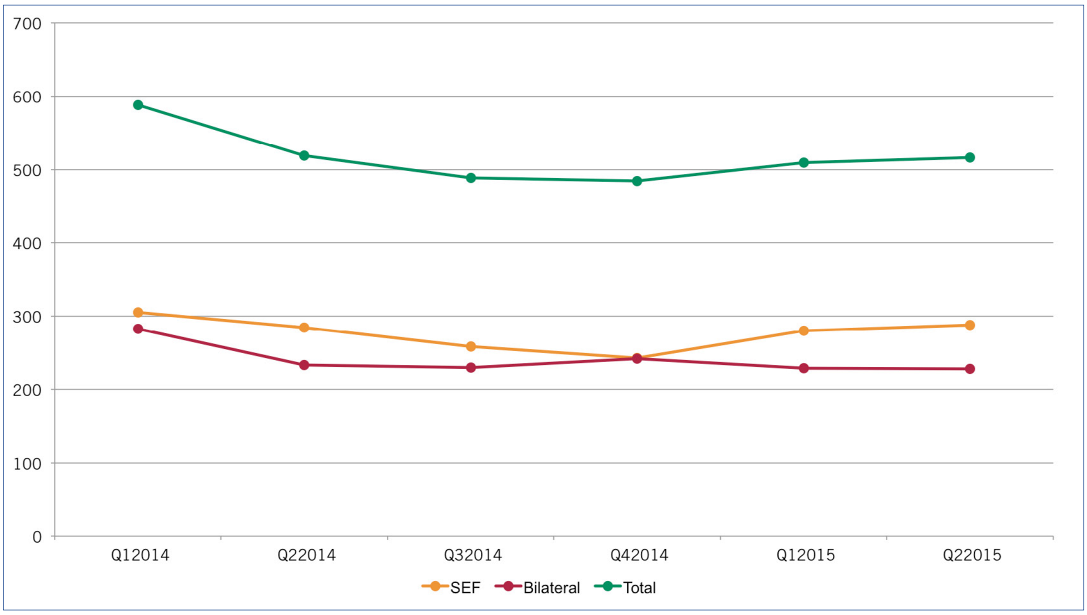
The Commodity Futures Trading Commission's (CFTC) swap execution facility (SEF) rules were introduced on October 3, 2013, and the first interest rate and credit derivatives products were required to be traded on these venues from February 14, 2014, having been classified as 'made available to trade' (MAT).

Since the introduction of the first SEF mandates, the proportion of derivatives transactions that are executed on these platforms has increased rapidly in both the interest rate and credit derivatives sectors. According to US SDR data compiled by ISDA SwapsInfo.org, 52.4% of average daily interest rate derivatives notional volume was SEF traded in 2014, up from negligible levels before the trading mandates came into force (see Chart 3). That proportion increased slightly in the first half of 2015, rising to 54.5% in the first quarter and 55.7% in the next three-month period.

SEF trading also accounted for a high proportion of CDS index average daily notional volume: 62.5% over the whole of 2014, and 70.7% in the first quarter of 2015 (see Chart 4). That fell slightly to 65% in the second quarter.

During the first six months of 2015, 55% of average daily interest rate derivatives notional volume was traded on a SEF.

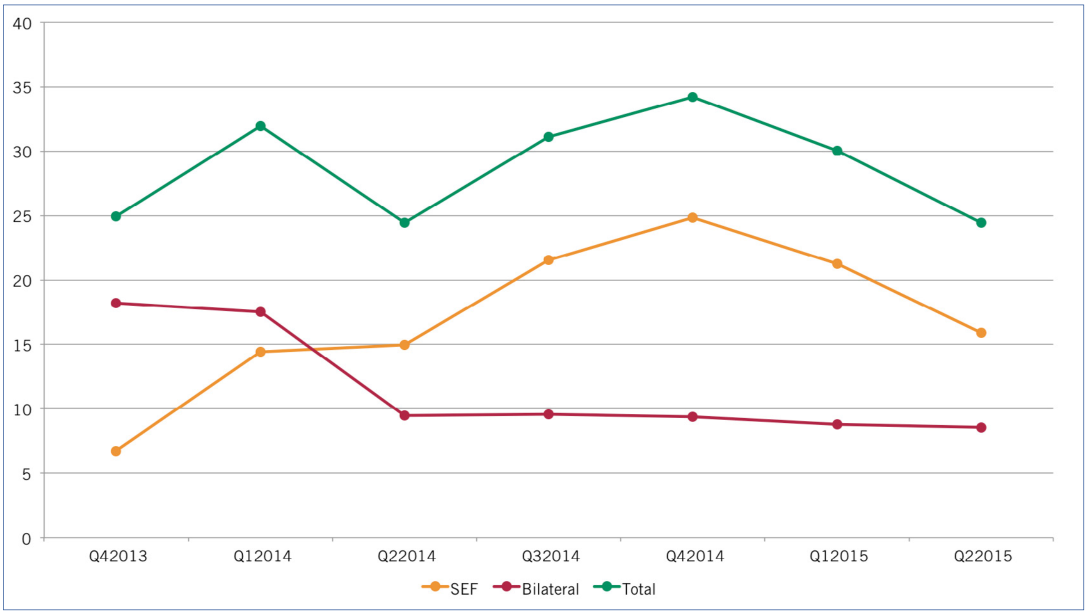
Chart 3: Interest rate derivatives average daily notional volume: total, SEF, bilateral (US$ billions)



Source: ISDA SwapsInfo data (DTCC/Bloomberg SDRs)

During the first six months of 2015, 69% of average daily CDS index notional volume was traded on a SEF.

Chart 4: CDS index average daily notional volume: total, SEF, bilateral (US$ billions)



Source: ISDA SwapsInfo data (DTCC/Bloomberg SDRs)

All swap transactions involving a US person are now required by the CFTC to be reported to a swap data repository, giving regulators the ability to spot systemic risks

Reporting

The first US reporting obligations for swaps came into force on December 31, 2012, starting with interest rate and credit derivatives trades conducted by swap dealers (SDs) and major swap participants (MSPs). By the end of 2013, all traded swaps instruments were required to be reported under CFTC rules. Regulators have full access to this information, giving them the ability to drill down to the individual trade or counterparty level. Regulators in theory can also aggregate this data, enabling them to observe broader trends and/or concentrations in the market that may pose a systemic threat.

Along with regulatory transparency obligations, Dodd-Frank requires certain derivatives transaction and pricing data to be reported to an SDR and made publically available "as soon as technologically practical" after execution, subject to a delay for trades with large notional amounts (ie, block trades).

Large derivatives market participants must register with US regulators, and are subject to strict business conduct standards

Regulation of SDs and MSPs

The Dodd-Frank Act created two categories of swaps participant for those firms with high levels of trading activity – SDs and MSPs. These entities had to register with the CFTC from December 31, 2012 (see Table 1), and are required to meet a number of regulatory requirements, including:

Margin requirements: Dodd-Frank recognizes there is a place for bespoke derivatives instruments that enable corporate and financial institution end users to closely match and offset risks. It also acknowledges that less liquid derivatives instruments, currencies and/or maturities may not be suitable for clearing[4]. As a result, the Dodd-Frank Act requires regulators to set margin requirements for non-cleared derivatives to mitigate risk (see box, *The Role of Non-cleared Derivatives*).

These rules are now close to finalization. The Basel Committee on Banking Supervision and International Organization of Securities Commissions (IOSCO) published a final global margining framework in September 2013, which calls for eligible counterparties to post initial and variation margin on non-cleared derivatives trades. US prudential regulators and the CFTC published separate national-level proposals in September 2014, and final rules are expected to be released in the third quarter of this year. The margin requirements are expected to be phased in from September 2016.

The Role of Non-cleared Derivatives

Central clearing of derivatives is growing rapidly, but a significant share of the derivatives market will remain outside of clearing houses. These non-cleared instruments are not necessarily more complex than cleared transactions, nor do they pose significantly more risk. In some cases, the contracts have non-standard terms because they are customized for a particular client. In others, a lack of liquidity and the relatively small number of dealers active in trading a particular product might mean there are too few firms to participate in the clearing house default management process, making clearing houses reluctant to take on a particular instrument.

Nonetheless, these instruments are often vital elements in the risk management strategies of corporates, insurance companies, pension funds, sovereigns, smaller financial institutions and others. Without them, these entities may experience greater earnings volatility due to an inability to qualify for hedge accounting, or be unable to offset the interest rate, inflation and longevity risks posed by long-dated pension or insurance liabilities.

For instance, a US exporter has issued a US dollar bond to grow its domestic business, but earns most of its revenue from exports to Europe. If the dollar strengthens against the euro, the company will face financial statement and cashflow volatility. It will therefore need to allocate a larger amount of its euro cashflow to service its dollar-denominated debt. To hedge this risk, the firm could swap the loan into euros using a cross-currency swap, allowing it to better match the currency in which revenues are received and interest expense is paid. Cross-currency swaps are currently not cleared.

[4] Clearing houses typically consider the depth of the market, liquidity and availability of prices, among other factors, when deciding whether to clear a derivatives instrument – criteria also considered by regulators when deciding whether to apply a clearing mandate. Some highly customized and/or illiquid derivatives sub-classes don't meet those requirements. Exemptions to the clearing mandate also exist for corporate end users under Dodd-Frank

Capital requirements: Dodd-Frank requires swap dealers to be subject to strict capital requirements to mitigate risk. A key driver has been a desire to incentivize clearing through higher capital requirements for non-cleared trades. Changes to the capital rules have been agreed at a global level through the Basel Committee, and involve increased bank capital requirements, higher quality capital, enhanced market risk rules, greater focus on counterparty credit risk, new liquidity requirements, a leverage ratio and a capital surcharge for systemically important banks. The Basel Committee has set a phase-in schedule from 2013 through to 2019.

Business conduct standards: SDs and MSPs are subject to a variety of other obligations covering external business conduct (eg, know-your-counterparty and fair dealing requirements, and obligations to disclose material risks of a swap), documentation (eg, swap trading relationship documents), internal business conduct (eg, confirmation standards, portfolio reconciliation, written policies and procedures for compression) and record keeping.

Table 1: CFTC provisional registrations (June 25, 2015)

CFTC registration requirement	No. of provisional registrations
Swap dealer	104
Major swap participant	1
Swap execution facility	21
Swap data repository	4

Source: CFTC

WHAT NOW FOR TITLE VII?

Despite the significant progress in transparency and risk management practices that have been spurred by Dodd-Frank, it is becoming increasingly clear that a number of challenges remain to be resolved. Given the size and complexity of Dodd-Frank, the speed with which it was finalized, and the pace at which the rules were implemented, it is understandable that some elements of the reform have not worked as intended. Five years on from the enactment of the Dodd-Frank Act, it is now an opportune moment to review those challenges and consider whether and how the rules can be improved.

Divergences in rules across jurisdictions have caused a fragmentation of liquidity pools, which will ultimately increase costs for end users

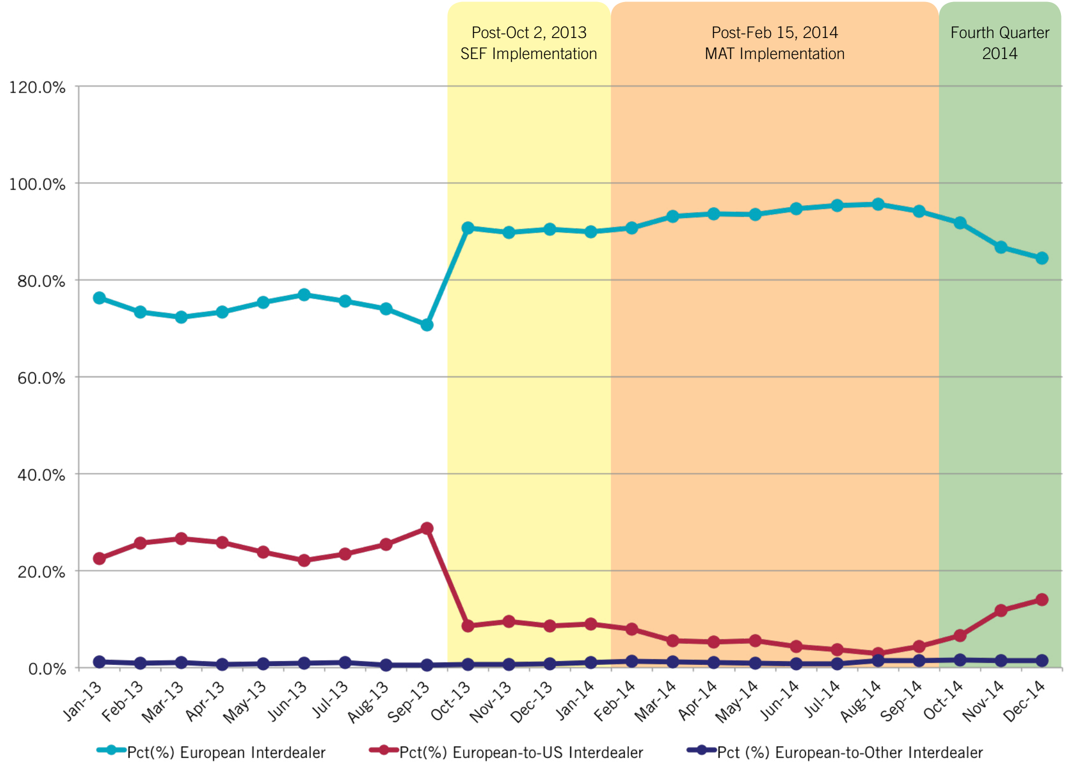
Cross-border Harmonization

A number of differences have emerged in the timing and substance of derivatives regulations in individual jurisdictions. Rather than being subject to multiple, potentially inconsistent requirements, derivatives users are increasingly choosing to trade with counterparties in their own jurisdictions. The result is a fragmentation of liquidity pools along geographic lines, which reduces choice, increases costs, and will make it more challenging for end users to enter into or unwind large transactions, particularly in stressed markets.

ISDA research shows 87.7% of regional European interdealer volume in euro interest rate swaps was traded between European dealers in the fourth quarter of 2014, compared with 73.4% in the third quarter of 2013 (see Chart 5). The change in trading behavior coincided with the introduction of US SEF rules, which encouraged non-US entities to avoid trading mandated products with US counterparties, so as not to be required to trade on a CFTC-registered SEF that offers restrictive methods of execution for these instruments. US entities, conversely, are unable to access the most liquid pool for euro interest rate swaps, which is centred in Europe, away from SEFs.

Chart 5: The European market for euro IRS: percentage of market share

Trading of euro interest rate swaps between European dealers jumped after the US SEF rules came into force in October 2013.



Source: LCH.Clearnet

To avoid liquidity fragmentation, regulators should work to harmonize rule sets as far as possible, particularly in clearing, trading and reporting. US counterparties should be allowed to apply overseas rules when trading in non-domestic jurisdictions, so long as the overseas regulatory regime is deemed to be equivalent to US regulations. A transparent substituted compliance mechanism based on broad outcomes, rather than a granular rule-by-rule comparison, would help minimize the problems caused by cross-border discrepancies.

Title VII – Areas of Focus	
Issue	**To be Addressed**
Cross-border harmonization	Markets are fragmenting as a result of duplicative requirements and inconsistencies in global rule sets, reducing liquidity and choice and increasing costs for end users. Greater harmonization of national rules is required, alongside a transparent process for determining equivalence based on broad outcomes.
Clearing	Central counterparties have become systemically important. More work is needed to ensure they are resilient – for example, through greater transparency on margin methodologies and minimum standards for stress tests. Further regulatory input is also required on acceptable recovery tools and the conditions for resolution that do not involve use of public money.
Commercial end users	Legislative action is needed to make clear that end users that hedge through centralized treasury units (CTUs) in order to net and consolidate their hedging activities are eligible for the clearing exemption. Many CTUs classify as financial entities under Dodd-Frank, subjecting them to clearing requirements. While the CFTC has issued no-action relief, legislation clarifying that end users using these efficient structures are exempt would provide greater certainty.
Trade execution	Targeted amendments of US SEF rules – for instance, allowing greater flexibility in execution methods in certain cases – would encourage more trading on these venues and help facilitate cross-border harmonization. Further refinements, including to the MAT determinations process (the CFTC should make the final decision following a short public consultation, and a new mechanism should be introduced to allow a SEF or SEF user to petition for the removal of a MAT determination if liquidity conditions change) and block trade rules (removal of the requirement for block trades to be executed away from SEFs), would also help eliminate incongruities.
Reporting	Regulators are unable to gain a clear picture of global risk exposures and possible concentrations because of differences in reporting requirements within and across borders. Regulators across the globe need to identify and agree on the trade data they need to fulfill their supervisory responsibilities, and then issue consistent reporting requirements. The Dodd-Frank SDR indemnification requirements should be repealed to foster greater cross-border sharing of data. Further work is also needed by the industry and regulators to develop and then adopt standardized product and transaction identifiers, as well as reporting formats. ISDA has played a leading role in this area through its taxonomies, FpML reporting standard and unique trade identifier prefix service (UTIPrefix.org), among other things.
Regulation of SDs and MSPs	Despite the requirement to register with the CFTC as SDs or MSPs from December 31, 2012, all firms remain provisionally registered. Likewise, all SEF and SDR registrations are provisional. Final registration is needed so these firms can put an end to regulatory doubt.
Margin	Finalizing the non-cleared derivatives margin rules swiftly is important in order to maximize the time for preparation. ISDA has been leading industry implementation efforts – for example, through the development of the ISDA Standard Initial Margin Model (ISDA SIMM), a common calculation engine for computing initial margin requirements, which will reduce the potential for disputes. But certainty in the rules is required in order to progress this effort. Achieving global consistency in the rule sets is also imperative. For example, proposals from US prudential regulators would subject transactions between affiliates of the same financial group to margin requirements, putting financial institutions operating in the US at a competitive disadvantage internationally.
Capital	Capital rules should be globally consistent to prevent financial institutions and non-financial corporates in one jurisdiction being put at a competitive disadvantage. Regulation should be coherent and appropriate to the risk of a given activity. The interplay of the various regulatory components should be comprehensively assessed to ensure the cumulative impact is fully understood to avoid excessively high financing costs for borrowers and increased hedging costs for end users.

Substantial progress has been made, but certain elements of derivatives reform should be modified to strengthen markets and facilitate end-user hedging

CONCLUSION

US legislators moved quickly to draw up and finalize the Dodd-Frank Act in response to the financial crisis. Five years on from its enactment, the vast majority of the key requirements on derivatives have been implemented. The first US clearing mandates, for example, were introduced in 2013. All swaps transactions involving a US person are now required by the CFTC to be reported to SDRs, and SEF trading volumes increased rapidly following the first MAT determinations in 2014.

But this first-mover status has also created problems. The speed with which the legislation was drawn up meant little time was given to coordination and cooperation with non-US legislators. Differences in implementation schedules and in the substance of the regulation in different jurisdictions have emerged as a result.

With other jurisdictions now developing or implementing comparable rules, there is now an opportunity to harmonize the various regulations to facilitate cross-border trading. Critical to this initiative is an effective and transparent substituted compliance framework. Efforts to achieve equivalence between jurisdictions have foundered on several occasions because regulators have conducted a granular, rule-by-rule comparison of the requirements. Substituted compliance determinations based on broad outcomes would maximize the potential for cross-border harmonization.

FURTHER READING

ISDA has published best-practice principles in many of these areas:

CROSS-BORDER HARMONIZATION

Read ISDA's principles for effective substituted compliance:
http://isda.link/commonexamples

CLEARING AND CCPs

Read ISDA's principles for CCP recovery:
http://isda.link/ccprecoverypaper

Read ISDA's principles for CCP default management, recovery and continuity:
http://isda.link/ccppaper

TRADE EXECUTION

Read ISDA's principles on the path forward for centralized execution of swaps:
http://isda.link/sefpaper

REPORTING

Read ISDA's principles on improving the regulatory transparency of global derivatives markets:
http://isda.link/datapaper

REGULATION OF SDs AND MSPs

Visit ISDA's Working Group on Margining Requirements page:
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