Growing China's Derivatives Markets
June 5, 2017, Beijing
Scott O'Malia, Chief Executive, ISDA – Opening Remarks

Ladies and gentlemen – good morning and welcome.

It's a great privilege to have so many distinguished speakers and guests here today. Thank you all for coming. I'd like to extend particular thanks to our keynote speaker – Mr. Li Haichao, deputy director-general, department of futures supervision, at China Securities Regulatory Commission (CSRC) – and to our sponsor, Bank of China.

The fact that so many prominent and respected market experts have come here today illustrates the growing importance of the derivatives market in China, both domestically and internationally. Certainly, China is a major priority for ISDA and its members. ISDA is committed to ensuring the growth of safe and efficient markets across the globe, and we will be a strong partner to Chinese market participants and institutions now and in the years ahead.

I am grateful we are joined by so many guests and dignitaries who are also focused on the future of the derivatives markets, and the importance of building those markets on a strong and predictable legal foundation. Today's conference will discuss important topics, such the necessity of a globally consistent and recognized close-out netting solution, and how the evolving global financial regulatory environment requires greater harmonization to achieve growth goals.

As the world's second largest economy and the third largest debt market, China is an extremely important player on the world stage. This was most recently confirmed by the International Monetary Fund's decision to include renminbi (RMB) in its special drawing rights basket.

With this growth, financial markets have flourished – and that includes the development of the domestic derivatives market. Increasingly, derivatives are being recognized as an important risk management tool by both foreign and domestic companies in China.

These companies might use derivatives to hedge their foreign exchange exposures, or lock in financing costs through an interest rate swap and hedge their interest rate exposure.

Use of these valuable risk management tools has been helped by the ongoing liberalization of China's financial markets. Recent developments include an expansion in the list of eligible investors in the onshore interbank bond market, and permission for foreign investors to use onshore foreign exchange derivatives such as forwards, swaps and options to hedge their bond positions. That should help improve liquidity in the market further.

Last year also saw some pilot credit default swap trades following the publication of new regulatory guidelines on credit risk mitigation, setting the foundations for a domestic credit derivatives market. Meanwhile, commodities trading remains strong, reflecting China's position as the largest consumer of raw materials. This has led to the launch of new hedging products, including the country's first listed commodity options earlier this year on the Dalian and Zhengzhou commodity exchanges.

In addition to further opening up of the onshore market, Chinese financial institutions and exchanges have also increased their overseas footprint significantly as a result of RMB internationalization – and the 'one belt and one road' initiative affirms China's further financial integration. For example, Frankfurt-headquartered CEINEX – a joint venture formed by Shanghai Stock Exchange, Deutsche Börse and China Financial Futures Exchange – has provided a new gateway for global firms to invest in the world's second largest economy through its offering of China- and RMB-related investment products.

With this expansion and diversification, it is inevitable there will be a greater reliance on robust derivatives markets to manage and hedge risk exposures for both domestic and international participants. This means it's important that the right foundations are in place to support this growth, such as a sound legal infrastructure and common standards. ISDA is working with members to make international regulators aware of the challenges and the opportunities involved.

Perhaps chief among these is netting enforceability, both under the margin rules and in other regulatory contexts. It's an issue we at ISDA care passionately about. In fact, you could say it is the foundation of our very existence. Three decades ago, ISDA published the first version of the Master Agreement, a standard legal template for derivatives trades that allowed for close-out netting – setting the derivatives market on an extraordinary path of growth.

Close-out netting is the basis of good risk management, and results in drastically lower credit exposures between counterparties. Being able to offset the positive and negative values of multiple trades between a pair of counterparties into a single net payment from one to the other means a default will be less disruptive to the financial system.

ISDA has long campaigned for netting certainty, and we've worked with authorities across the globe to help them draft legislation on the enforceability of close-out netting. So far, we have netting opinions in more than 60 countries, with others in the pipeline. We believe the development of close-out netting legislation in China will create more certainty for financial institutions, and encourage more participation. Once these elements are introduced, the conditions will be in place for China's derivatives markets to further develop and flourish.

We are making progress, and ISDA recently published a netting opinion for certain Chinese sovereign entities not subject to China's enterprise bankruptcy law, as well as an update to our China netting memorandum.

This is just a part of the work that ISDA does. We are a global organization, with more than 890 members across 68 countries. We have offices in seven locations on three continents. That's given us a deep understanding of the global regulatory framework. We stand ready to share this experience with our members in China, and to facilitate discussion and education on some of the issues and challenges that have been faced elsewhere.

Market education and sharing of best practice will be critical to this effort. This was an important motivation for a memorandum of understanding signed between ISDA and China

Futures Association at the end of 2015. By working together and cooperating closely, our two associations will act as a forum for industry discussion and sharing of expertise. I'd like to take this opportunity to thank Zheng Xiaoguo, vice chairman at China Futures Association, for moderating our first panel discussion today.

Alongside the need for sharing of best practice, the growth and internationalization of China's financial markets also creates a greater need for harmonization of rule sets across jurisdictions. Simply put, harmonization adds to market depth and liquidity, which reduces costs and increases choice for end users.

That brings me to the broader topic of global regulatory change, and its impact on China.

Back in September 2009, the Group of 20 (G-20) agreed to reform derivatives markets in several key ways. They agreed that standardized derivatives should be cleared through a central counterparty, and traded on exchanges or electronic trading platforms where appropriate. All derivatives would have to be reported to a trade repository, and capital requirements would be higher for non-cleared transactions. A requirement to post margin on non-cleared derivatives was also added in 2011.

Eight years on from that initial commitment by the G-20, significant progress has been made across all areas. Reporting of all derivatives trades is now required virtually everywhere, and regulators have ready access to that information in their own markets. Clearing of standardized derivatives has quickly gained traction, and now about three-quarters of interest rate derivatives notional outstanding is cleared through a central counterparty (CCP). Margin requirements are being rolled out for non-cleared transactions in the US, the European Union, Canada, Switzerland, Japan, Hong Kong, Singapore and Australia.

As a G-20 member, China has made good progress in rolling out the reforms. Reporting of derivatives transactions is required, and the first clearing mandate for interest rate swaps came into force in July 2014. By last year, about 99% of CNY interest rate swaps were cleared – well above the global average.

Clearing has also moved beyond the scope of the mandates. Last year, Shanghai Clearing House launched a clearing service for certain FX options – a notable development and significant innovation.

But harmonization and cooperation between regulators and rule sets is also critical. This is particularly important when it comes to standards on the safety and soundness of the most systemically important market infrastructures – the clearing house.

Without equivalence and recognition of clearing houses across jurisdictions, the global derivatives market will be split into pockets of liquidity. Under Commodity Futures Trading Commission (CFTC) rules in the US, for instance, US persons can only clear at a derivatives clearing organization that has registered with the CFTC or has received an exemption.

Likewise, non-recognition of a third-country CCP by the European Securities and Markets Authority (ESMA) means EU banks and investment firms will eventually be subject to punitive capital requirements for cleared positions, as these non-recognized clearing houses would be classified as non-qualifying CCPs for the purposes of the EU Capital Requirements Regulation. That will make it difficult for EU participants to use these CCPs.

Why does this matter? Because as markets grow and become more international, anything that hampers the ability of a local counterparty to trade with a foreign participant, or vice versa, reduces potential liquidity and market depth. Less liquidity means less choice, and could make it more challenging for end users to properly manage their risks, particularly in stressed markets.

In that light, we welcome the announcement by the CFTC that Shanghai Clearing House has received no-action relief until the end of November, allowing clearing members that are US persons or affiliates of US persons to clear proprietary trades.

We also welcome the recent inclusion of Shanghai Clearing House on the list of third-country CCPs that have applied to ESMA for recognition. We hope that full recognition, based on consistent application of global standards, will be granted

I would like to bring another matter to your attention regarding the global requirements for non-cleared margin. Under these rules, US- and European-regulated entities are required to collect on a gross basis when trading with counterparties in non-netting jurisdictions[1]. That makes trading with US and EU counterparties that are subject to the rules more expensive for entities in non-netting jurisdictions. Not surprising, it has made domestic entities in China reluctant to trade with foreign counterparties under those terms, which reduces their potential pool of counterparties. This is another reason to implement a netting solution in China.

Over the past eight years, financial markets and their participants have undergone a significant and lasting transformation. ISDA has helped its members through this process by providing global solutions on legal documentation. This has ensured that all participants are in compliance with their own country's rules, and allowed global solutions to ensure cross-border trading and capital flow to come into effect. As the global reforms are nearing completion, we are looking to the future to see how we can find new solutions and opportunities.

The first opportunity we see relates to market innovation and technology. The current market structure is built on a bilateral framework that is both inefficient and non-scalable. While we have been quite successful in establishing legal and documentation standards, there is much more work to be done on data and operation process standards. By harmonizing these elements, we can facilitate the deployment of new technologies, such as distributed ledger and smart contracts, but also facilitate greater interoperability. Once a foundation of common standards is built, automation can lead the way.

Our second opportunity is China. While the derivatives market may still be in its relatively early stage of development, I am confident it will continue grow and mature. As the market continues to expand, we must all work together to ensure it functions in an efficient way that reduces complexity, costs and operational risk in future. It is also important the rules align with global regulatory standards to ensure Chinese markets are recognized by others and meet or exceed international standards.

[1] Except when EU entities can satisfy the conditions of the exemption in Article 31(2) of the EU margin regulatory technical standards

To some extent, China has an advantage, because much of the infrastructure is being built from the ground up. Chinese counterparties don't have years of legacy systems and processes to overhaul. But it's also important to make sure growth is on firm foundations from the start. That means common standards, common processes and strong legal structures. Close-out netting is a critical component of that.

I hope you enjoy the rest of the conference. Thanks again for coming today. Thanks also to our distinguished keynote speaker, Mr. Li Haichao, and to all our speakers and moderators. Thanks again also to our sponsor, Bank of China.

Thank you.