ISDA Safe, Efficient Markets

Whitepaper series "Incentives to Clear"
Clearing in Smaller or Closed Jurisdictions

The whitepaper series

This whitepaper is part of a series of papers developed by ISDA members to complement the work of the FSB Derivatives Assessment Team and their post-implementation evaluation of the effects of the G20 financial regulatory reforms[1].

Summary

Mandatory clearing requirements might not be an appropriate tool in jurisdictions with a relatively small derivatives market or exchange controls, as such markets might not have the degree of standardisation across derivative contracts or sufficient market depth to establish a well-managed, cost efficient CCP.[2]

We recommend that such markets focus on implementation of a clean netting regime prior to establishing any clearing mandate. Reliable netting will enable the development of more liquid and standardised derivatives markets. Even then, the FSB criteria for mandatory clearing should be applied carefully: it might well be the case that no local derivatives contracts meet these criteria, but local firms already clear derivatives in globally systemically important currencies, for instance because their counterparties are under a clearing mandate and therefore demonstrate level of voluntary clearing sufficient to mitigate systemic risk.

The issue

The G20 commitments to OTC derivative market reform and the risk mitigation tools like mandatory clearing or bilateral exchange of initial margin, are best suited to jurisdictions with large, developed derivatives market, with a sufficient degree of contract standardization and market liquidity[3] [4]. The

[1] http://www.fsb.org/2018/08/fsb-and-standard-setting-bodies-consult-on-effects-of-reforms-on-incentives-to-centrally-clear-over-the-counter-derivatives/

[2] Please note that the majority of comments are focussed on jurisdictions with closed economies. However many of the points made are also valid for small jurisdictions in general unless these jurisdictions have easy access to global CCPs.

[3] See section 4 in the FSB report "Monitoring the effects of agreed regulatory reforms on emerging market and developing economies (EMDEs)" (http://www.fsb.org/wp-content/uploads/Monitoring-the-effects-of-reforms-on-EMDEs.pdf):

[4] Please also see 1.4 in the executive summary of the B20 report "B20 The Impact of Regulatory Reforms on Emerging Markets" (http://globalsummitryproject.com.s197331.gridserver.com/archive/b20-2012_los_cabos/www.b20.org/pdf/03.The.Impact.of.Regulatory.Reforms.on.Emerging.Markets.pdf): *The impact and trade-offs of regulatory change may be very different for emerging markets than for the advanced economies. The international regulatory reform agenda has been driven primarily in response to the problems*

predominant aim of clearing and exchange of initial margin for bilateral transactions is to reduce systemic risk, at the cost of implementing additional market infrastructure. Small derivatives markets are unlikely to pose systemic risk, while at the same time these markets might not be large enough to sustain the implementation of dedicated CCPs or infrastructure to safely exchange bilateral margin. There are also further complications to clearing in small or closed derivatives markets. In some cases, bilateral exchange of initial margin may be a more effective and efficient means to reduce systemic risk for such jurisdictions.

In their report "OTC Markets and Derivatives Trading in Emerging Markets", IOSCO provides the recommendation "*Recommendation 6: While jurisdictions that have relatively large and complex OTC markets should assess the use of CCP clearing for CCP eligible products, the jurisdictions which have relatively small and non-complex markets should not need to centrally clear the transactions, as it may impose a considerable cost in doing so."*

Jurisdictions with small or closed financial markets will not be able to benefit from the efficiencies of global CCPs. This is because:

- Such global CCPs would not be able to settle margin flows in the unconvertible local currency.
- Local firms might be small in relation to access criteria.
- Local collateral might not be eligible for the global CCP.
- Local clearing members might not be able to participate in the default management.
- Global firms might not be able to bid for portfolios that include transactions in a restricted currency.

Setting up a local CCP could be very inefficient for small jurisdiction and could pose risk issues particular to developing markets:

- *High fixed cost:* Setting up the operational capabilities and a credible, PFMI compliant risk management framework is not dependent on the size of the CCP. If a local CCP has to cover the cost of an initial investment that is comparable to a global CCP, this CCP has either to charge significant higher clearing fees or cut corners in their risk management framework.
- *Less Mutualisation:* Such a CCP will have fewer clearing members with a lower level of sophistication and experience in clearing. If one of those members defaults, there are fewer members to bid at the auction, to accept clients of the defaulted member for porting, and to pay into recovery tools.
- *Correlation:* Local members will be more correlated with each other and could be susceptible to the same shocks in the local economy.
- *Directionality:* With fewer, smaller firms serving a similar type of clients, those local clearing members could all have portfolios that are similarly directional. If the majority of clearing members have similar positions, those clearing members will not be incentivised to bid aggressively in the auction if one of them defaults.
- *Availability of HQLA:* Local clearing members, especially if the currency is not convertible, could have issues sourcing HQLA. If the HQLA is collateral from another jurisdiction, the CCP

encountered in the advanced economies during the global financial crisis. Emerging markets are typically very different in terms of the health of their banking systems, the development of their capital and broader financial markets, and in the financial needs of the broader economy, given the pace and stage of economic growth and development. Consequently, it may be that some regulatory changes aimed at curbing problems in developed financial markets may not be appropriate for emerging markets where starting positions and dynamics are different.

has to either accept credit risk, or has to allow local collateral and local cash. Local collateral could mean the CCP will have to charge higher haircuts than for HQLA.

- *Wrong way risk:* A local CCP with local clearing members, clearing transactions in local currency collateralised with local collateral will have to deal with large degrees of wrong-way risk and make the market less stable in a crisis.
- *Legal Basis:* Local law might pose difficulties for the CCP in setting up enforceable collateral and netting provisions, affecting the qualifying CCP status of the CCP, and potentially making it costly for global firms to access this CCP.
- *Price differences:* It is likely that a basis (price differences) will develop between the local CCP and global CCPs that might offer the same or similar products, for instance non-deliverable swaps. Such price differences have even be observed in larger jurisdictions, for instance Japan.

Whilst the G20 commitments were agreed at a global level, including some of the jurisdictions in question, one could argue that these commitments should be implemented in a harmonized and coordinated manner that ensures a level playing field for market participants. Given the issues listed above, there will however not be a level playing field for clearing in smaller jurisdictions. By setting up local CCPs, such jurisdictions will incur higher cost and risk compared to developed, large financial markets, which can use global CCPs and benefit from the associated economies of scale, and whose government bonds count as HQLA.

Financial markets become even more inefficient if the jurisdiction in question does not allow for enforceable netting for bilateral transactions. This will make bilateral transactions very expensive, especially if they have to be margined.

There may be other issues, for instance payments of local cash to foreign banks as currently experienced by foreign banks in Korea, where variation margin payments for bilateral transactions can only be met in bonds instead of cash[5].

In such cases clearing could offer a relative benefit. Local CCPs often operate under separate laws, which could allow for cleared transactions to be treated net and would make them less expensive as bilateral transactions. For the reasons given above, such cleared transactions would still be expensive compared to developed markets and destroy value for the local economy.

High cost could force transactions offshore, for instance by a non-deliverable market developing, as is the case for KRW interest rate swaps. Developments of non-deliverable offshore markets will usually run counter to the policy objectives of the local jurisdiction. Please see the appendix for statistics about the non-deliverable KRW swaps.

Policy Recommendation

The G20 reforms have mostly achieved the goal of enhancing safety and soundness. Nevertheless, a decade on from the crisis there is an opportunity to analyze the consequences and the suitability of these reforms for different markets and products. G20 reforms were agreed in the context of a global crisis, without the benefit of long timeframes to analyse all consequences. We appreciate the FSB undertaking a program of post-implementation review of these reforms.

[5] https://www.risk.net/derivatives/5592371/reform-fails-to-solve-collateral-woes-in-korea

We urge that countries with small, closed or developing derivatives markets are given time to develop their markets in an organic and orderly way. Before clearing mandates and exchange of bilateral initial margin are considered, certain necessary conditions need to be satisfied:

1. Netting is a true risk reducing tool and indispensable for the development of safe and efficient financial markets. The first step therefore is to implement a clean netting regime.
2. Review legal frameworks: other than a clean netting regime, the legal framework should be generally supporting of clearing, for instance by providing settlement finality and collateral rights.
3. Development of a derivatives markets with a sufficient amount of standardised products whose markets are liquid enough to enable safe clearing. While the market grows, there also should be no mandatory exchange of bilateral initial margin, as this tool will likely make transactions costly and could stifle the market.
4. As well as development of a derivatives market with liquid products there should also be a liquid and efficient collateral market, without undue restrictions.
5. Should there already be a CCP in this jurisdiction, or access to a CCP in another jurisdiction, the compliance of this CCP with the Principals for Financial Market Infrastructures[6] need to be considered.
6. Supervisors need to have sufficient data about trading activity.

In its report "Implementing OTC Derivatives Market Reforms"[7], FSB set out high-level criteria for assessing whether a product is suitable for a clearing mandate:

- The degree of standardization of contractual terms and operational processes.
- Depth and liquidity of the market.
- The availability of fair, reliable and generally accepted pricing sources.
- Degree to which the risk characteristics of the product can be measured, financially modelled, and managed by a CCP that has appropriate expertise.

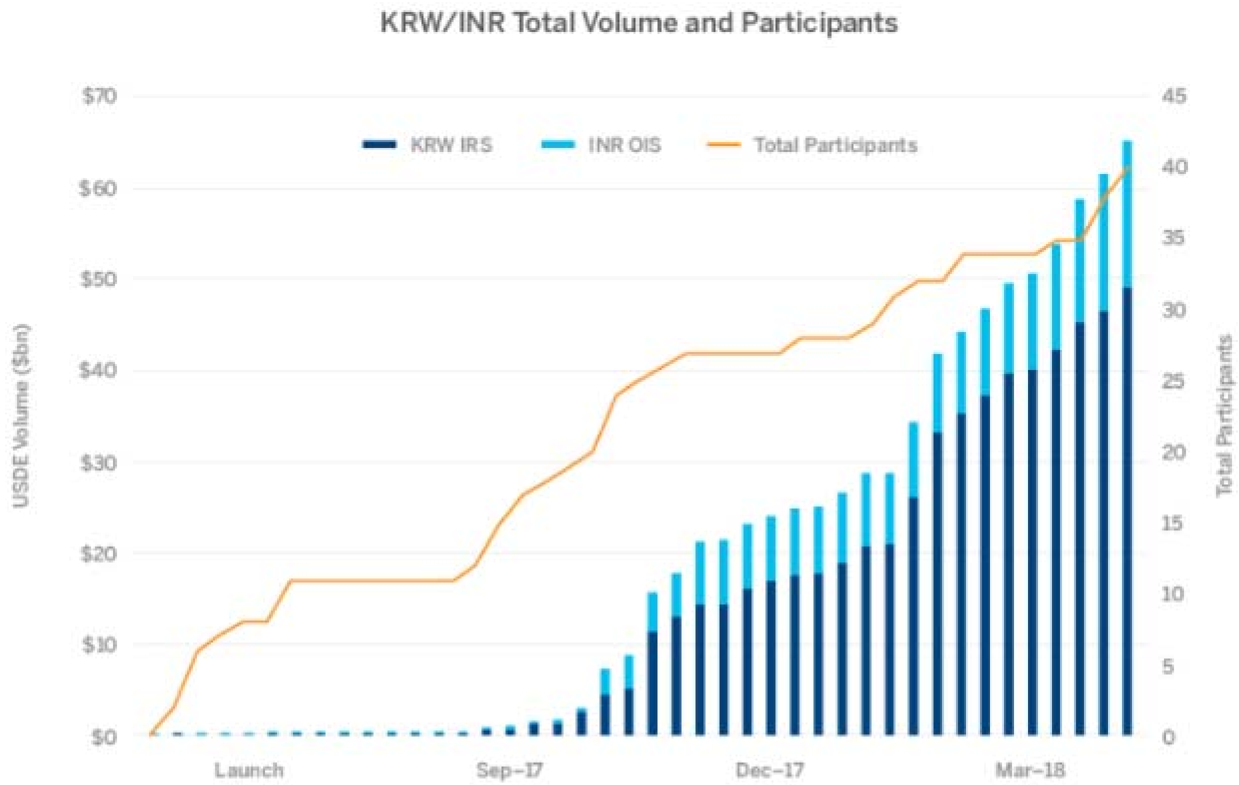
FSB also state that "*Authorities …should not mandate central clearing in circumstances that are not consistent with the G-20 objectives*." In many cases the derivatives markets in smaller or closed jurisdictions do not meet these conditions today. In addition, it is conceivable that the derivatives markets in local currencies will not grow to an extent that all these conditions are met in the short-to-medium term. For instance, even in jurisdictions with large and highly developed derivatives markets, only a limited number of the most liquid and standardized contracts are mandated to clear.

We propose that jurisdictions with small or closed markets limit their clearing mandates to derivative transactions in global, systemically important currencies. This would be consistent with existing global clearing mandates implemented in jurisdictions with large, open derivatives markets. In many cases, a local clearing mandate may be not be necessary if local firms already clear such transactions as their counterparties are under a clearing mandate in another G20 jurisdiction. This would also provide for a level playing field between global firms and firms in the jurisdictions with a small or closed market.

[6] https://www.bis.org/cpmi/publ/d101a.pdf
[7] http://www.fsb.org/wp-content/uploads/r_101025.pdf

Appendix: KRW non-deliverable swaps data for background

CME is claiming to have 12 liquidity providers and 7 FCMs actively clearing these currencies for >40 clients[8].



LCH's public volume information shows $6bn gross notional KRW swaps[9].

[8] http://www.cmegroup.com
[9] https://www.lch.com/services/swapclear/what-we-clear