

Multi-year Expert Meeting on

TRADE, SERVICES AND DEVELOPMENT

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SESSION 4:

FINANCIAL SERVICES AND REGIONAL INTEGRATION

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Financial services and regional integration: EU financial infrastructure regulation

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Context

- The **internal market** is a key EU concept – free movement of persons, goods, services & capital
- A central pillar of the internal market is the harmonisation of relevant laws, regulations & administrative provisions between EU member states
- In contrast, financial market infrastructure – exchanges, clearing & settlement systems – heavily regulated as monopoly despite growth of OTC market
- Equities trading venues governed by MiFID I – significant competition

Context

- Much less competition in other financial instruments and post-trade infrastructure
- Post-crisis G20/EU regulatory/supervisory reforms mandate derivatives trading on exchanges and central clearing
- London a major centre for bond & derivatives trading. 40% global OTC trades & 75% of EU trades
- Growing tensions between *home-host* authorities in EU internal market, and growing tension between EU & non-EU markets (ie., US)

3 Stages of Securities & Derivatives Transactions

1) Trading

Parties agree to a trade (on exchange, trading platforms or bilateral/off exchange) – contract formation

Post-trading ('the plumbing of financial markets'):

2) Clearing

ensuring that parties fulfill obligations under contract
'matching a buyer for every seller and a seller for every buyer in a securities transaction'

3) Settlement

Delivery of securities for payment (D v P)
'irrevocable delivery of a security in a transaction for payment (usually cash)'

A bit of history

- Collapse of Bretton Woods (currencies float).
- Growth of derivatives activity (to hedge & speculate against forex):
 - Euro currency markets and US dollar reserve currency
 - Technology advances and financial innovation
 - Growth of regulation and credit risk transfer instruments (CDS and securitization)
- 1974 - collapse of Bank Herstatt and Franklin National Bank
- Paper-based securities settlement Europe and US (begins to change in 1970s) begins to evolve to electronic settlement systems

Derivatives from 1970–1985

The four main uses of derivatives:

- Speculation
 - Hedge
 - Manage asset liability
 - Arbitrage
-
- 1980 swap between The World Bank and IBM. Cross Currency Swap.
 - Swaps to overcome UK exchange controls. Parallel loans.
 - 4 main types of ‘financial derivatives’ – *Interest rate swaps, foreign exchange swaps, credit derivatives/swaps, and equity/cash derivatives (also, commodities)*
 - Complexity of documentation: International and Swaps & Derivatives Association (ISDA) Master Agreement for OTC contracts.

EU clearing and settlement

- European Commission - 2006 Voluntary Code of Conduct for Clearing and Settlement (principles based approach – transparency, competition and interoperability)
- Industry association's 2007 Guideline on access and interoperability
- Objective: unbundle trading costs from clearing and settlement services so that they can be priced more efficiently – problem of vertical silos
- Crisis has driven a more intrusive regulatory approach

Clearing

Clearing has evolved in recent years to take on greater importance in the functioning of financial markets by including such activities as ‘central counterparty clearing’ (‘CCP clearing’). A central counterparty is a specialised financial institution that mediates between the buyers and sellers of securities. The centralised clearing of financial products can occur through one of three mechanisms:

- 1) a centralised deal registry, to which parties report as to the trades they have entered into bilaterally and facilitates transfers of collateral;
- 2) a single clearinghouse, interposed as the counterparty and guarantor to every trade, requiring standardised contracts including minimum initial margins and margin variations, isolating counterparty risk and minimising that risk through conservative risk management practices and multilateral netting so that individual participants have smaller exposures overall; or
- 3) a formal exchange, providing visibility on prices and volumes of transactions processed, broader access including to retail investors, and even less counterparty risk due to the contribution of capital from market makers.

Clearing houses/CCPs

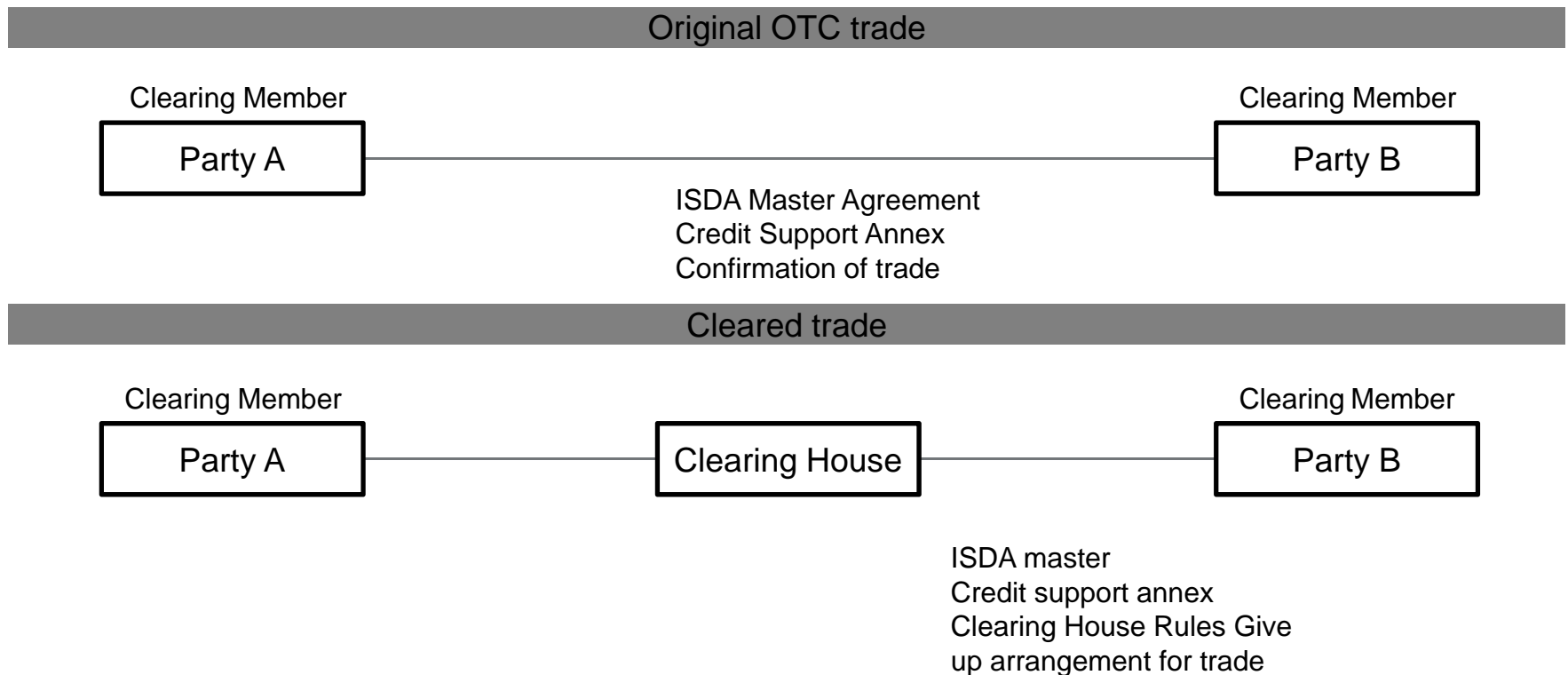
Clearing houses traditionally performed clearing for exchange-traded derivatives and commodities. As central counterparties (CCPs), they become the ***buyer to every seller and the seller to every buyer of a particular set of contracts*** (eg., those contracts executed on a particular exchange or exchanges).

The contractual obligations between counterparties that are participants in a CCP are modified by the legal doctrine of **novation** so that the CCP is substituted as the counterparty on that contract or set of contracts.

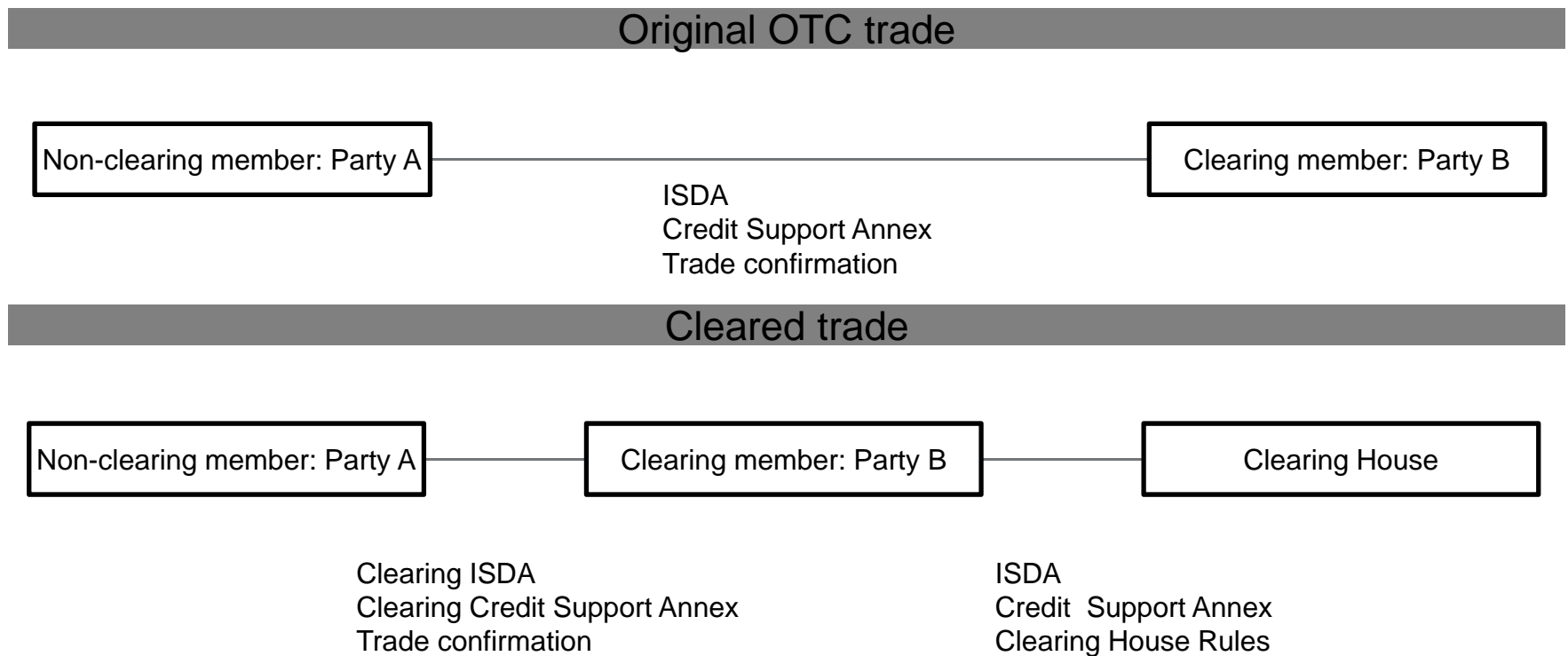
Over-the-counter derivatives markets (OTC)

1. Each OTC market is a distinctive market with its own structures/practices
2. Enhancing the safety and soundness of markets is a high priority and the crisis drew attention to the systemic risk of the high volume, deeply interconnected and under-regulated OTC markets
3. Approach to margin and collateral in OTC markets inadequate in crisis
4. The need for more transparency of exposures in OTC markets and the role of exchanges and clearing houses/CCPs in reducing risks.

OTC Derivative Regulation: The Mechanics of Clearing



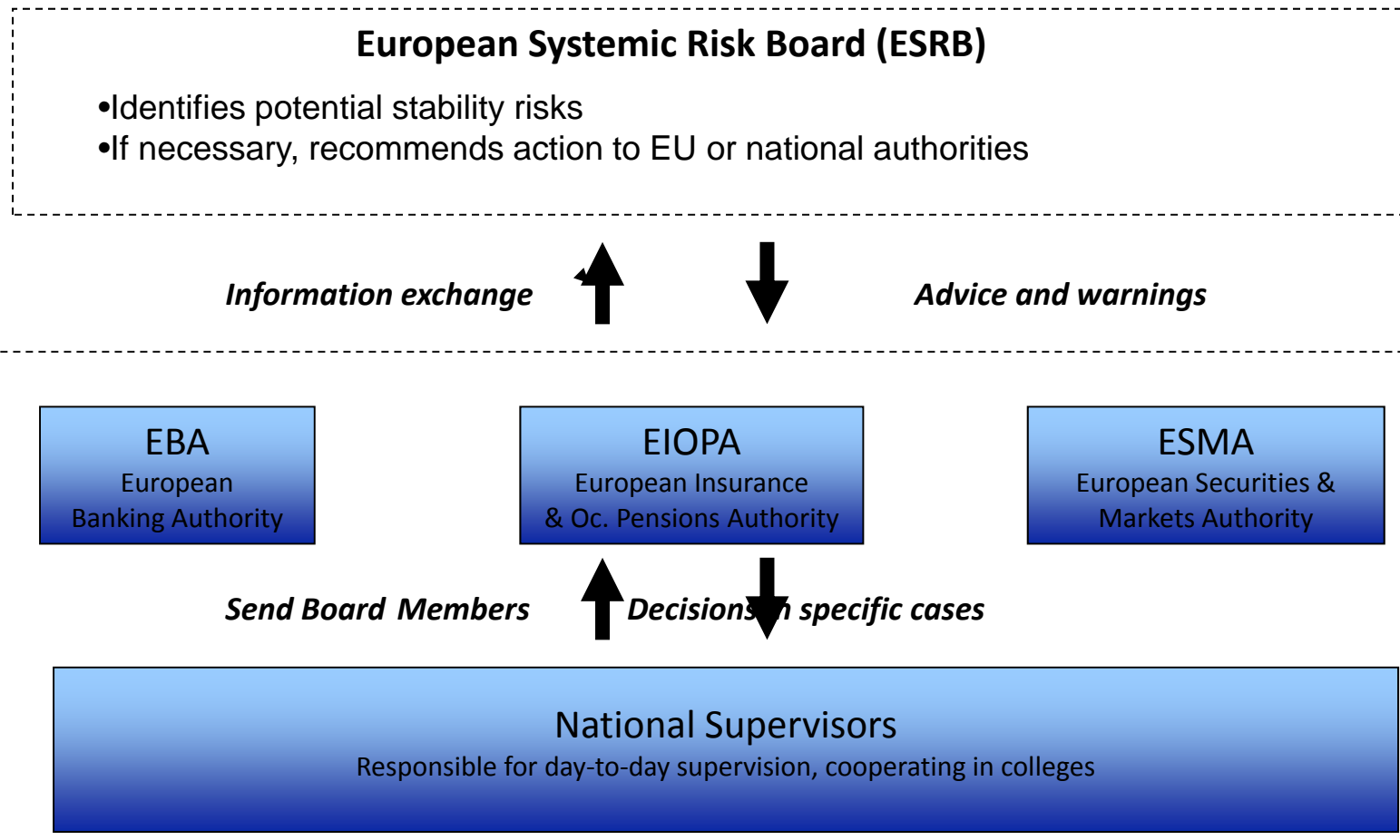
Clearing for Non-Clearing Members



Post-Lehman's collapse: Benefits of Derivatives Central Clearing

- 2nd December 2009 European Council said that it “Welcomes the paradigm shift in the approach to derivatives markets... namely moving from so called “Light handed regulation” to a more ambitious and comprehensive regulatory policy, that is aimed at reducing counterparty and operational risks, increasing transparency of the derivatives market and strengthening market integrity and oversight and, operationally is expected to shift derivatives trading and clearing from predominantly OTC bilateral transactions towards centralised trading and clearing infrastructures”.
- G20 commitment to have all standardised OTC derivatives contracts traded on exchange or electronically by 2012 and non centrally cleared contracts to be subject to a higher collateral requirement.
- A major weakness in the OTC derivative market is that there are relatively few players involved in very large numbers of trades. Hedging can be cyclical meaning that if one counterparty fails there is a domino effect.
- The European Commission's main proposal is to shift OTC derivative trades to a centrally cleared market.

New EU Structure of Financial Supervision



European Commission Communication (2009) on Derivatives Markets

- Concludes that structure of derivatives (opaque, complex and externality of counterparty risk) had resulted in Lehmans, AIG and other financial failures such Bear Stearns
- Commission recommendations:
 - Central counterparty clearing.
 - Regulation should incentivise central counter party clearing.
 - Central data repository to record details in relation to over the counter transactions, enhance transparency.
 - Exchange trading of OTC derivatives.

Draft Regulation on Market Infrastructure (EMIR) (2013) and Dodd-Frank Act of 2010

EMIR requires CCPs to be regulated – so does Dodd-Frank – ‘Derivative Clearing Organizations’.

- Issues: Capital, Margins, Collateral and Default auctions procedure
- Defines the types of derivatives and swaps contracts that are eligible to be cleared
- Requires that cleared derivatives and swaps are traded on exchanges
- Requires that cleared derivatives and swaps are reported on data registries

However problems of centralised clearing

- Collateral intensive.
- Relatively complex documentation.
- Operational complexity.
- **CCP failure!**

EU approach to standardised derivatives contracts

- G-20 Commitment requires to clear all *standardised* derivatives contracts;
- Two approaches to identify *standardised* derivatives:
 - Bottom-up approach

Suggests that Central Counterparties disclose the range of products they already offer to clear or new products they consider appropriate to clear towards national authorities or ESMA. ESMA shall then assess whether or not the Central Counterparty is allowed to clear them and if a mandatory clearing obligation shall apply;
 - Top-down approach

ESMA shall have the power to determine derivatives subject to a mandatory clearing obligation no matter whether a Central Counterparty already clears them or not. The authority shall compile a list of the products that it considers suitable and shall think of ways to promote the clearing of these products;

➤ European Commission: Combination of both approaches!

Tensions within EU Internal Market: ECB location policy and UK response

- ECB Eurosystem policy framework (July 2011)

(1) Systems that settle euro-denominated payment transactions must:

settle in central bank money

be legally incorporated in the Eurozone

exercise managerial and operational control from within Eurozone

Unless settle less than €5 billion per day or have less than 0.2% market share

(2) Central clearing counterparties must:

be legally incorporated in the Eurozone

exercise managerial and operational control from within Eurozone

Unless have daily net credit exposure of less than €5 billion or < 5% market share

Tensions within EU Internal Market – ECB location policy and UK response cont.

ECB standards for use of CCPs in Eurosystem foreign management operations (Nov 2011)

Eurosystem to use only those CCPs that meet ECB standards
these standards include ECB location policy

Another UK legal challenge (Feb 2013)

Summing up

- How EU internal market principles clash with the need to enhance macro-prudential regulation (ie., derivatives central clearing).
- Home-host authority tensions play out at global level as well (US v EU)
- Maximum harmonisation of standards? Or minimum permissible behaviour?
- Linking infrastructure regulation with economic development