MEMO# 31335

August 16, 2018

Global Standard-Setting Bodies Consult on Incentives to Centrally Clear OTC Derivatives

[31335]

August 16, 2018 TO: Derivatives Markets Advisory Committee
ICI Global Trading & Markets Committee RE: Global Standard-Setting Bodies Consult on Incentives to Centrally Clear OTC Derivatives

The Basel Committee on Banking Supervision, the Committee on Payments and Market Infrastructures, the Financial Stability Board and the International Organization of Securities Commissions (collectively the “standard-setting bodies” or “SSBs”) recently issued a consultation on whether adequate incentives exist to centrally clear over-the-counter (OTC) derivatives.[1] The Consultation is part of a broader effort by SSBs to evaluate the progress of reforms to OTC derivatives markets following the financial crisis of 2008.

The Consultation seeks input on 14 questions concerning four topics: (1) incentives to clear OTC derivatives; (2) markets for cleared OTC derivatives; (3) the impact of regulatory reforms on clearing incentives; and (4) access to clearing. For ease of reference, these questions are reproduced below. Comments on the Consultation must be received by 7 September 2018. **Please contact George Gilbert (george.gilbert@ici.org) by August 24** if you would like to share your views on the Consultation, including whether ICI Global should comment.

According to the Consultation, data from trade repositories and other regulatory reporting shows that central clearing has increased markedly for many types of OTC derivatives, especially interest rate and credit derivatives. The increased use of cleared derivatives is consistent with the objective of promoting central clearing as part of mitigating systemic risk and making derivatives markets safer.[2]

The Consultation also states that certain post-crisis reforms, such as capital, margin, and clearing reforms, appear to create an overall incentive to clear OTC derivatives, at least for dealers and larger and more active clients.[3] The Consultation notes that clearing mandates have led to increased central clearing, and the preferential capital treatment of centrally cleared derivatives also encourages dealers to clear more OTC derivatives trades. In addition, the imposition of initial margin requirements on certain uncleared derivatives transactions appears to incent clearing.

The Consultation finds that non-regulatory factors also influence market participants' clearing decisions.[4] According to surveys and market outreach conducted by the SSBs, liquidity, counterparty credit risk management, and netting efficiencies are important considerations, especially for larger firms. The Consultation notes that regulation can interact with these factors to affect incentives. For example, clearing mandates may shift liquidity from uncleared products to cleared ones. Once liquidity is established in a cleared product, market participants may wish to clear additional products, perhaps to benefit from netting opportunities or lower capital requirements. On the other hand, the relatively high fixed costs associated with central clearing can discourage smaller or less active counterparties from clearing OTC derivatives. These counterparties also may have lesser access to central clearing services than larger counterparties.[5]

The Consultation also notes that the provision of client clearing services is concentrated in a relatively small number of bank-affiliated clearing firms, which could amplify the consequences of the failure or withdrawal of a major provider. The Consultation states that concerns have been expressed about the ability to port client positions and collateral in this situation.[6] If client positions and collateral cannot or will not be ported, clients might have less incentive to centrally clear their OTC derivatives transactions. The Consultation notes that certain regulations aimed at improving the resilience of banks—such as the calculation of the leverage ratio and the methodology for scoring globally systemically important banks (G-SIBs)—might discourage firms from providing clearing services to clients.

George M. Gilbert
Assistant General Counsel

Appendix: Questions Included in the Consultation

Incentives

1. Do you agree or disagree with the finding that, in general, there are strong incentives for dealers and larger (in terms of level of derivatives activity) clients to centrally clear OTC derivatives? Do you agree or disagree with the finding that some categories of clients have less strong incentives to use central clearing?
2. Do you agree or disagree with the finding that relevant post-crisis reforms have, overall, contributed to the incentives to centrally clear? Is the consultative report's characterisation of distinctions in how the reforms have affected incentives for different types of clients consistent or inconsistent with your experience?
3. Do the margin requirements for uncleared derivatives give a sufficient incentive to clear? How do these requirements interact with mandatory clearing obligations to incentivise clearing? Are there particular instruments, and specific types of entities where the incentive to clear is not adequate? In such cases, are there specific aspects of the requirements that diminish incentives to clear?
4. The consultative report seeks to identify the most important regulatory and non-regulatory factors which affect incentives to centrally clear OTC derivatives for dealers, other financial intermediaries, large clients and small clients. Please identify any significant missing factors and comment on the relative strength of regulatory and non-regulatory factors discussed in the consultative report.

Markets

5. Is the consultative report's characterisation of the shift of activity and trading liquidity towards centrally cleared products, and the consequent impact on uncleared products, consistent or inconsistent with your experience?
6. There are various industry efforts underway to reduce the cost of clearing, including portfolio compression and direct clearing membership models. Based on your experience are these proposals, or other forthcoming changes to clearing infrastructure and models, likely to affect incentives to provide or use clearing services?

Reforms

7. Do you agree or disagree with the report's characterisation of the effects of the following reforms on incentives to centrally clear?
   a. central clearing mandates (both in terms of product scope and entity scope);
   b. minimum standards for margin requirements for uncleared derivatives;
   c. capital requirements for credit valuation adjustment (CVA) risk;
   d. capital requirements for jump-to-default risk (including where applicable the Standardised approach for counterparty credit risk (SA-CCR) and the Current exposure method (CEM));
   e. G-SIB requirements; and
   f. The leverage ratio.
8. Do you agree or disagree with the consultative report's characterisation of the impact of these reforms on the incentives to provide client clearing services?
9. Are there any areas where potential policy adjustments should be considered which would enhance the incentives for or access to central clearing of OTC derivatives, or the incentives to provide client clearing services?

Access

10. Do you agree or disagree with the report's characterisation of the difficulties some clients, especially clients with smaller or more directional derivatives activity, face in:
    a. accessing clearing arrangements; and
    b. conducting trading and/or hedging activity given the restrictions imposed by their client clearing service providers?
11. Do you agree or disagree with the finding that the provision of client clearing services is concentrated in a relatively small number of banks? Does the current level of concentration raise any concerns about incentives to centrally clear, or risks to the continuity of provision of critical economic functions, including during periods of stress?
12. Do you agree or disagree with the report's characterisation of the incentive effects created by up-front and ongoing fixed costs of:
    a. using clearing services?
    b. providing client clearing services?
13. In light of the finding in this report that economic factors generally incentivise central clearing for certain market participants but perhaps not for others, please describe your views regarding the costs and benefits of the scope of the clearing mandates, both in terms of the products and entities covered.
14. Should regulation seek to create incentives to centrally clear OTC derivatives for all financial firms, including the smallest and least active? If so, what would that imply for the costs of uncleared trades? If not, for which types of firm and product is it most important to have incentives for central clearing? Conversely for which types of firm and product would it be acceptable not to have incentives for central clearing? Please

elaborate.

endnotes

[1] Incentives to centrally clear over-the-counter (OTC) derivatives: A post-implementation evaluation of the effects of the G20 financial regulatory reforms (August 7, 2018), *available at* http://www.fsb.org/wp-content/uploads/P070818.pdf (Consultation). The Consultation presents data that the SSBs have compiled from various public and non-public sources, including qualitative and quantitative surveys and market outreach. The SSBs, for example, conducted a survey on incentives to clear OTC derivatives earlier this year. *See* ICI Memorandum No. 31047 (January 23, 2018), *available at* https://www.iciglobal.org/iciglobal/pubs/memos/ci.memo31047.global.

[2] Consultation at 17-18.

[3] Consultation at 23-45.

[4] *See id.*

[5] *See* Consultation at 46-52.

[6] *See id*.