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November 28, 2018

Global Standard-Setting Bodies Issue a Final Report on Incentives to Centrally Clear OTC Derivatives

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November 28, 2018 TO: Derivatives Markets Advisory Committee
ICI Global Trading & Markets Committee RE: Global Standard-Setting Bodies Issue a Final Report 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 final report on whether adequate incentives exist to centrally clear over-the-counter (OTC) derivatives.[1] The Final Report is part of a broader effort by the SSBs to evaluate the progress of reforms to OTC derivatives markets following the financial crisis of 2008.

The Final Report follows a consultation that the SSBs conducted during the summer of 2018. ICI Global’s comment letter in response to the consultation explained that regulated funds generally support the objective of clearing standardized derivatives products and expressed concern that the resolution plans for central counterparties (CCPs) do not adequately protect customer assets. This creates a disincentive for clearing. The letter recommended certain modifications that the SSBs could make to their guidance on CCP resolution to improve customer protections and promote increased clearing of OTC derivatives.[2] The Final Report acknowledges ICI Global’s comment and notes that policy developments are “still underway” in this area and that “it might be informative for the relevant SSBs” to take note of these concerns.[3]

The Final Report also provides data from trade repositories and other regulatory reports that show central clearing has increased markedly for many types of OTC derivatives, especially interest rate and credit derivatives. Data further show that both dealers and clients are beginning to rely more heavily on centrally cleared derivatives. The Final Report finds that 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.[4]

The Final Report asserts 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.[5] The Final Report states 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 Final Report finds that non-regulatory factors also influence market participants' clearing decisions.[6] According to the surveys and market outreach conducted by the SSBs, liquidity, counterparty credit risk management, and netting efficiencies are important considerations, especially for larger firms. The Final Report 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.[7]

The Final Report 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 Final Report states that concerns have been expressed about the ability to port client positions and collateral in this situation.[8] If client positions and collateral cannot or will not be ported, clients might have less incentive to centrally clear their OTC derivatives transactions. The Final Report 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.

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endnotes

[1] Incentives to centrally clear over-the-counter (OTC) derivatives: A post-implementation evaluation of the effects of the G20 financial regulatory reforms—final report (19 November 2018), *available at* http://www.fsb.org/wp-content/uploads/R191118-1-1.pdf (Final Report). The Final Report presents data that the SSBs have compiled from various public and non-public sources, including qualitative and quantitative surveys and market outreach.

[2] *See* Letter from Dan Waters, Managing Director, ICI Global, to Secretariat of the Financial Stability Board, dated 7 September 2018, *available at* https://www.iciglobal.org/pdf/31372a.pdf.

[3] *See* Final Report at n. 20.

[4] Final Report at 16-24.

[5] Final Report at 25-47.

[6] *See id*.

[7] *See* Final Report at 48-54.

[8] *See id*.

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