

A global perspective on derivatives regulation

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Today I want to cover some of the more important issues relating to derivatives activity now occupying regulators.

But I will start with the work the International Organization of Securities Commissions (IOSCO) and the Financial Stability Board (FSB) are pursuing on potential resilience shortfalls in non-bank financial intermediation (NBFIs).

I will then turn to current projects of more direct relevance to ISDA—margining, central counterparties (CCPs), some reactions to the Archegos incident and finally benchmarks.

Procyclicality and structural vulnerabilities

After the Global Financial Crisis of 2008, the resulting reforms included a raft of measures in response to the role derivatives played in the crisis. The industry has also been dealing with benchmark reforms which also stem from behaviours which came to light a while back—the rate-rigging scandals of nearly 10 years ago.

Global regulators are still monitoring the implementation and effectiveness of the post-crisis reforms, now in light of the real-life stress test when markets were affected by the so-called “dash for cash” last March.

This triggered a renewed focus by regulators on potential structural vulnerabilities in NBFIs. Why?

A number of interrelated factors are at play. For many years, a “low for longer” and “reach for yield” environment caused corporate leverage to balloon. Reforms to the banking sector also made it more costly to house associated risk on bank balance sheets.

These are just some of the more obvious drivers of the explosive growth of investment markets—especially investment funds—as the places where corporate credit, mainly in the form of bonds or commercial paper, are intermediated.

These structural trends have also led to concerns about record financial market valuations buoyed by central bank policies.

But the “dash for cash” episode last March was a live stress test of NBFIs. The extremely large central bank interventions which then took place in underlying markets raised a new set of questions about whether NBFIs should be made more resilient so as to prevent any need to intervene in future.

Note: This is the text of the speech as drafted, which may differ from the delivered version.

In light of these questions, IOSCO and the FSB are pursuing some very significant workstreams including examination of liquidity and redemption pressures in investment funds.

Right now, the most advanced workstream is exploring policy options to address potential vulnerabilities in money market funds which could affect financial stability. The US Securities and Exchange Commission and the European Securities and Markets Authority are also consulting in this area.

An overriding consideration is how to ensure that these NBFI activities are sufficiently resilient, but to do so in a way which does not stifle investment flows and hence their contributions to the real economy, especially during times of stress.

This work is in progress and IOSCO and the FSB will be consulting the market on questions relating to NBFI resilience over the next few months.

CCP/margining practices

One element of the NBFI project is of direct relevance to ISDA: the connection between margining practices and financial stability.

IOSCO has now joined with the Committee on Payments and Market Infrastructures (CPMI) and the Basel Committee on Banking Supervision (BCBS) to more closely examine the dynamics of margin calls in derivatives markets during the market turmoil last March and April.

We are all aware of the fact that unprecedented demand for liquidity amidst the “dash for cash” episode put a huge strain on core funding markets, especially short-term markets.

We saw that CCPs themselves proved to be very resilient in the midst of market turbulence, but extreme volatility led to significant increases in initial margin, intra-day margin calls and variation margin collection and payout.

Of course, CCPs can be expected to adjust their margin models when faced with deteriorating market conditions.

But margin calls were unexpectedly large during the “dash for cash” episode—in centrally cleared and in uncleared derivatives markets. In some cases, initial margin requirements increased more than 100%. So our work will examine whether margin behaviour during such an extreme scenario teaches us anything which may need to be factored into the regulatory framework.

One concern is whether sudden changes in margin rates can have strong procyclical effects, particularly if previous margin models did not sufficiently account for extreme scenarios.

Some market participants may not have anticipated the size or timing of increases and needed to resort to cash buffers or obtain further funding.

This also raises questions about whether efforts to access liquidity may have affected other parts of the financial system and how easily assets which are held for the purpose of meeting liquidity needs can be monetised in times of major stress.

The study IOSCO is doing with the CPMI and BCBS will look at initial and variation margins in centrally cleared markets as well as in uncleared markets.

Throughout the exercise, we will be cognisant of the exceptional nature of last year's shock—one that originated outside the financial system and which raised the prospect of a sudden stop in economic activity.

Bearing this wider context in mind, we hope to get a clearer picture of transparency, predictability and volatility across different markets, jurisdictions and margining models, including any changes in the amount of margin and the timing of such changes.

CCP resolution

I will now turn to some unresolved questions about CCP resolution, which has been a focus of contention for some years.

The continuity of clearing functions is absolutely critical for financial stability. The post-crisis reforms led to the creation of a very few large CCPs which could wreak havoc if they failed, exposing taxpayers to losses in the event of a bailout.

As regulators, our primary objective is to ensure that CCPs have adequate financial resources available at all times to manage extreme but plausible risks.

This means adequate resources to ensure their resilience, their recovery and—if it comes to it—their resolvability. And of course, the structure and functions of CCPs are wholly different to banks, and so resolution frameworks for CCPs cannot easily be compared to bank resolution frameworks.

But the question of whose resources should be used to support CCP resolution—and in what proportion—has long been a source of tension between clearing members and CCPs.

How this issue is managed has a direct impact on incentives for central clearing as well as on the extent to which CCP shareholders, clearing participants and clients are willing to support default management and recovery.

A number of questions are embedded in this debate, starting with whether or not resolution should be prefunded, and if so by whom, to what extent, and in what form?

Decisions have to be made about the sequencing of loss allocation, “skin-in-the-game” and the treatment of equity.

There are also concerns about over-reliance on recovery plans and whether CCPs might not be properly incentivised to face up to the possible consequences of their distress or failure.

However, the approach decided on may have second-order effects which may themselves impede resolution.

For example, if a CCP is on the verge of failure, clearing members would reduce their credit exposures to the distressed CCP by closing out their positions and selling related assets.

This could create a spiral of downward pressure on asset prices and liquidity, which may contribute to financial instability.

As yet, there are no international standards for the amount and composition of the financial resources to fund CCP recovery and resolution. Some hold a view that clearing house managers and some regulators are too complacent—believing that recovery plans embedded in CCP rule books would suffice in all circumstances, rendering resolution only a theoretical possibility.

So the debate continues, including questions about the degree to which CCPs, as for-profit entities, should internalise losses to stave off the prospect of taxpayer solvency support. The Systemic Risk Council has suggested that owners' equity should be eliminated in a CCP's resolution, or else they should not be able to keep the CCP's profits. Others disagree.

The FSB issued guidance late last year to help authorities determine whether there are any gaps in the adequacy of financial resources and the treatment of equity.

But the outstanding question is whether the CCP rule books provide sufficient incentives for all stakeholders to facilitate an orderly resolution.

I am now working with the Chairs of the FSB, CPMI and the FSB Resolution Steering Group to tackle these issues, hopefully once and for all.

Archegos and financial stability

So far I have touched on some familiar topics. But derivatives are now back in the news in another context—as a feature in the recent Archegos saga.

When Archegos defaulted on its total return swap margin calls, this triggered a multi-billion dollar sell-off and extremely large losses at a number of prime brokers.

This may have been an isolated incident, with no apparent systemic implications. For obvious reasons, I will refrain from commenting on specific issues which may now be the focus of regulatory interest. However, the episode does raise some high-level questions about the scope and efficacy of some post-crisis reforms to the derivatives market.

Today I will briefly touch on margining and trade repositories.

The BCBS-IOSCO margin requirements for non-centrally cleared derivatives are in the process of being implemented in stages, but with some delays.

In the summer of 2019, full implementation was deferred by a year because of operational concerns and a further delay was announced a year later to cope with additional operational challenges posed by the COVID-19 pandemic. The final implementation phase is now scheduled for September 2022.

In this context, it is important to bear in mind the purpose of the BCBS-IOSCO margin requirements, which is to set out a framework requiring in-scope firms to collect and post margin, with a view to reducing the systemic impact of a counterparty default.

Total return swaps are equity derivatives which would be subject to these margin requirements; therefore it is reasonable to ask whether, assuming full implementation, the margin requirements would have worked to reduce losses arising in this type of incident.

There are many issues involved. Questions may arise about jurisdictional differences, whether the counterparties to the trades would be subject to the margin regime and whether the positions reached the level where initial margin requirements would actually kick in, as well as the impact of splitting concentrated positions across multiple prime broker counterparties.

It is early days. But incidents like these are valuable opportunities to test the effectiveness of the post-crisis reforms. And as a result, I am asking IOSCO to do some work in this area.

And of course, in addition to the regulatory margin requirements, prime brokers may choose to collect additional margin as part of their own internal risk management, depending on factors such as the counterparty's credit quality and underlying exposures as well as the concentration of these exposures. This is also an area for further examination.

Trade repositories

I now want to touch on trade repositories (TRs). Established as a core element of the response to the Global Financial Crisis, TRs were intended to give regulators an overview of derivatives activity to see where there might be a build-up of systemic risk and also to detect potential misconduct. Firms have been acting on requests to submit information to repositories for some years now.

The Archegos incident provides a good opportunity to assess the degree to which TRs are achieving their original objectives. An assessment could cover any problems with data quality and the comparability and aggregation of information across different global TRs.

More fundamentally, questions also arise as to the ability of regulators to use information in TRs to quickly detect an untoward build-up of risk before any blow-up. In theory, TRs should provide a good line of sight into a firm's exposures to multiple prime brokers and the associated aggregate leverage and concentration profiles of those exposures.

In Hong Kong, with some data-cleansing we can have a good ex-post picture of an Archegos type of situation. But more work needs to be done to ensure that potential red flags are more apparent to regulators ex-ante—we are doing this and will also pick this up at an international level.

Benchmarks

I just want to say a few words about benchmark reform.

IOSCO fully supports the transition away from LIBOR¹. The transition to overnight risk-free, or nearly risk-free, rates—which are sufficiently robust for extensive use—will be key to support financial stability on a sustainable basis.

¹ London Inter-Bank Offered Rate.

The current focus is to make it clear to everyone of the need to accept the fact that LIBOR is going to end. So there is a real need for coordination and collaboration to raise awareness of the transition in all the places where LIBOR has been used, including in emerging and developing markets.

Hong Kong banks will cease issuing new LIBOR-linked contracts by the end of this year. Many other jurisdictions have taken similar action.

Now that firms have certainty about the LIBOR cessation date, the fixing of spread adjustments by ISDA creates a clear economic link between LIBOR and risk-free rates. This should provide clarity for market participants to deal with the transition of LIBOR referencing contracts which expire after the end of 2021.

In view of the risks associated with a failure to prepare adequately for the transition, the onus is on firms to take immediate action, and so continued engagement by the private sector is crucial.

Thank you.