Cross-border implementation and global consistency of OTC derivatives and banking requirements

This document was drafted by Eurofi with input from its members. It does not engage in any case the Greek EU Presidency nor the Greek Financial Authorities.

Strengthening financial regulation is a key objective of the G20 commitments agreed in Pittsburgh in 2009. Work is underway to implement them in domestic regulations in the different areas covered by the G20 commitments: banking sector, capital markets, insurance sector.

Some observers however stress that the data and monitoring systems currently available are insufficient to identify and manage risks appropriately in the global financial system (particularly Credit Default Swap exposures, interconnectedness within the shadow banking system and with banks…) and argue that this may affect the effectiveness of the policies being drawn up.

1. Cross-border implementation and global consistency of OTC derivatives requirements

Much progress has been made in the definition of OTC derivatives rules, but their implementation is taking longer than expected and differences in timing have appeared across the main jurisdictions. This may create temporary legal uncertainty and legal arbitrage risks.

Although the definition and implementation of requirements for transactions to be reported to Trade Repositories (TRs) is moving ahead rapidly in most G20 countries with implementation phased-in over the course of 2014, progress with central clearing requirements is slower according to the FSB[1] and is still quite limited for trading requirements. In the EU the rule-making process is almost completed while the implementation of the rules is still work-in-progress. The reporting of OTC derivatives trades to TRs started in February 2014 in the EU but the clearing mandate of EMIR is not expected to be implemented before Q3 2014 and MiFIR trading requirements for standardised OTC derivatives will probably not be implemented before 2016. The US is somewhat ahead with swap trading, clearing and reporting obligations having been put in place by the CFTC in 2013, which are since being continuously developed further. However the process is less advanced for SEC regulated swaps. Most Asian jurisdictions are further behind schedule due to specific domestic priorities.

Legislative progress is also being made in the area of margins for non-centrally cleared derivatives for which globally agreed standards were published in September 2013, although their implementation is not expected to begin until the end of 2015 in most jurisdictions.

Basel III prudential standards, meant to act as an incentive towards central clearing with enhanced standards are also in effect in around half of FSB jurisdictions at present.

[1]According to the FSB by the end of 2014, almost all jurisdictions will have some trade reporting requirements in effect. For central clearing most large market participants' interest rate and credit derivative transactions are being cleared and several large OTC derivative markets including the EU, HK, Japan, Singapore and the US plan to have specific clearing mandates in place by end 2014.

Although the OTC derivatives rules defined have significant commonalities, there are many differences across jurisdictions in their detailed requirements, reflecting presumably different local market conditions and domestic legal frameworks.

Such discrepancies may create complexity both for direct participants and for the buy-side and potentially lead to liquidity fragmentation. Several differences remain between the EU and the US requirements regarding in particular (i) the product scope they apply to (which includes both OTC and exchange-traded derivatives in the EU and only OTC derivatives (swaps) in the US), (ii) the exemptions applied to non-financial corporations which are wider in the EU due to the application of thresholds (iii) reporting obligations (transactions must be reported by both counterparties on a T+1 basis in the EU whereas US rules dictate that reporting take place in real time with only one counterparty required to report in the US), (iv) minimum risk management standards that apply to CCPs (e.g. EU CCPs must maintain sufficient financial resources to withstand the failure of the two clearing members to which they have the largest exposure, whereas in the US they must only have resources to withstand the failure of the clearing member to which they have the largest exposure).

In the absence of an authority with the power to coordinate policy-making and enforce policies consistently at global level, which some market observers are calling for, developing international cooperation mechanisms among jurisdictions is essential to facilitate the cross-border implementation of these rules and preserve the global dimension of derivatives markets.

The objective of regulatory and supervisory cooperation is to avoid overlaps, contradictory requirements and limit extraterritorial effects. Major steps forward are being made in the OTC derivatives area, following the declarations made at the G20 Saint Petersburg summit "that jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulations and enforcement regimes, based on essentially identical outcomes". However, how any international agreement on margin requirements for exchange-traded derivatives will be reached remains to be clarified.

The US CFTC and EU Commission (EC) first published a joint understanding of cross-border issues in July 2013, followed by a multilateral set of understandings announced in August by the OTC derivatives regulators group consisting of regulators from jurisdictions with large OTC derivatives markets. A key understanding of this latter group is that a flexible outcomes-based approach should form the basis of assessments regarding equivalence or substituted compliance. The group also agrees that a stricter-rule approach should apply to address gaps in mandatory trading or clearing obligations and that jurisdictions should remove barriers to Trade Repositories (TRs) regarding the access of authorities to TR data and the reporting to TRs (i.e. avoiding inconsistent rules across jurisdictions and suppressing restrictions due to domestic privacy laws).

A task force on cross-border regulation set up by IOSCO in September 2013 is also expected to make recommendations by the middle of 2014 regarding the conceptual approaches and tools to be used to regulate cross-border securities markets and the role IOSCO should play in this context. A feasibility study has also recently been launched by the FSB of options for how information from TRs can be aggregated and shared among authorities, the results of which will be published in the first half of 2014. Some industry players however point out that the current differences in the data elements required e.g. between the EU and US will remain an obstacle to such aggregation efforts and need to be addressed in parallel.

Furthermore a proposal was made by the EU Commission in January 2014 to establish within the EU-US Transatlantic Trade and Investment Partnership (TTIP) process a framework for regulatory cooperation in financial services. Regulatory cooperation - also with regard to the financial markets as necessary annex of any free trade - would be based according to the proposal on several principles including joint work to ensure timely and consistent implementation, mutual consultations in advance of any measures and a commitment to assessing whether the other jurisdiction's rules are equivalent in outcomes.

While generally supporting such approaches to facilitate the cross-border implementation of rules in the OTC derivatives area, many industry players and observers stress that their impact will depend on the finer details of how "substituted compliance" (in the US) and "equivalence assessments" (in the EU) referred to e.g. in the CFTC / EC agreement will be designed and how the high-level principles proposed in these declarations will work in practice (i.e. whether there will be one set of rules even if differences subsist in the detailed requirements). Another issue to be overcome according to some regulators are the potential differences in the degree of supervision and enforcement of rules (even if the rules themselves are considered to have similar outcomes) which naturally also impact the market participants' cost calculations and thereby have a double effect with regard to a level playing field.

Regarding the practical implementation of these principles, progress has recently been made in the trading area where an agreement was reached in February 2014 between US and EU regulators to exempt from US trading rules European-approved platforms that trade derivatives, until equivalent EU rules come into force in around 2 to 3 years' time, alleviating fears of liquidity fragmentation in the market[2].

Questions however remain regarding the way equivalence assessments should be conducted in practice. Some observers believe that there should be a certain degree of flexibility in such decisions in order to avoid a "zero-one" system by which a foreign jurisdiction is considered to be either equivalent or not equivalent with limited discretion. There have also been discussions regarding the criteria to be used in such assessments and the degree of proportionality that may be allowed. In the context of the recognition by the EU authorities of foreign CCPs some regulators have suggested that equivalence assessments should be based on commonly agreed standards (e.g. IOSCO standards), when possible, rather than national laws which are the product of processes in which foreign jurisdictions have not taken part. Others consider on the contrary that domestic rules should be the starting point if a jurisdiction is to defer entirely to the laws and supervisory system of the foreign jurisdiction when rules are equivalent (which is the approach of the EU for example) and believe that such an equivalence approach is quite workable provided that it focuses on the equivalence of outcomes and does not adopt an excessively granular approach.

2. Cross-border implementation and global consistency of banking requirements

At the end of 2013, 25 out of the 27 main jurisdictions in the world had Basel III rules in place. Although the implementation of Basel III banking prudential requirements is phased-in as far as 2019, their implementation has been anticipated by the market in many cases creating major impacts for the profitability and activities of many EU banks in particular.

Differences have appeared in the rules applying to the banking sector.

Basel III rules are designed as minimum requirements and differences have emerged in their implementation across regions. Such differences may create level playing issues and regulatory fragmentation. Examples mentioned by industry players include differences in the definition of the leverage ratio based on differing accounting rules across jurisdictions (which are not expected to converge in the short term) or provisions contained in the EU Capital Requirement Regulation (CRD IV) which would exempt EU banks from holding capital against counterparty credit risk for trades with sovereigns and provide reduced requirements for corporates.

In addition Basel III does not define specifically how capital and liquidity should be allocated within a cross-border financial group. Concerns have emerged in Europe regarding the US Federal Reserve's proposals part of its 2014 regulatory programme, to require foreign banks, which were previously exempted from US capital requirements when owned by a well-capitalized foreign bank, to create a local bank holding company subject to US prudential requirements. This change is justified, according to US regulators, by the increasing size of the US operations of foreign banks, their interconnectedness with the US financial system and the risks associated with large intra-group funding costs[3]. Foreign

[2]The CFTC issued two no-action relief letters which allow US swap dealers and major swap participants to execute swaps transactions on qualifying EU-regulated multilateral trading facilities, without further regulatory approvals from the CFTC. The agreement follows concerns that differences between Europe and the US in the detail and implementation timelines for new OTC derivatives markets rules would split the market in two, thereby potentially damaging liquidity and driving up costs for market participants.

[3]According to D. Tarullo (testimony on Dodd-Frank implementation - 6 Feb 2014), prior to the crisis the Fed's approach to regulating the US operations of foreign banks rested on substantial structural flexibility for the foreign bank, substantial reliance by the Fed on the supervisory and regulatory framework of the foreign bank's home country and substantial expectations of support by the parent foreign bank of its US operations. This change is justified by the fact that the US operations of foreign banks in the years leading up to the crisis grew much larger and became much more complex

banks stress that they would be required with such a rule to comply with specific capital and liquidity requirements for their US operations reducing their capacity to manage liquidity and capital positions on a global basis.

Fragmentation trends within the Eurozone have also been emphasized (e.g. limitation of amounts foreign banks can transfer out to the parent company based in a foreign jurisdiction), but these should progressively disappear with the implementation of the Single Supervisory Mechanism (SSM) notably.

Moreover the differences that have emerged between the banking structure reforms already implemented in some jurisdictions (e.g. reforms adopted in France and Germany, the US Volcker rule) and proposals made notably in the UK and by the EU Commission, that may touch global financial groups, are stressed by industry players.

Differences in the level of bank intermediation across jurisdictions and accounting rules mean that the outcomes of Basel III requirements might differ quite significantly across regions.

There are major differences at present in the functioning of the financial system between the EU and Asia where bank-intermediation is dominant for retail and SME financing and the US where market-based mechanisms are much more developed. In the US a significant proportion (up to 70%) of the retail credits originated by banks (mortgages, consumer credits...) are transferred to the Government Sponsored Enterprises (GSEs) which are not subject to Basel III requirements, thus offloading these credits from the banks' balance sheets. The outcome of Basel III capital, liquidity and leverage requirements are therefore quite different for EU, Asian and US banks. These differences may be further increased by differing accounting rules.

The unintended consequences resulting from inconsistencies in recovery and resolution plans (RRP) are also stressed.

Sufficiently integrated and consistent RRPs need to be in place for global financial groups in order to avoid local restrictions or lock-ups in case of stress, which may threaten the viability of such groups or frustrate the resolution actions of the home authority. The implementation of an EU R&R framework for banks consistent with the "key attributes of effective resolution regimes" drafted by the FSB should contribute to this objective, provided supervisors and resolution authorities cooperate efficiently, which may require some changes in the mandate of supervisors. Differences between the EU Bank Recovery and Resolution Directive (BRRD) and the US measures are also stressed regarding in particular the scope for bail-in and loss absorbency requirements, with differences in the level of recapitalisation required in different jurisdictions.

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and interconnected with the rest of the US financial system. For example 5 of the top 10 US broker dealers are currently owned by foreign banks and together hold almost $ 1.2 Tio in assets. The US operations of large foreign banks also became much more dependent on the most unstable sources of short term wholesale funding and established very substantial net credit exposures to the parent foreign bank in the years leading up to the financial crisis. As a result during the crisis these banks were heavy users of the Fed's liquidity facility.