Forum for Financial Stability at the Deutsche Bundesbank

Frankfurt, 7 July 2016

Summary of the discussion

Participants: Claudia **Buch** (Chair, Vice-President of the Deutsche Bundesbank), Andrew W **Douglas** (DTCC), Guido **Fürer** (Swiss Re), Michael **Koetter** (Frankfurt School of Finance & Management), Claas Carsten **Kohl** (Airbus Group), Jan Pieter **Krahnen** (Goethe University Frankfurt), Thomas **Laux** (Eurex Clearing), Loriana **Pelizzon** (Goethe University Frankfurt), Angelo **Ranaldo** (University of St Gallen), Volker **Stemann** (Deutsche Bank), Grigory **Vilkov** (Frankfurt School of Finance & Management)

The inaugural meeting of the Forum for Financial Stability at the Deutsche Bundesbank considered the new architecture of the OTC derivatives markets. Like few other markets, the OTC derivatives markets have experienced a fundamental change after the financial crisis. Before the crisis, OTC derivatives markets were mainly bilateral and opaque with insufficient provision of collateral dominated by a couple of major dealer banks.

As the financial crisis laid bare the problems of OTC derivatives markets, G20 leaders stipulated fundamental reforms of OTC derivatives markets at the summit in Pittsburgh in 2009. It was decided to, inter alia, increase transparency by obligatory reporting to trade repositories and to enhance the robustness by conducting more business on exchanges or electronic trading platforms and clearing through central counterparties complemented by further measures to avoid regulatory arbitrage, e. g. higher capital requirements for non-centrally cleared derivatives contracts.

The participants of the Forum explored two overarching questions. First, given the cornerstones of the OTC derivatives reform agenda (ie central clearing, multilateral trading, transparency), which elements are conducive to the stability of OTC derivatives markets and which are counterproductive? Second, would the application of the above-mentioned cornerstones or parts thereof to other financial market segments like Fixed Income, Currency and Commodities Markets make the financial system safer?

Impact of OTC derivatives reform agenda on stability of OTC derivatives markets

In September 2008 serious deficiencies of the bilateral clearing of OTC derivatives contributed to systemic turbulences. On the one hand, derivative contracts were often not or not sufficiently collateralized. When a counterparty defaulted, the contract became worthless, thereby propagating financial shocks. On the other hand, there was a lot of uncertainty about who was holding large open positions and who the counterparties were. Central clearing, however, where a central counterparty (CCP) manages the counterparty default risk, worked well even during the crisis.

Considering the **pros and cons** of CCP clearing compared to bilateral clearing, the participants of the Forum generally agreed that key advantages of central clearing include, amongst others, reduced counterparty risk due to collateralisation, increased price transparency, pooling of liquidity and efficient management of collateral through multilateral netting. Nevertheless, it was also stressed that, in general, new regulatory requirements might be accompanied by higher clearing costs which will particularly challenge market participants which did not clear their business centrally in the past. Some participants emphasised that exemptions from compulsory CCP clearing may be necessary under certain circumstances.

The participants' discussion weighed key aspects related to the competition of CCPs. While some participants asked why CCPs are not **acting as public utilities** and doing business on a non-profit basis, others stated that when it comes to a profit-driven business model, the incentive structure should aim at risk reduction. In the discussion, some participants stressed that CCP regulation in Europe focuses mainly on competition whereas regulation in the US underlines the public good character of CCP clearing.

Faced with the fact that central clearing centralises risks and thereby might make CCPs too big to fail, the participants discussed the importance of effective **recovery and resolution regimes for CCPs**. Considering that a CCP default would have severe – potentially systemic – effects, it was mentioned that stress testing is crucial to prove robustness. In this context, one participant highlighted that CCPs existed before the 2008 crisis and continued to work well during that crisis.

All participants agreed that the design of the **incentive structure** for CCPs is key to mitigating systemic risk. It was said that incentives differ between both the macro and micro perspective on the one hand and between participants and CCPs on the other hand. Competition-driven "predatory margining", for instance, might be reasonable at a micro level, but it could be harmful from a macroprudential point of view. Against this background, one participant underlined the threat to financial stability in a highly competitive environment and therefore proposed the consolidated transnational supervision of CCPs.

Panel members also discussed **harmonisation and standardisation issues**. Some members said there is still room for improvement concerning the harmonisation of regulatory provisions across different jurisdictions in general and of data in particular. Regarding transparency and data availability, the panel criticised the lack of harmonised global data and the short data history. However, one member questioned the benefit of the additional data requirements introduced by the new regulatory requirements. Other members stressed that inferior data prevent regulators and supervisors from mitigating potential systemic risks. Some participants pointed out that a high level of standardisation could have negative side-effects. Full harmonisation could hamper (necessary) innovation. Moreover, one should be aware that regulation increases incentives to shift business to less regulated or unregulated markets.

New principles for OTC derivatives markets: a blueprint for other financial market segments?

Given that other markets, like fixed income, commodity and currency markets, still share the same characteristics as OTC derivatives markets in the past, the panellists considered whether the new principles for OTC derivatives markets are suitable for other financial market segments in order to make them more robust. They agreed that a one-size-fits-all approach is not adequate. As different markets have different characteristics and drivers, detailed analysis is needed to identify where further regulation could add value. Some participants stressed that fixed income, commodity and currency markets are already experiencing significant changes and that they currently do not see a need for additional regulatory interventions.