MARKET NOTE

Derivatives

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Checking in on OTC Clearing Rules

Introduction

In 2009, the G20 meeting resulted in a directive that moved regulators to pursue transparency in the OTC derivatives markets. Regulators across the globe have been charged with examining the total outstanding counterparty risk across all entities. To make this a reality, all OTC derivative contract trades need to be reported to a trade reporting facility or trade repository.

Many regulatory bodies have been involved in developing rules and implementing a structure that will diminish the systemic risk that was historically associated with OTC derivatives. A key component to achieving this goal involves data, specifically timely and accurate data reporting.

This paper reviews where the industry is in the process of implementing the directives handed down by the G20 almost ten years ago. With new regulations mostly set in stone now may be the best opportunity for firms to consider a review of the OTC trade reporting process.

Background

The 2008 financial crisis left a lasting impression on anyone that lived through it. When the G20 convened in Pittsburgh in 2009 addressing the financial crisis was at the top of the agenda. The resulting directives got regulators to work on drafting new rules to apply to the OTC derivatives space (*see Exhibit 1*).

Regulatory Overview

Regulators are shifting their focus to refinement of new rules and strict enforcement of existing derivatives regulations. Penalties are already being doled out in cases where firms are not properly following new protocols. All market participants; commercial hedgers, banks, brokers, proprietary trading firms, asset managers and hedge funds, are already being more closely monitored.

There is a heavy emphasis on data delivery and that the data reported to trade repositories is timely and accurate. Regulatory bodies are relying on the completeness of reported data to monitor risk and make further rule changes. The most recent update on the progress of OTC Derivatives Market reform from the Financial Stability Board included a heavy emphasis on data reporting.[2] Their reliance on this data results in a heavy hand in assuring compliance.

Brief Trade Repository Summary

Trade reporting of OTC derivatives transactions have been mandated by all the major global regulatory bodies. Appropriate transaction data must be reported to a trade repository. Regulators are relying on this data to monitor firm behavior and guard against any systemic risk events. They also are using this data to consider further regulatory actions to safeguard the global financial system.

In both summaries there is a heavy emphasis on trade data which is already being backed up by regulatory actions.

Exhibit 1: Regulatory Timeline

Source: Financial Stability Board

The Financial Stability Board (FSB) monitors and reports on the implementation progress by jurisdiction. In a recent report to the G20 it was noted that there were still many jurisdictions where various milestones had not been implemented on time. Most developed nations have kept pace with the directives, while most emerging markets have not.

Early Compliance Failures

Regulators in the US and Europe are becoming much more vigilant in demanding trade reporting requirements be followed. Recently the CFTC and FCA have levied substantial fines to financial firms that reported inaccurate trade data. Some initial OTC derivative reporting fines were enforced back in 2015 and with increased frequency through 2016 and 2017. Note in the examples below that fines may be substantial.

- $10 million fine for providing misleading pricing on swap transactions
- $2.5 million fine for not properly reporting transaction cancellations
- £34.5 million fine for improper derivative trade reporting

None of these fines were implemented due to nefarious activity. Each appeared to be more about negligence that may have been easily avoided. A quality partner that offers an all-encompassing trade reporting and regulatory monitoring solution is a way to guard against costly occurrences of negligence or careless errors.

A common goal of banks, dealers and asset managers is to avoid regulatory penalties. However, a well-planned, sound regulatory reporting program can benefit a firm beyond just avoiding penalties. Firms that plan, design and implement a flexible framework to efficiently aggregate trade and position data across assets and trading divisions, will not only meet immediate regulatory demands but be able to easily adjust for the inevitable regulatory modifications.

Process Review

The time has never been better to review the internal trade reporting process. Virtually all aspects of trade reporting have changed. Firms should be making sure that they are accurately reporting the correct transactions. Transactions should be mapped correctly to the destination trade reporting facility. In cases where there are reporting exceptions, firms should be assured that exceptions are applied correctly.

There are aspects of the implementation of the G20 directives that continue to evolve. For example, in a recently released CFTC white paper[3] that directs CFTC staff to put forth new rule proposals to address many cross-border issues. Of course, a looming concern with respect to the global financial system is the final structure of Brexit. Finally, the European Union's Securities Financing Transaction Regulation is expected to go live in the first quarter of 2020. All these factors result in this process continuing to have some fluidity to it.

Now is the time for a comprehensive comparison of the process a firm has in place is something that should be at the top of a firm's priorities. The regulators have moved from writing the rules to monitoring behavior and enforcement. Firms should use this pause in major new regulations to assure they are compliant. As seen with recent compliance failures, the cost of not doing so may greatly outweigh the cost of a process review.

Partners

With so many moving parts in the regulatory environment most firms are best off not trying to develop or manage an in-house reporting structure. There is no reason to internally develop a bespoke solution where it is better to take advantage of a commodity sourcing model or leverage 3rd party vendor that can provide cost effective, value added services.

When selecting a partner for trade reporting a combination of factors should come into play. An ideal partner should have a mix of global knowledge and a local presence. A global partner will understand the myriad of regulatory differences around the world. However, a partner that has a local presence will have employees who are more responsive and understanding of your firm's specific needs.

There are two trade repositories, CME Group and DTCC, that cover most major jurisdictions, both of which have experience with the regulatory changes. As the regulatory landscape continues to settle into small refinements and increased enforcement there are potential synergistic benefits to working with a global provider.

In the past firms were reliant on a reporting arrangement with a specific trade repository. The effort and sheer cost to move from one to another may have resulted in a firm being beholden to their current provider. With a shift in regulatory oversight and required data, now may be the time for firms to look over their full reporting process, including their vendor.

Conclusion

Regulations are in place and strict enforcement pressure may be on the horizon. All impacted market participants; banks, dealers, asset managers and hedge funds would be wise to review their processes. As noted earlier, the cost of not doing so may be greater than taking the time to address the new regulatory regime now.

Now is the time for firms to re-evaluate trade reporting solutions, processes, and vendors. The pace of regulatory change is slowing to a point where a review makes sense. There is no such thing as business as usual in this space and it is imperative that your solution is fit for purpose, cost effective, provides the level of service and issue resolution that you expect and is flexible enough to adapt to future changes.

[1]*Financial Stability Board (2017) Implementation and Effects of the G20 Financial Regulatory Reforms: Third Annual Report.*
[2]*Financial Stability Board (2018) OTC Derivatives Market Reforms: Thirteenth Progress Report on Implementation.*
[3]*CFTC (2018) Cross-Border Swaps Regulation Version 2.0: A Risk-Based Approach with Deference to Comparable Non-U.S. Regulation*

