FOLLOWING THE RULES

HOW IS STRUCTURAL REFORM IN EUROPE AND THE US AFFECTING THE DERIVATIVES MARKET? ASHWIN CHAK EXPLAINS

Since the global financial crisis, the G20 has focused on strengthening the regulatory system so that it is better equipped to reduce the risk of financial excesses destabilising the global economy. This article focuses on market structural reforms implemented and proposed to support that objective.

EMIR and Dodd-Frank

The US Dodd-Frank Act and the European Market Infrastructure Regulation (EMIR) both impose regulation on derivatives. But while there are many similarities between the two sets of rules, there are also some significant differences.

Both pieces of legislation come from the same starting point: the G20's commitment to reform and strengthen the financial system. As such, they share several requirements, including the introduction of clearing and margin rules that are based on the standards of the Basel Committee and the International Organization of Securities Commissions.

They also introduce similar risk-mitigation practices, such as timely confirmations, and portfolio compression and reconciliation.

Finally, they both have trade-reporting requirements, although these vary between the two pieces of legislation. For example, in Europe, both counterparties to a trade need to report the transaction, whereas the US just requires one-sided reporting.

A key difference between the two pieces of legislation is the broad extra-territorial impact of Dodd-Frank as a result of it directly regulating dealers that transact with 'US persons'. European rules do not extend their scope in the same way. Also, Dodd-Frank largely focuses on registered swap dealers, whereas EMIR applies to all derivative users with some limited exemptions for non-financial institutions.

Execution rules

The Dodd-Frank Act introduced mandatory clearing for OTC derivatives in 2013, following this up with mandatory execution rules on swaps earlier this year. The US Commodity Futures Trading Commission (CFTC) is responsible for determining which swaps are subject to mandatory execution requirements, but those that are must be executed exclusively on a swap execution facility. As a result, the bilateral execution of a swap subject to the mandatory execution criterion involving a 'US person' including guaranteed affiliates is no longer possible unless an exemption applies.

Most US corporates today benefit from an end-user exemption from having to execute their swaps on swap execution facilities. Nevertheless, the mandatory execution rules for swaps have resulted in the fragmentation of market liquidity across US and non-US pools. There is nervousness in the market that this, in turn, may result in different prices being offered for what is essentially the same product, and the market for swaps becoming less efficient and potentially more volatile. A number of market participants have restructured activity in response to these rules.

There have also been instances of clients in Europe and Asia moving banking relationships or expressing a preference to face non-US entities. Mandatory execution rules are also presenting some operational challenges. Swap execution facility platform providers have had to respond quickly to meet the requirements of Dodd-Frank, resulting in greater operational uncertainty at times.

And, while corporates do usually benefit from the end-user exemption on mandatory execution, the new rules can still directly affect them. This is because a bank's ability to arrange swap syndication at an efficient price in support of a corporate debt issuance could be adversely impacted, driving up hedging costs. Let's look at this issue in more detail by using a specific example.

A corporation could mandate a group of banks to issue a $1bn, 10-year bond on a fixed-rate basis on any given day.

That issuer would also like to transfer its financing from a fixed to a floating rate, which would mean it would need to enter into an interest rate swap transaction at the time of the refinancing. The issuer's goal would be for the swap to be executed close to the time that the price of the bond is established in the market to form an effective hedge.

Since the underlying swap transaction exposes the issuer to substantial credit risk with the bank executing the derivative, the issuer may prefer the swap to be syndicated across its relationship banks with an agreed spread lock leading up to final pricing.

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If, however, the swap is subject to mandatory execution requirements, it will need to be executed on a swap execution facility, which not allow for the syndication to be prearranged. Consequently, the bank arranging the swap will have to price in the additional uncertainty to offset its exposures.

Impact of reform

Last year, the CFTC introduced mandatory clearing for certain categories of liquid swaps and EMIR is expected to bring in similar requirements towards the end of 2014. Although the existing requirements do not cover FX products, non-deliverable forwards are likely to be mandated for clearing under CFTC rules. Meanwhile, margin requirements for uncleared derivatives are expected to become effective towards the end of 2015 and will be implemented in a phased approach. Inevitably, these changes will bring higher liquidity costs for financial institutions and increase the systemic risk of clearing houses.

Regional differences in the rules relating to derivatives make it increasingly complex for financial institutions to manage their risks efficiently. This will drive up the cost of managing risk, which will impact on the prices offered to clients. The combined effect of the new execution rules, collateral and margin requirements are also likely to lead to a rise in liquidity costs.

Pricing may also have to take market reaction to large trades into account, as both the US and European legislations introduce greater reporting transparency.

For corporates, particularly those with international banking relationships, understanding the extra-territorial impacts can be very challenging. This could get even more complex in the near term, as European and Asian regulations begin to take shape. This, in certain instances, may require treasurers to re-evaluate their financing relationships, particularly when they are cross-border.

In the long term, regional divergences in the regulation of derivatives should hopefully converge, particularly on certain key aspects, to prevent unintended arbitrage opportunities and market disruption. Until that happens, however, both banks and corporates will need to remain focused on navigating through the wave of regulatory reform.

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DODD-FRANK ACT – KEY REQUIREMENTS

Registration
Companies must register as swap dealers if their activity exceeds $8bn notional of swaps involving US persons or certain non-US persons benefiting from US guarantees in the last 12 months.

Internal and external business conduct rules
Swap dealers must follow a suite of rules, including confirmation timeliness and guidelines for communicating with customers.

Trade reporting
Trades must be reported in real time, and open trades must be updated on a daily basis. Reporting rules involve the introduction of standardised data attributes, including legal entity identifiers, unique swap identifiers and unique product identifiers.

Mandatory clearing
This applies to certain classes of liquidity swaps. The US Commodity Futures Trading Commission (CFTC) identifies the products that must be cleared.

Execution
Mandatory execution of trades on a swap execution facility is applied to certain categories of OTC derivative. Again, the CFTC identifies the affected products.

Margining
Uncleared swaps will be subject to margin requirements, for which the rules will be finalised for implementation in December 2015.

EMIR – KEY REQUIREMENTS

Reporting
All new and outstanding derivatives – both OTC and exchange-traded – must be reported to a registered trade repository.

Clearing
There is a requirement to clear OTC derivatives that the European Securities and Markets Authority has deemed subject to mandatory clearing through a central counterparty from later this year.

Risk mitigation
Risk-mitigation measures for uncleared derivatives, cover timely confirmation, mark-to-market valuation, portfolio reconciliation, dispute resolution, portfolio compression, initial and variation margin, and the obligation to hold appropriate capital to manage uncollateralised risk. Application of these measures will vary according to whether an entity is categorised as NFC or NFC+ under EMIR.