

CDS Market and Regulatory Overview

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Agenda

- Supervisory Efforts in the OTC Derivatives Market
- Role of OTC derivatives in the financial crisis
- Addressing counterparty credit risk
 - Central clearing
 - Credit risk mitigation of uncleared trades
- Improving transparency
- Greater standardization
- Global regulatory coordination
- Q&A?

Supervisory Efforts in the OTC Derivatives Market

- **Background**

- Efforts stemmed from concern regarding increase in backlogs of unconfirmed trades
- 2005: FRBNY engages major dealers with primary supervisors to coordinate actions to address backlogs

- **History of Regulatory Focus**

- September 2005: Operational improvements in credit derivatives
- November 2006: Efforts expanded to equity derivatives
- July 2007: Volume spikes, subsequent operational inefficiencies and financial sector weakness steer focus to resiliency of infrastructure, risk management and product design
- July 2008: Scope of objectives broadens to include buy-side clients and other asset classes including FX, commodities and interest rate derivatives as well as collateral management practices
- October 2008: Acceleration of CCP solutions to reduce counterparty credit risk
- June 2009: Focus on improving market transparency and decision making through more effective and inclusive governance
- March 2010: commitments for improving transparency, central clearing, and governance

Role of OTC Derivatives in the Financial Crisis

- The financial crisis demonstrated some significant weaknesses in the OTC derivatives market
 - Fragility due to counterparty credit risk
 - Opacity of market risks and linkages
 - Weaknesses in firm-level risk management
 - Importance of strong operations
- These issues have driven regulatory efforts in Europe, Asia and North America to reduce risks caused by derivatives and to improve regulation of the markets

Counterparty Credit Risk – Central Clearing

- Counterparty credit risk concerns spurred clients to move trades and initial margin away from the riskiest dealers, exacerbating liquidity pressures for deteriorating financial institutions
- In response, regulators advocated for greater use of central counterparties
 - Launch of clearing services for credit derivatives (Clearnet SA , CME, Eurex, ICE Trust/ICE Clear Europe)
 - As of April 2010, \$7.5 trillion of gross CDS notional has been cleared
- Industry established clearing commitments for credit derivatives
 - Targets for G14 dealers to submit and clear minimum amount of clearing-eligible trades
 - Increase use of clearing to buy-side market participants
 - Expand product eligibility

Counterparty Credit Risk—Uncleared Trades

- **Bilateral collateralization practices**
 - Increased frequency of portfolio reconciliation between dealers
 - Improved dispute resolution procedures
 - Consideration of methods to segregate client margin
 - Review of market practices revealed need to further automate margin call processes, standardize documentation and expand reconciliation to non-dealer counterparties
- **Portfolio compression**
 - Since 2008, \$53 trillion of notional outstanding compressed in CDS

Improving Transparency

- Improve regulatory transparency
 - Reporting non-cleared trades to trade repositories will increase position and trade transparency to regulators
 - In June 2009, dealers committed to reporting trades to trade repositories for credit, interest rates and equity derivatives
- Increase public transparency:
 - Provide aggregate market data to the public via trade repositories
 - Reporting price and volume information would give insight into the liquidity, trading interest, size and depth of the market
 - Major dealers committed to provide trade data to regulators for analysis and to conduct a transparency gap analysis

Greater Standardization

- Standardization is a necessary component to achieving regulatory policy objectives
- Standardization impacts other aspects of the market, including:
 - Promoting the use risk-reducing infrastructure such as central counterparties and exchanges
 - Facilitating increased transparency
 - Making products easier to understand, price and model
 - Making the markets more orderly with agreed-upon processes
- Major dealers committed to provide their supervisors with an outline of the level of standardization across credit, interest rate and equity products
- Regulators are reviewing various methods to move the market toward use of more standardized products

Global Regulatory Coordination

OTC Derivatives Supervisors' Group

- OTC Derivatives Supervisors Group initiatives began in 2005 and focused initially on credit derivatives and operational issues.
- Current priorities include: transparency, central clearing, standardization and bilateral risk management for all major asset classes.
- Major market participants, including 14 dealers and nine buy-side firms, have made a series of commitments to their primary supervisors detailing the specific improvements in the OTC derivatives market infrastructure they will make.
 - Last commitments were set March 1, 2010

Global Regulatory Coordination

OTC Derivatives Regulators Forum

- Forum formed in mid-2009 to coordinate and share information on developments related to CCPs and trade repositories for OTC derivatives.
- Objectives of the ODRF include:
 - Promote consistent public policy objectives and oversight approaches for CCPs and TRs
 - Adopt, promote and implement consistent standards in setting oversight and supervisory expectations
 - Coordinate the sharing of information made available to regulators or the public by CCPs and TRs
- Over 40 financial regulators, including central banks, prudential supervisors, market regulators and other governmental authorities with direct authority over OTC derivatives infrastructure or market participants or consider OTC derivatives matters more broadly.

Global Regulatory Coordination

The Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions (“CPSS-IOSCO”)

- Issued in May 2010 two consultative reports containing proposals aimed at strengthening the OTC derivatives market
 - The report “Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties” presents guidance for clearinghouses that clear OTC derivatives products
 - The report “Considerations for trade repositories in OTC derivatives markets” presents a set of considerations for trade repositories in OTC derivatives markets and for relevant authorities over such repositories.

Questions?

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