Keynote address at 2015 ISDA Annual Asia Pacific Conference

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26 October 2015

Today I would like to reflect a bit on some issues which I know the International Swaps and Derivatives Association (ISDA) cares about deeply.

As you know, in the wake of the financial crisis the Group of Twenty (G20) leaders kicked off an ambitious plan for global financial reforms.

The initial G20 vision was for a set of global, top-down harmonised regulations to prevent future crises.

We have been told that rulemaking is all but finished, and that we are now in the implementation phase. Well, as many of those in the world of over-the-counter (OTC) derivatives know all too well, that is not really the case. As of today, many of these reforms are still very much a work in progress.

And this is as true for the world of derivatives as it is for other projects such as cross-border recovery and resolution of large banks facing liquidity or solvency crises.

OTC derivatives

Now I know that, quite rightly, Keith and his colleagues at ISDA have been working overtime on the new frameworks for OTC derivatives to be traded on exchanges or electronic trading platforms, to be centrally cleared, reported and margined bilaterally if not cleared. ISDA's recent work on temporary stays in the context of possible central counterparty (CCP) failure has been discussed a great deal in regulatory circles.

I am sure you are aware of the background to these reforms. But in case anyone needs reminding, after the financial crisis the OTC derivatives market's complexity and opaqueness were seen to have been a big contributor to a near meltdown in major financial markets, with the AIG credit default swap as the poster child.

To address this, the new regulatory framework for OTC derivatives had to be created from scratch.

We have had a fairly good start but it is clear to everyone that much more needs to be done.

The main issue with which regulators have been struggling is that the implementation of the G20 reforms has been extremely uneven across different countries. And another relatively slow burning issue is the extent to which CCPs used for central clearing of an enormous market are now the new risk monsters. Right now discussions about CCPs having skin in the game as well as their recovery and resolution in a future crisis are intensifying.

I have been involved in the "uneven implementation" issue from three angles. First as a member of the informal grouping of a few regulators known as the OTC Derivatives Regulators Group (ODRG). And then as a member of the Board of the International Organization of Securities Commissions (IOSCO), and finally as Chair of IOSCO's Task Force on Cross-Border Regulation which finished its work a few weeks ago.

Now I should say that participants in all of these international groupings are acutely aware of the problems ISDA and its members have been grappling with. For example, at the last ODRG meeting in Toronto earlier this month consistency across clearing mandates was a hot topic. And although an outsider might view all of this as arcane and technical, the underlying issues are fundamental.

The first problem is regulatory arbitrage. Quite simply, business may move from a market with a clearing mandate to one without to avoid the first market's clearing requirements.

The second problem is market fragmentation. If a smaller market has a clearing mandate which is not required elsewhere, then some foreign market participants may not want to transact with local firms. This will reduce the choice of counterparties available to local participants and can hurt market liquidity.

This could also result in the market fragmenting into an onshore liquidity pool subject to local clearing requirements and an offshore liquidity pool which is not. This is partly to do with different views about the systemic risk of products and underlying currencies in different locations. The Hong Kong Dollar is important in Hong Kong, but not in Europe. And Sterling is important in global markets, but not in Hong Kong.

A consequence of this, as the UK's Financial Conduct Authority has warned, is that swaps clearing services could become a missing market – a service customers need but banks are unwilling to supply.

All I can say is that work continues on the possibility of better coordination between authorities in this area. However, obstacles definitely remain. And one obvious one is that in most places the legal authority to mandate clearing obligations does not mention international consistency as a factor that regulators should pay attention to. More on this cross-border stuff later.

Progress on Hong Kong's OTC reforms

Let me turn now to Hong Kong and say a bit about the progress we have made on our own OTC reforms.

As many of you know, we have been working with the Hong Kong Monetary Authority (HKMA) in developing a new regulatory regime for OTC derivatives.

So far, the focus has been on mandatory reporting, clearing and trading and record-keeping obligations.

I will quickly go over what we have done so far.

Back in October 2011, the SFC and HKMA launched a joint consultation to set out the proposed scope of mandatory obligations for OTC derivatives transactions.

Then in July 2012 we began a consultation on the proposed licensing regime for two new regulated activities. This covers those who deal in or advise on OTC derivatives, as well as clearing agency services.

The action then moved to the Legislative Council (LegCo). In April 2014, the Securities and Futures (Amendment) Ordinance 2014 was passed. This is the basic legal framework for OTC derivatives in Hong Kong.

There were two further consultations in 2014 which led to the first phase of the new regime coming into effect in July this year. This introduced mandatory reporting mainly for interest rate swaps and non-deliverable forwards. These requirements essentially apply to banks, approved money brokers, SFC-licensed corporations and CCPs.

The latest phase of this long journey took place last month, when we began a consultation about the second phase of mandatory reporting and the first phase of mandatory clearing.

Mandatory clearing covers standardised interest rate swaps between major dealers, either local or global.

We think that the limitation to dealer-to-dealer transactions is appropriate – at least in the first phase – because they are the most active participants in the OTC derivatives market and therefore imply the greatest systemic risk.

Now the hard question is how to decide which products should be subject to this obligation?

Our proposal is to follow what we are calling a “clearing determination process”. This will gauge the nature, depth and liquidity of the market for a product; the level of systemic risk and the market impact of subjecting the product to central clearing. We will also look at whether the product is subject to mandatory clearing in other jurisdictions.

We also propose that new clearing thresholds will be determined by a person’s average position during a calculation period.

The other piece of the latest consultation is the second phase of mandatory reporting, which will be expanded to cover all OTC derivatives and will require a wider range of transaction-related information to be reported.

The next phase of implementation is slated to begin in mid-2016. We hope the bill can be sent to LegCo for approval in January so we can meet this timeline.

Now I know that ISDA, among others, has complained about the short consultation period. The truth is that the proposals took time to put together despite some late nights and the very tight legislative timetable is a significant limiting factor – I sympathise but I am sure ISDA and others will be assiduous in commenting throughout the legislative process.

In the longer term, I am afraid we have more to come.

For one, we are working on further expanding the coverage of the mandatory reporting and clearing obligations. We will also consider introducing a regulatory regime for systemically important participants – that is, large end users of OTC derivatives – as well as how best to implement mandatory trading.

We also have more to do to make sure that the Hong Kong regime remains aligned with those in the rest of the world and keeps pace with the evolving international regulatory agenda.

On this front it was good to see the resolution of some of the key extraterritorial issues relating to CCPs in Asia. This was mainly thanks to collective action among our fellow regulators in Asia Pacific which helped resolve difficulties with the European Commission regarding the recognition of our CCPs.

Without this agreement the added capital charges on European banks joining local CCPs could have frozen them out of the market.

Cross-border regulation

This brings me to a wider but related topic, which is about work we have led for IOSCO about cross-border regulation. This has amounted to an extremely valuable and somewhat sobering reality check on international cooperation after the crisis.

In mid-2013 IOSCO established its Task Force on Cross-Border Regulation. I chaired this group of regulators, and I have to say that part-way through the project I almost wish I had not – such were the differences of views!

Now we decided to lead this project because its work is of special relevance to Hong Kong. As a net importer of financial services and as an open market, it is important for Hong Kong to be involved in the development of ways in which regulators can more effectively supervise securities market activities straddling different jurisdictions.

With this in mind, the Task Force focused on the difficulties that we and many other regulators now face, especially after the 2008 crisis, in trying to ensure better coordinated regulation of global finance.

And of course this correlated with an understandable push by the industry for greater consistency in rulemaking and as a result reduce compliance and fragmentation costs across the system.

Addressing cross-border issues is core to IOSCO's objective of building sound global capital markets. But even the aspirations of the G20 and the Financial Stability Board (FSB) for consistent implementation of reforms have been beset with problems. The largest current issue is the standoff between the US Commodity Futures Trading Commission and European Union (EU) over the recognition of OTC derivatives CCPs.

Much has been said about cross-border problems, but it is useful to remind ourselves of the basic issue. This is that finance is global, but regulation is local. This means that firms and transactions are often subject to the conflicting or inconsistent rules of different countries. And unless the conflicts are sorted out by regulators and governments, firms may need to limit their activities so they are subject to only one rule. Inconsistencies can be tolerated until associated costs mean that affected activities become uneconomic.

And of course the problem became more acute after the crisis as more regulation operated extraterritorially to protect domestic markets. And this was none more so than in ISDA's area of interest.

Last month, the Task Force published its Final Report which was the culmination of two years of very difficult work involving securities regulators and industry groups worldwide.

Now, you will not be surprised to know that one of the report's major findings was that in some areas there is a fairly big disconnect between the priorities of regulators and the industry. And that the priorities of regulators trend more to market fragmentation.

The crux of the issue is that the industry is pushing to have a system where national rules with potential cross-border effects can first be elevated to the international level to be sorted out as a global standard, which can then be consistently implemented in each jurisdiction.

However, this is not supported by the current global regulatory architecture. Regulators have to carry out national or local legal mandates to protect investors and their markets from external risks. And outside the EU the idea of solving resulting conflicts by relying on oversight by a foreign home regulator is viewed with varying degrees of scepticism.

Having said that we did at least find that cross-border regulation is moving towards some more engagement via different forms of recognition of foreign regulatory systems to solve the more acute conflicts. So far this is mainly bilateral. But groups such as the ODRG have tried hard to inject a multilateral aspect.

In any event, IOSCO has now agreed with our recommendations to incorporate cross-border issues more explicitly into its work. For example, from now on IOSCO's various committees must consider the potential cross-border impact of a proposed standard. This should include whether differences in the timing of rulemaking can be ironed out, and whether there should be multilateral cooperation prior to the domestic policy-making stage.

Now a few weeks ago I attended the FSB's plenary in London chaired by Mark Carney. This was to talk about our report. The FSB is interested in our work because at the G20 summit in Russia in 2013 – and more recently in Washington this year – the G20 leaders came up with an apparent silver bullet for all of these cross-border difficulties in OTC derivatives regulation. They called it "deference".

Unfortunately, this apparently simple concept is fraught with problems.

At a basic level, this idea means that jurisdictions should defer to other jurisdictions' rules if they match up to local rules so that firms can choose which ones to comply with. And this solves conflicts and inconsistencies.

But it is not as simple as that.

Admittedly, deference looks great in principle. It seems to be based on the largely successful approach in the EU. This involves the legal techniques used to build a single market under a treaty-based system which are now being applied, for the first time, to financial centres outside the EU.

But the concept of deference actually begs lots of questions. According to the G20 statement, deference should happen "when justified by the quality of respective regulations and enforcement regimes", it should involve "essentially identical outcomes", it should be "non-discriminatory" and pay "due respect to home country regulation".

And these are the same questions our Task Force has struggled with for over two years.

In our final press release, we said that “IOSCO should engage more with the G20 and FSB to raise greater awareness of the key issues and challenges faced by IOSCO members on cross-border regulation, including the need for more refined thinking on the concept of deference”.

Now, what are these issues? This is what I said at the FSB plenary.

First, national securities regulators are primarily bound by their domestic laws and national interest-driven policy objectives when acting cross-border.

Second, the constitutional authority of international standard setters such as IOSCO is inevitably weak as it is not based on binding treaty obligations and therefore non-binding global standards cannot trump local law. In fact, international standards are rarely referred to directly in securities legislation. If they are not, it is hard for national regulators to take them into account if local law already deals with an issue.

Third, peer pressure to apply international standards on a uniform basis can be effective, but this tends to be far harder in securities markets compared to banks as there is far more diversity and complexity of firms, investors, products, infrastructures and exchange platforms.

Fourth, national motives for regulating cross-border activity are extremely varied and produce different outcomes. These range from a wish to increase market access for firms to a worry that risk arising from cross-border activity might harm local markets. And these motives are not always mutually exclusive.

Fifth, on top of this regulators sometimes act protectively if they think that recognition of a foreign regime could cause domestic business to move overseas. In other words, even if differences in rules do not increase systemic risk or investor protection outcomes, if they still imply a difference in the cost of doing business, regulators will react accordingly in their national interests. Demands for reciprocity when deferring to foreign regimes also involve a competitive angle.

Sixth, recognition or deference becomes difficult when the countries involved are at different stages of development. Criteria for proportionate extraterritoriality are impossible to define in rules.

Finally, there is often a basic reluctance to outsource regulation when a failure could end up with blame at the door of the domestic regulator.

So we are a long way from the ambition expressed by global firms that any proposed markets regulation that could have a significant cross-border effect is first decided on as an international standard, before being transplanted into local law on a uniform basis.

And our report points out that if local law actually endows national regulators with the ability to deal with each other more effectively (including information gateways and recognition standards), much more could be achieved. This is largely the responsibility of legislators.

However, on the brighter side, the report recognises that in practice regulators have put an enormous effort since the Global Financial Crisis into trying to overcome these hurdles when it matters, normally through bilateral negotiation of different types of recognition or deference agreements supported by memoranda of understanding. Occasionally discussions are

multilateral, as in the ODRG. This is despite the fact that all these efforts put a major strain on scarce resources within regulators and local law may be unclear on the subject.

We therefore concluded in our report that the general direction of travel is fairly clear.

"The emphasis is towards more engagement via recognition to solve cross-border overlaps, gaps and inconsistencies through a combination of more granular international standards implemented at a jurisdictional level, and an increasing emphasis on determining when it may be appropriate to recognise foreign laws and regulations as a sufficient substitute or equivalent for domestic laws and regulations".

The asset management debate

I want to talk about one more recent example of international policy-making just to show that the ISDA community is not the only one having to wrestle with cross-border problems.

Earlier this year we saw that among securities regulators and the G20 – and more particularly the FSB, which is made up of mostly central bankers and finance ministers – the conversation had turned to the potential systemic importance of firms outside the banking sector.

This was pitched as an extension of the push to end "too big to fail" to capital markets and is an aspect of the shadow banking debate.

The question was whether to designate some big funds and asset managers which are identified as potential sources of systemic risk with the clunky label of "non-bank non-insurer global systemically important financial institutions", or NBNI G-SIFIs. The designation was to be judged simply by reference to the size of a fund or asset manager.

What lies behind this debate is the fear that bond markets could be illiquid, and at the first sign of problems – basically an interest rate hike – there will be massive redemptions which cannot be funded from asset sales or other sources of bridge financing.

Our view as securities regulators was that the fixation on size to deal with this risk was wrong. And that any bank-like solutions to deal with this risk – such as capital buffers – also did not make much sense.

Central bankers have an understandable focus on bank balance sheets, bank capital and bank risks.

But in the securities space, the reality is far more complex. Securities markets are increasingly diverse and complicated. Specifically, asset managers have fiduciary obligations and the financial gains and losses lie with investors, not on fund balance sheets.

So over the summer, I joined other Asian regulators in writing to IOSCO Board members to ask them to change direction.

In late July, following an IOSCO Board decision in June, the FSB announced that it would put aside the question of whether the G-SIFI designation should apply to big asset managers and instead focus on the actual market liquidity and redemption practices of asset managers in stressed scenarios.

This is a far better real-world approach. As many have pointed out, it is not the institutions which are systemic but rather it is the markets they trade in.

So ISDA can take some comfort from this episode that international regulatory cooperation is as tough in other areas as it is in OTC derivatives. In other words, you are not alone.

Thank you for listening and I wish you all an enjoyable conference.