Chapter 3
Regulating Global FMIs:
Achieving Stability and Efficiency across Borders

Aaron Unterman
Ontario Securities Commission, Canada

ABSTRACT

A key regulatory response to the 2008 financial crisis has been to greatly enhance the role of financial market infrastructures (FMIs) including central counterparties and trade repositories in the global OTC derivatives market. This chapter analyses the implications, from a regulatory perspective, of reliance on internationally active FMIs that can be systemically important to multiple jurisdictions by examining the multiple sources of domestic and international laws applicable to such entities. This chapter argues that, although achievements have been made, greater international coordination is necessary to ensure that global FMIs operate in a stable and efficient manner.

INTRODUCTION

Lack of transparency, transmission of counterparty risk and the inability of regulators and market participants to understand the network of over-the-counter (OTC) derivatives transactions and relationships between global financial institutions played a central role in the 2008 financial crisis. Prior to the crisis, the OTC derivatives market flourished in a largely borderless and unregulated environment and involved many of the world's largest and most systemically important institutions. Although the market proliferated, the vast majority of transactions involved a relatively limited number of large interconnected international dealers. Leading up to the crisis, OTC derivatives played an increasingly important role in most developed economies and created systemic cross border links that were opaque to both regulators and market participants. The predominance of cross border transactions in this market facilitated the global contagion of credit risk to an extent not previously witnessed.

Traditional methods of credit evaluation became unreliable due to opaque chains of counterparty exposures as well as underdeveloped record keeping and processing systems. Even prior to the crisis, vulnerabilities of the OTC market were recognized with a view emerging that: "(i) there should be a clear

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system for aggregating individual exposures across intermediaries through timely, consistent reporting using common identifiers and (ii) credit enhancement through central counterparty clearing potentially could mitigate the potential for contagion, runs, and other systemic ills" (Corcoran, 2013, p. 4).

In order to address the vulnerabilities of the OTC market, a key aspect of the global regulatory response to the 2008 crisis was to greatly enhance the role of financial market infrastructures (FMIs) in the global economy, for the purposes of increasing transparency and mitigating counterparty risk. FMIs facilitate the payment, clearing, settlement and recording of monetary and other financial transactions. They can be systemically important and perform a crucial role during and post transaction. The G-20 leader's statement from the Pittsburgh Summit (2009) laid out the roadmap for the derivatives market reform in the following statement:

All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.

This chapter will focus on the regulatory implications of the G-20 commitments to mandate the use of trade repositories (TRs) and central counterparties (CCPs), as well as the international reform efforts to implement these commitments. As this chapter will explain, the implementation of these reforms challenges the traditional construct of market infrastructure regulation and highlights the difficulties of efficiently regulating FMIs that operate on a cross-border basis. This chapter argues that the two main objectives of international FMI regulation should be market stability and market efficiency. Market stability includes monitoring and mitigating systemic risk and providing protection to market participants who use FMIs. To achieve market efficiency, there must be a regulatory structure that functions seamlessly across-borders, promotes innovation and does not create unnecessary costs. In the wake of the financial crisis, the focus on market stability has largely displaced efficiency concerns. However, in this chapter, the author argues that in order to facilitate the cross-border nature of OTC derivatives activity, the need for efficiency presents the more pressing regulatory challenges.

OVER-THE COUNTER DERIVATIVES MARKET REFORM: RATIONALE, ACHIEVEMENTS, AND REGULATORY IMPLICATIONS

Benefits and Challenges of International FMIs

Prior to the financial crisis, the OTC derivatives market was essentially unregulated in most jurisdictions, which created a major gap in international financial regulation and an opaque market fraught with risk. The regulatory goals of increasing transparency and mitigating systemic risk in the OTC derivatives market, in response to the lack of oversight revealed by the 2008 financial crisis, are uncontroversial. FMIs such as TRs and CCPs can play an important role in achieving these goals. However, the growing importance of these FMIs also introduces important new risks by centralizing credit risk and trade information.

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