

# Currency derivatives: waiting for the next wave of regulation

In my earlier contribution to this column I highlighted the resilience of the FX market shown during the crisis, went through the regulatory initiatives mulled at the time and summarized the main risks / challenges being faced in Forex. As far as FX is concerned, my conclusions were that regulators should encourage more use of CLS Bank to reduce Settlement Risk rather than forced clearing and warned that fresh regulations may hinder the resilience of the marketplace and its own development.

Financial market participants, including ACI International have lobbied the European Commission to leave out the USD 49.2 trillion FX derivatives market from new regulation on the basis that they were not a contributing factor to the crisis. The exact details on how the new rules will affect this market remain unknown until the new rules are announced.

## OTC Market

Regulators concerns on derivatives are fully justified. We all remember that in September 2008, American International Group Inc, a major participant in the credit derivatives market nearly collapsed and threatened to take the entire financial down with it. Moreover, the growth in derivatives dealt Over the Counter (OTC) over the past decade has been tremendous and almost reached USD 615 trillion as at the end of 2009<sup>1</sup>.

That lawmakers and financial firms are at loggerheads over the forthcoming financial regulations is well known. What may be surprising is that upcoming regulations on OTC derivatives will also cover currency derivatives.

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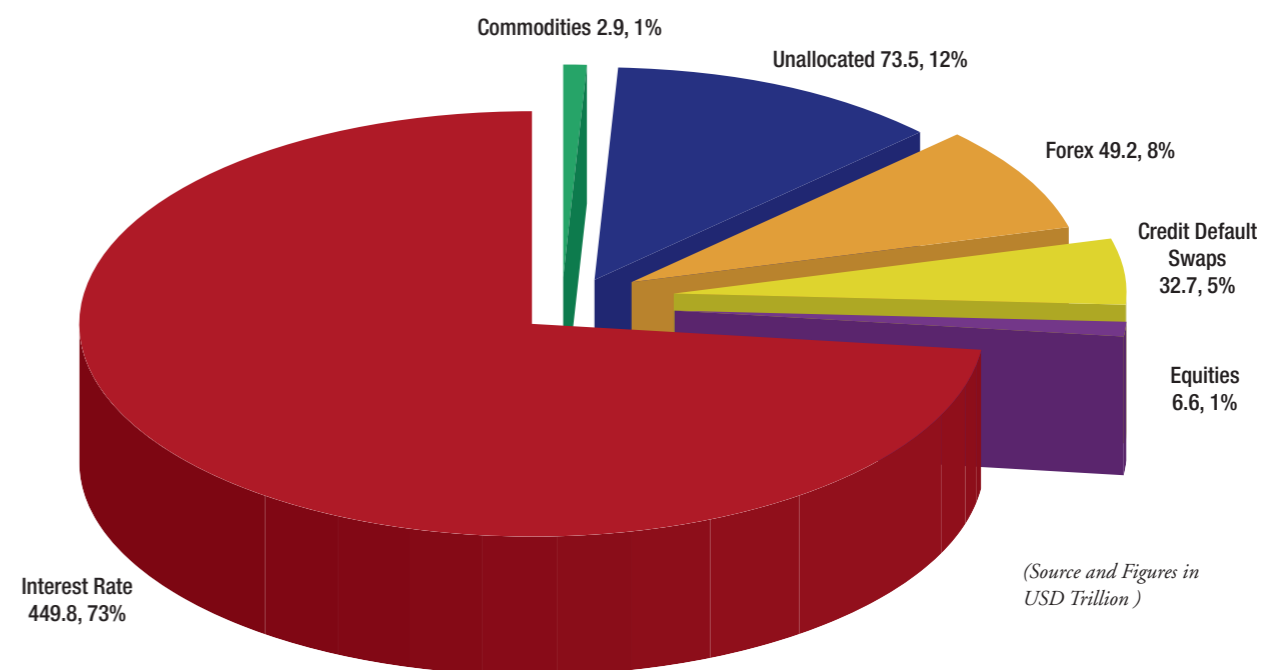


Figure 1: OTC Derivatives By Risk Category

From this vast amount of outstanding notional amounts, derivatives in foreign exchange make up around 8%. This is namely made up of forwards and FX swaps with a maturity of less than twelve months. On the other hand, the bulk amount of the OTC market is dominated by interest rate derivatives with over 73%. Figure 1 above illustrates the remaining risk categories of derivatives.

The first indications derived from the studies published and comments given by regulators were that FX Forwards and FX Swaps would eventually be exempted from new regulations on derivatives. The news broke in May, when the EU Commission announced that currency derivatives will be covered by draft European Union rules due in July.

Regulators are wary that remaining loopholes would be exploited by the industry, so they opted for a blanket solution. For instance, market participants can purposely structure interest rate derivatives as currency derivatives to achieve the same aims but avoid regulation. Therefore, the European Commission made it clear that currency derivatives will not fall outside the scope of new regulations concerning derivatives. FX derivatives are normally too customized or may not be liquid enough for central clearing. However, European regulators are expected to discriminate between standardized derivatives that are cleared centrally and those using bilateral clearing. This will be done by widening the difference of the capital charges between centrally cleared and bilaterally cleared contracts contained in the Capital Requirements Directive.

## Clearing houses

Clearing houses remain at the heart of regulators plan to reduce risk in the derivatives markets. This is meant to have a twofold purpose: firstly to increase financial stability by reducing default risk and secondly, to increase post trade transparency (PT).

## Default risk

The main benefit of a clearing house is that it minimizes counterparty credit risk by asking Members to deposit substantial initial capital and maintain variation margins. However, clearing houses do not eliminate all risks. For instance, market risk remains because market movements will still effect the risk position of a system relevant clearing member.

In fact, clearing houses themselves will become exposed to risks arising from variations in collateral value. As the recent financial crisis has shown, most OTC transactions were collateralized but when all of a sudden, the collateral became illiquid and fell in value, counterparties which assumed to be covered had to scramble to find the cash to meet their obligations.

## Post trade transparency

Transparency is a hot issue as it can divulge sensitive pricing information, details on transactions and even type of exposures. According to regulators, lack of transparency has created difficulties in accessing reliable prices, assessing risks and checking best execution.

Clearing houses could end up reducing transparency regarding fair values and counterparty exposures

because each participant's variation margin for individual instruments exposures is not publicly disclosed. Thus while clearing houses do effectively decrease counterparty credit risk, they can simultaneously decrease external insight into a firm's overall exposure to both credit and market risks. Another idea being floated that would bring transparency to the OTC market would be the creation of a Trade Repository (TR) for all OTC derivatives. This will be in the form of a centralized registry that maintains an electronic database of every OTC derivative. As highlighted in a consultative report published recently by BIS<sup>2</sup>, "the primary benefit of a TR stems from the improved market transparency facilitated by its record keeping function, the integrity of information it maintains and effective access to this information by relevant authorities and the public in line with their respective information needs".

### Conclusion

Radical changes in the way that derivatives are dealt,

executed and settled are certain. At this stage, the market eagerly awaits the new wave of rules to be announced in July. The rest of 2010 will be dedicated to consultancy. Meanwhile, market participants and financial firms will attempt to lobby the commission on a number of measures being proposed.

Surely, there will be a push towards compulsory clearing via regulated central clearing counterparties. Clearing through a clearing house will become the norm and not the exception. When this is not possible, a higher capital charge will be imposed to make bilateral clearing unappealing. Moreover there can be incentives to standardize derivatives so they can be traded on exchanges. With so many changes in regulations, it is hard to envisage how the foreign exchange market will look like in a five years time or so. What is for sure is that as long as there is trade and a need for cross boarder cash transfers, there will be an FX Market and in all probability, this will be stronger and even bigger than today.

2 Considerations for trade repositories in OTC derivatives markets. BIS, MAY 2010. <http://www.bis.org/publ/cps90.pdf?noframes=1>