Financial Crime Compliance: A Brief Guide for Senior Bank Management, Compliance Officers and Internal Auditors

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Derivatives: Limiting Market Change

Author Flora Prieto, a senior risk management specialist based in Madrid, contributed this article, aimed to reflect on the role of debt in the current economic environment.

Taking a long look at the financial industry – the challenges it faces and the changes being pushed through – is a thoroughly interesting exercise, regardless of one’s perspective. Because when a particular market experiences radical transformation, the urge to comment becomes an imperative.

The Derivatives Market

The great dynamism seen in the derivatives market is positive as well as encouraging. Bypassing criticisms to some of these products’ features seems to be pushing forward new developments. Ethical drivers may end up creating different operating processes. However, it should be noted that these changes are being driven by investor demands.

Throughout this year, within the European Union context, the MiFID II Directive and the MiFIR regulation are in effect. At an industry level, the International Swaps and Derivatives Association (ISDA) has released its 2014 Credit Derivatives Definitions aimed to replace and update the 2003 ones, over the final quarter of this year. The driving forces for these changes can again been found at a supranational level, in particular, the G-20 formal declarations in 2009. During its meetings in Pittsburgh and London the G20, in response to what were considered as “major factors of crisis”, insisted on the need for more transparency in financial markets and the application of risk mitigation techniques which would allow to keep (among other things) OTC derivatives under control. Recent changes in the regulatory frameworks of the leading economies like Japan or the US with the Dodd-Frank Act, have already set up requirements aimed to give response to most of these demands, completing the picture of a market and an industry, undergoing a radical reshape.

At the EU level, the efforts seem to be oriented towards building up stronger markets. There is no questioning on these products’ characteristics or the important financial role they play for many corporations, financial institutions and governments worldwide.

Let us address some concerns on how the overall process is managed at the buy and sell side, by originators and investors. The EU Authorities’ approach has followed a very logical sequence. First, they set up a regulatory and supervisory body, like the European Securities and Markets Authority (ESMA) in 2011, followed a few months later by the passing of the European Markets Infrastructure Regulation (EMIR) in 2012. Supposedly, if market participants are given clear guidelines with a strong commitment towards implementing the changes, the derivatives ‘jungle’ can be turned out into a friendlier world.

Both MiFID II and MiFIR regulate aspects of the derivatives’ business. The first one is mainly focused on investors’ protection issues. With this purpose, it establishes position limits to be held by one person on commodity derivatives as well as reporting requirements applicable also to emission allowances and other types of derivatives. The information to be disclosed should differentiate the positions aimed to outweigh commercial activity risks from other ones. This is a relevant distinction as limits do not apply to non-financial entities hedging their commercial exposure. Nothing has been said yet on the criteria to apply in order to differentiate hedging from speculative transactions. In any case, there are still many areas of this Directive, like this one, which need a more detailed development. This task is expected to be accomplished by ESMA by mid-next year through the drafting of regulatory technical standards.

The MiFIR Regulation, on the other hand, emphasizes the need for greater transparency in the market by imposing disclosing requirements on volumes and prices that would ensure a correct price’s formation. Trading and clearing obligations for certain types of derivatives, portfolio compression or non-discriminatory access, are just some of the other topics covered by this law. It reaffirms the supervisory role on financial markets of ESMA, granting it even temporary intervention powers on the sale and distribution of financial products or the practice of financial activities, if deemed necessary. The corresponding national authorities would also share some of these responsibilities.

The goal of transparency is achieved by imposing reporting obligations of derivatives’ contracts to Trade Repositories (TRs) as well as central clearing through Central Counterparties (CCPs) for a great number of them. For those, falling out of this scope, risk mitigation techniques should be applied. These last ones include daily mark-to-market, timely confirmation,
portfolio reconciliation, portfolio compression, dispute resolution and exchange of collateral. Certain exemptions may exist depending on the nature of the transaction (e.g. intragroup) and, indirectly by the definition of clearing thresholds. Both financial and non-financial counterparties may be subject to this regulation.

The process is still ongoing and many have been accomplished in 2014 such as reporting to TRs started in February and the authorisation of the first CCP took place in March.

These new rules are not aimed to act as boundaries which would close the EU market to third-country providers wanting to participate in it as CCPs or TRs, to the extent ESMA, as supervisory authority, would recognize them. The EU authorities’ main concern lies on the potential negative impact derived from asking them twice to comply with the same requirements. This open attitude may end up playing a key role in ensuring that derivatives continue to be a global business. Its importance may be twofold: from an institutional standpoint, because it can contribute to the development of emerging markets as these participants need to get adapted to a certain set of requirements, and from a markets perspective, as mechanisms reinforce the desired transparency which should prevail everywhere.

The Impact of Change

Although there are many benefits expected from this transformation in the financial markets some concerns are also arising. Different ISDA research reports published throughout 2014 have highlighted the fact of an increasing market fragmentation along geographical lines as a consequence of the new rules being put in force by US authorities, and in response to the global demands for more regulation of the derivatives’ business. The different regime affecting US and non-US persons, in terms of obligations of where to trade (trading platforms should register as SEFs or swap-execution facilities) and what to trade (the made-to-available trade or MAT rule defines the products which should be mandatorily negotiated on SEF) have affected the way the market operates, leading to a higher preference for counterparties of the same geographical area.

In other words, European dealers preferably engage in derivatives’ transactions with other European counterparties while US-based ones tend to do the same among themselves. As an example, just consider Euro interest rate swaps: data released by ISDA shows an increase in cleared European interdealers’ activity from 75% in May 2013 to 93% one year later. European-US dealers’ transactions during the same period fell down from representing 24% to just 6%. An ISDA Insight Survey on end-user’s opinions on these facts revealed a perceived negative impact on firm’s risk management activities as well as an increase in costs.

There is the risk that this market geographical disruption would tend to consolidate leading to the surge of differentiated areas where derivatives deals are arranged subject to specific and different conditions, regardless of the product type. Thus, when reviewing the scheduled implementation calendar applicable to 2014 ISDA Definitions, it can be seen that not all the same terms would apply everywhere. Well-established markets such as Europe, the US, Japan, Australia or New Zealand would lead the change from the beginning while emerging ones, such as...
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as EMEA or Latin America would not join this trend. In practice, this implies to acknowledge the fact that market differences go beyond counterparties’ peculiarities and get, directly influenced by the existing economic and regulatory environments. It needs to be taken into account that some of the most relevant changes are related to the consideration of new credit events (e.g. governmental intervention) and widening of settlement facilities (e.g. asset-package delivery). As these definitions would mostly affect credit default swaps, preventing developing economies’ parties from incorporating them, it can be understood like the acceptance of a two-level industry on the basis of their corresponding financial systems’ stability. This poses a potential threat if understood as if OTC transactions would be questioning global financial system’s presumptions. This has nothing to do with the unfortunate episodes of unethical behavior seen in this industry whose consequences are known to everybody.

The recent financial crisis is, undoubtedly, leaving its mark on these changes. It would be odd to neglect the importance that setting strong grounds have for the development of any market. A clear lexicon, capable of giving response to the new financial products stream, detailed regulatory technical standards defining the need and conditions under which technical processes such as portfolio compression or portfolio reconciliation should be undertaken or the parties’ acceptance that, despite being OTC deals, they should be subject to certain enforceable terms and conditions, result necessary.

The imposed clearing obligation is a common feature in the laws being approved by the different countries, in response to G20 demands. However, despite all the efforts being done, the results are evident that there would continue to be a part of non-cleared transactions. ISDA reports estimate that they would end up representing around 30% of the global OTC derivatives activity.

Non-cleared transactions have been tackled by regulatory authorities from a different perspective which is mainly focusing its interest in the application of risk mitigation techniques and definition of margin requirements. The overall purpose is to reduce counterparty risk. Financial experts agree on the fact that this is a necessary segment of the market which cannot be eliminated. The wide variety of types of existing derivatives, the need for their customization and stakeholders’ interest in ensuring companies apply an active risk management strategy, make necessary their continuity. The existence of reduced levels of liquidity as a consequence of deal’s features (like its unusual or long maturity periods or its denomination in non-frequently negotiated currencies) should not imply lower levels of investor’s protection or higher sources of market instability.

All these steps being taken up to now and the ones to follow over the coming years, confirm the critical role that adequate hedging strategies have for any company’s financial success. As it has been mentioned above, a clear distinction is drawn between commercial risk’s management and other risks’ management. However, it should be kept in mind the fact that this is a financial alternative not suitable for everyone. Stricter margin demands, both in the form of variation and initial requirements, do not act taking liquidity out of the market, but rather the opposite by increasing participants’ confidence and keeping basis risk at a minimum level. The challenge lies on the industry which would need to find out other ways of giving response to customers’ needs.

The new regulations have broken up existing prejudices by allowing the possibility of limiting positions, defining clearing thresholds, imposing stricter margin requirements or even, temporarily ban a product. There is no doubt that although this affects all participants, non-financial counterparties are the ones seeing how their way of doing business changes the most. The fact that the bulk of their hedging activity may fall under the category of commercial risk and, therefore could benefit more from clearing thresholds, would not prevent them from having to implement internal monitoring tools, which would ensure their compliance with the new rules. The consequence of this would be more control on their derivatives’ activities. Over the long-run, it is even possible to think of the surge of a new managerial approach, the corporate portfolio one.

Any attempt to make the derivatives world a more manageable one should lead to positive results from a transaction’s perspective, because the figures managed in this market are, simply, exorbitant. Companies and investors could just feel that they needed to be a part of it, despite not having at hand, all the necessary tools for correctly benefitting from them. From a dealer’s perspective, because they have to manage simultaneously - the product, the customer and their risk – each of them with its peculiarities and demands, avoiding any overlaps while taking use of the capability to supersede some of them by applying some of the most sophisticated technical tools currently available in the market.

The author invites your comments and feedback via email to OS@riskrewardlimited.com

REFERENCES

- ISDA research reports are available at: http://www.isda.org