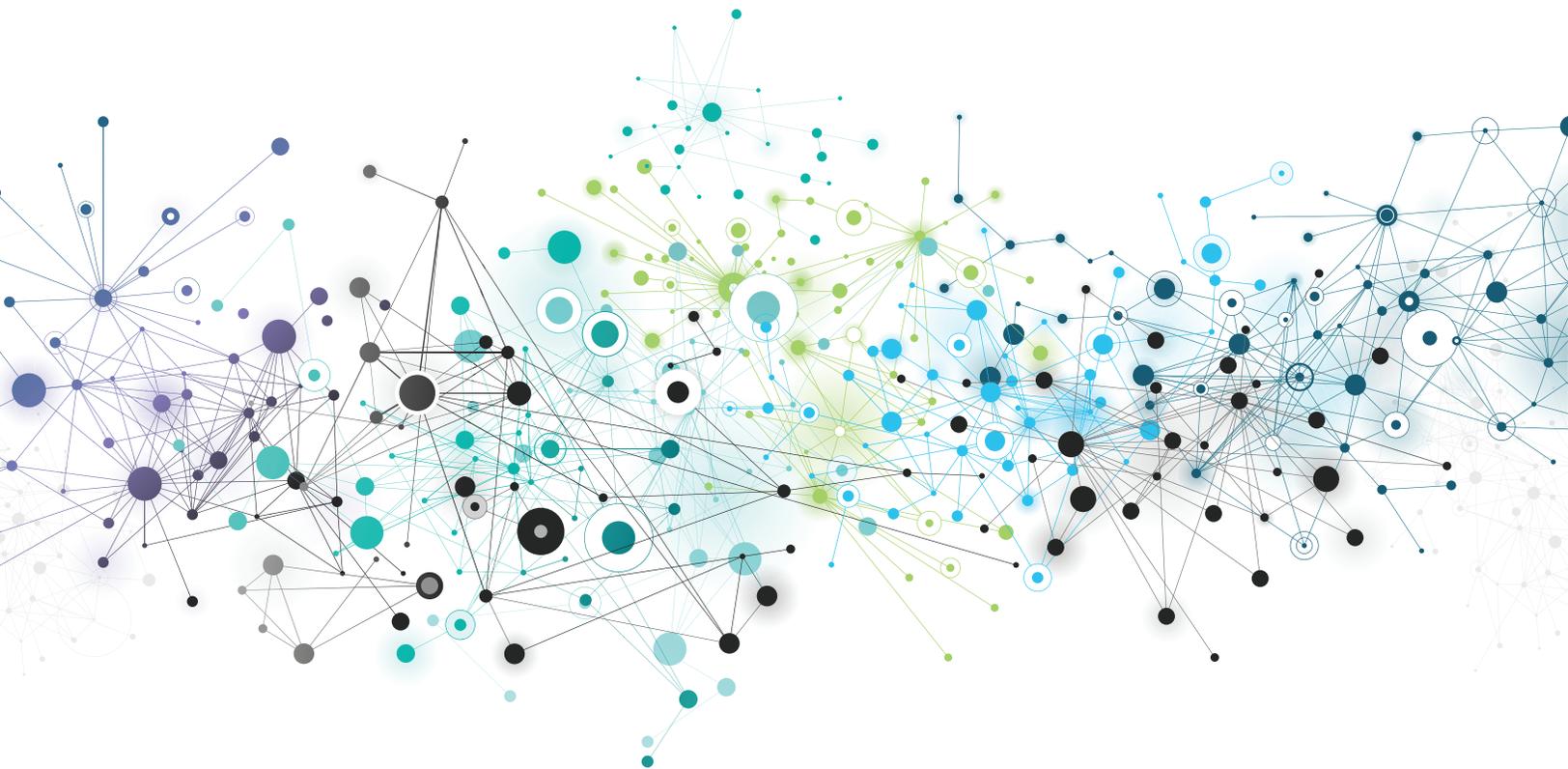


OTC INTELLIGENCE

DERIVATIVES ROUND TABLE | **INTEREST RATE SWAPS**

Summary Report from May 28, 2014



Round table hosted by:



Financial regulators are re-shaping OTC derivative markets in an effort to reduce systemic risk. Change has been unfolding for more than five years, but the complexity and nuance of the derivative-market reforms are just now being understood. Participants have been anticipating and preparing for final regulatory outcomes; however, certainty remains elusive as the regulatory process is still incomplete in many jurisdictions. On May 28, 2014, market participants and industry stakeholders gathered in Toronto to share insight, and gain perspective on how to best prepare for these reforms. This document highlights the key take-a-ways from the event, including: market preparations, resource allocations, structure and user experience.

Market Preparations

For Canadian participants, the focus for the past year has largely been on understanding the consequences of US regulatory change, and how it affects their Canadian businesses.

Buy-side participants have been working to stay abreast of the dynamic regulatory environment, negotiating contracts, and making requisite changes to their legal, technical and business infrastructure. Some market participants have been caught unprepared by the speed and extent of the reforms and are now scrambling to come into regulatory compliance, or to find alternative hedges for their market risk.

Resourcing these projects has been a challenge for all market participants in general, and for leaner operations in particular, due to the size of the commitment and uncertainty surrounding the final outcome.

Dealers and marketplaces have had to get up the curve on their new regulatory requirements and have made large investments in the business infrastructure. Both groups have taken on the role of educator, as clients seek information and advice. Additionally, dealers may have had to re-paper their offshore businesses, redefine the scope of their agreements with clients and vendors, and prepare for real-time credit checks, streaming prices, reporting and central clearing. These requirements have forced major changes across organizations, and introduced new ongoing expenses.

Market Structure

The United States has taken a prescriptive rules-based approach to re-regulating the OTC interest rate swaps (IRS) markets – led by the Commodity Futures Trading Commission (CFTC). The aggressive pace set by the CFTC has become the focal point for other G20 members; many are content to let the US take the lead and learn from their experience. This approach has challenged market participants to meet the emerging burden, but also created uncertainty as new rules are written, then subsequently re-written as the iterative process evolves. At the same time, participants are waiting for other jurisdictions to weigh in with their respective rules.

While Canadian dollar swap trades are temporarily exempt from US trading requirements and the Canadian regulatory framework for trading has yet to be presented, both Canadian and US participants are already trading electronically. As per Dodd-Frank regulations, any swap transaction entered into by a US Person (buy- or sell-side) that takes place electronically must be executed on a Swap Execution Facility (SEF) or Designated Contract Market (DCM). As such, many participants have chosen to start taking advantage of electronic trading.

In Canada, the regulatory approach has been more collaborative. Due to the complexity and scope of the work, the Canadian project plan workload has been shared across members of the Canadian Securities Administrators (CSA). Much of the project work is largely completed for participant registration, clearing, reporting, reconciliation, and collateral, but the market is still waiting to see what will be proposed for “trading”.

Early indications are that the Canadian trading framework will be more “flexible”, when compared to the US approach. The intention is to allow the market to evolve more naturally, while still honouring commitments to the G20. Canadian regulators will continue to move cautiously to consider the nature of each derivative market, on a category-by-category basis, to ensure that change does not negatively impact participants’ timely access to liquidity and price efficiency.

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Harmonization

The International Organization of Securities Commissions (IOSCO) is mandated, in conjunction with the newly formed OTC Derivatives Regulators Group (ODRG), to harmonize regulation and timelines across G20 jurisdictions. ODRG is examining cross-border issues including: equivalence and substituted compliance, clearing determinations, risk mitigation techniques for non-centrally cleared derivatives transactions, data and trade repositories.

Two areas of concern that have already been raised by market participants are mandated trading and shadow banking.

Mandated Trading

It has been suggested that the scope of the new Canadian trading rules will be broad enough to accommodate mandated trading in the future, but that the market should not expect it at the outset. This raises two issues: timing and equivalence. Will the CFTC move to mandate Canadian dollar swaps trades before the CSA? If the CFTC goes first, does that introduce new sources of risk for Canadian participants? Further, would such an event be inconsistent with the broader objectives of global harmonization and limiting opportunities for regulatory arbitrage?

Shadow Banking

Canadian regulators are cognizant of the fact that closing one regulatory window may unexpectedly open another. There is a risk that heightening regulatory frameworks will drive further market innovation in the direction of unregulated shadow banking activities. For example, asset transformation and its greater dependence on the Repo market, as fully-invested investors meet Central Clearing Party (CCP) requirements to post cash as collateral on valuation margin. As a result, Canadian regulators are carefully observing experiences in other markets to identify potential areas of concern.

Transparency

The Swaps Data Repository (SDR) is now receiving and publishing Canadian IRS trades in near real time. Most reported Canadian-dollar trades are executed by Canadian Banks with US persons, or US banks with any counterparty; however, some records of trades executed with Canadian counterparties

are voluntarily submitted by Canadian banks. Although there is some confusion around which trades are currently being submitted to the SDR, there is little evidence to suggest that the SDR feed has compromised any participant strategies or reduced their access to liquidity.

Standardization

The speed with which regulations have been introduced in the United States has forced US-based investors to be engaged in understanding how their business will be impacted by the new requirements. Additionally, some investors have also assisted with the development of market-evolved trading solutions.

One such solution has been the introduction of Market Agreed Coupon contracts (MAC trades), which standardize the coupon, start date, and end date of a swap. Generally, the coupon is based on a Securities Industry and Financial Markets Association (SIFMA) defined coupon curve for the currency, and the start and end dates are fixed to the quarterly International Monetary Market (IMM) dates. The effect is to allow contracts to be opened, increased, closed, or compressed cleanly with no residual basis risk or rolled forward to the next IMM date, as needed. The benefit to market participants is a potential opportunity to reduce the cost of managing market risk and line-item expense with clearing houses. The drawback of MAC trades is that they do not allow for any customization, and hence, a lack of suitability.

Presently, Tradeweb reports that MAC trades account for about 10% of the buy-side trade volume executed on its SEF, but adoption of these trades is expected to rise as some investors take advantage of their inherent efficiencies to further reduce market risk and operating expense.

Market Experience

As Canadian dealers work to understand how market reforms will impact their businesses, they are also compelled to address the needs of their buy-side clients. This requires compliance with US and European rules, in addition to what will be mandated domestically. Further, Basel III and the Volcker Rule will have an impact as they may force some restructuring of business lines and capital allocation.

» IN CANADA, THE REGULATORY APPROACH HAS BEEN MORE COLLABORATIVE. DUE TO THE COMPLEXITY AND SCOPE OF THE WORK, THE CANADIAN PROJECT PLAN WORKLOAD HAS BEEN SHARED ACROSS MEMBERS OF THE CANADIAN SECURITIES ADMINISTRATORS (CSA). »

Adoption

IRS participants in the US and Europe are quickly adapting to their respective regulatory environments and some are extending their electronic trading to include CAD IRS transactions. Conversely, Canadian investors are looking for more guidance and certainty from regulators. For many, nothing will change as long as their transactions do not include a US person(s). For others, they are ready, able and willing to trade CAD IRS both on-SEF and electronically off-SEF; however, in the absence of a clear mandate, adoption is taking longer than what has been experienced in Europe or the United States.

Summary

The Canadian experience has been less prescriptive than what we have seen from the US and Europe. The Canadian approach has been reserved and may be more principle-based than the US in order to focus on the broader objectives. Canadian regulators are observing other market jurisdictions and giving careful consideration to what they see. The consequence of this approach has been greater market uncertainty with regard to requirements and timing, and slower adoption by market participants in general. In the meantime, the US continues to push ahead aggressively, and much of their work is affecting market behaviour in Canada. The CSA is expected to introduce a trading regime that complies with Canada's G20 commitment to assist its global partners in reducing systemic risk, while harmonizing its rules with other jurisdictions to avoid any negative effects from regulatory arbitrage.

It is anticipated that later this summer the CSA will publish, for comment, its initial proposals for the OTC Derivative Trading Rules and that this will begin the industry debate in earnest. It is clear that many participants are engaged and will have opinions to share at that time.

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