

# Resilience of OTC Derivatives Market: Regulatory Initiatives and Policy Recommendations

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# Agenda for the Presentation

- 1. Why OTC Derivatives Are Important?**
- 2. Some Stylized Facts On Global OTC Derivatives**
- 3. Regulatory Framework For OTC Derivative Markets: Recent Global Initiatives**
- 4. Regulatory Measures on OTC Derivatives initiated by the Reserve Bank of India (RBI): A Case Study**
- 5. Some Policy Recommendations For Emerging Economies**

# 1. Why OTC Derivatives Are Important

1. The global OTC derivatives market is very large, larger than exchange traded derivatives or exchange traded cash equities
2. OTC derivatives markets have grown very fast. The information on OTC derivatives market is deemed crucial for financial market stability and macroprudential policy
3. OTC derivatives markets are viewed as an amplifier of stress in the present global financial crisis

## 2. Some Stylized Facts about Global OTC Derivatives (I)

1. The OTC derivatives can be divided into four main categories:
  - i. Financial Derivatives (including interest rate and credit default derivatives)
  - ii. Foreign Exchange Derivatives
  - iii. Equity-linked Derivatives
  - iv. Commodity Derivatives

## 2. Some Stylized Facts about Global OTC Derivatives (II)

2. Gross market value (cost of replacing all existing contracts) is a better measure of market risk than notional value of contracts
3. Gross credit exposure (after accounting for legally enforceable bilateral netting arrangements) represents the aggregated gross market values and shows the payment flows at risk

## 2. Some Stylized Facts about Global OTC Derivatives (III)

4. About two-third of the global OTC derivatives exposures are estimated to be collateralized
5. Most of the collateral used takes the form of cash, implying a conspicuous absence of securities as collateral!
6. The uncollateralized segment of the global OTC contains high risk potential!!

## 2. Some Stylized Facts about Global OTC Derivatives (IV)

7. US dollar is the dominant currency in most OTC derivative markets on notional value, whereas Euro leads in terms of gross market value.
8. Largest proportion of OTC derivatives business is done in the European Union, with London as the leading derivative centre
9. Though global in nature, cross-border OTC derivatives are concentrated mostly in G-10.

## 2. Some Stylized Facts about Global OTC Derivatives (V)

10. Estimated exposure to the residents of emerging markets has increased over time
11. The majority of transactions in the OTC derivatives market are still traded, cleared and settled bilaterally, adding to calls for more transparency
12. Most of the OTC derivatives markets are wholesale in nature



### 3. Regulatory Framework For OTC Derivative Markets: Recent Global Initiatives

1. Most of the initiatives in the US and European Union focus on the post-trading infrastructures and market arrangements
2. Use of centralized clearing through a CCP (Centralized CounterParties) is the most common initiative today for lowering the counterparty risk and transparency

### **3. Regulatory Framework For OTC Derivative Markets: Recent Global Initiatives (contd..)**

3. National supervisors and international committees have undertaken steps to mitigate the risks inherent in OTC markets
4. The Basel Committee on Banking Supervision has issued guidelines on revisions to the Basel II market risk framework and guidelines for computing capital for incremental risk in the trading book.

## 4. Regulatory Measures on OTC Derivatives initiated by the Reserve Bank of India (RBI): A Case Study

1. Since RBI regulates the money, government securities and foreign exchange markets,, by default it regulates the derivatives thereon.
2. Whereas the exchange traded derivatives are regulated by the respective stock exchanges and overseen by Securities and Exchange Board of India (SEBI), OTC derivatives market is completely within the purview of RBI

## **4. Regulatory Measures on OTC Derivatives initiated by the Reserve Bank of India (RBI): A Case Study**

3. The RBI (Amendment) Bill 2006 has legalized all OTC derivatives, where at least one of the parties in transaction in a RBI regulated entity (either a scheduled commercial bank or a primary dealer or a financial institution).
4. The comprehensive guidelines (2007-08) lay down general principles for derivative trading and sound governance requirements

## **4. Regulatory Measures on OTC Derivatives initiated by the Reserve Bank of India (RBI): A Case Study**

5. Only Interest Rate Derivatives (such as Interest Rate Swaps and Forward Rate Agreement) and Foreign Currency Derivatives (such as Foreign Currency Forward, Currency Swaps and Currency Options) are allowed
6. OTC Credit Derivatives (such as Credit Default Swaps and Credit Default Obligations) and OTC equity-linked derivatives are not permitted in India

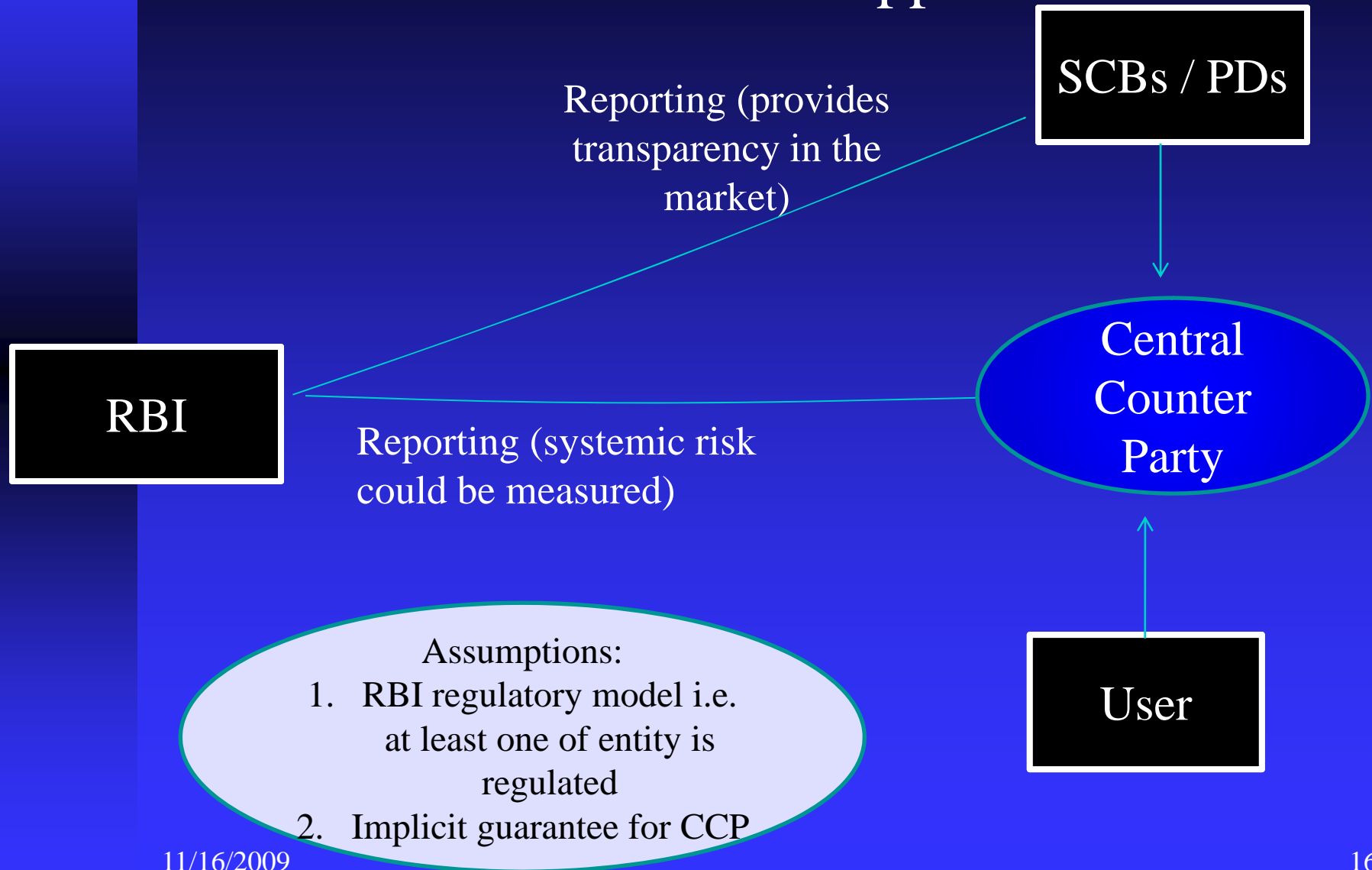
## **4. Regulatory Measures on OTC Derivatives initiated by the Reserve Bank of India (RBI): A Case Study**

7. Interest Rate Swaps and Currency Forwards account for about 85% of the OTC derivative trading in India.
8. The present outstanding volume of the interest rate swaps is about \$700 billion (controlled by 20 major players) and that of currency forwards is about \$500 billion
9. The market is estimated to be expanding at about 35% annually (CCIL estimates)

## **4. Regulatory Measures on OTC Derivatives initiated by the Reserve Bank of India (RBI): A Case Study**

10. With the Clearing Corporation of India Limited (CCIL), India was a pioneer in embarking on the path of Centralized Counter Party. It provides a clearing and settlement arrangement on a non-guaranteed basis for the OTC interest rate derivatives since November, 2008.
11. Based on the concept of multilateral netting by a central counterparty, the process has reduced the liquidity risk, enhanced the efficiency of the payment system in India and reduced settlement costs associated with growing volume of market activity

# Regulatory Framework for Indian OTC Derivatives: CCP Approach





## **4. Regulatory Measures on OTC Derivatives initiated by the Reserve Bank of India (RBI): A Case Study**

12. RBI has asked all banks and primary dealers to report all their interest rate derivatives trades on the reporting platform within 30 minutes from the deal time. At the end of March 2009, 63 members have joined the segment for reporting IRS/FRA trades
13. As of July 2009, the CCIL reported that it will soon offer guarantees on IRS and Currency Forwards. This will help banks save on capital requirements, reduce settlement and operational risks in OTC transactions.

## 5. Some Policy Recommendations For Emerging Economies

Three major goals of our policy recommendations are to:

1. Achieve greater transparency,
2. Increased disclosure, and
3. More Standardization.

We are neither proposing more regulations in the OTC derivatives market nor ignoring the functional value of OTC markets

## 5. Some Policy Recommendations For Emerging Economies (contd..)

- A Our first policy suggestion relates to strengthening the post-trade infrastructure through CCP approach:
1. Greater competition amongst institutions performing the role of CCP
  2. Supporting CCP institutions with adequate financial resources, and
  3. Scenario planning and clear procedures for default management in case of run on CCP institutions

## 5. Some Policy Recommendations For Emerging Economies (contd..)

- B. Our second policy suggestion relates to more disclosure from the market participants:
  1. Participants should be asked to reveal the risk profile of each transaction,
  2. The valuation of the OTC products should be marked-to-market for accounting purposes
  3. The buyer of the OTC products may be asked to reveal his funding source!

## 5. Some Policy Recommendations For Emerging Economies (contd..)

- C. Our third policy suggestion relates to greater standardization in the market:
  1. Participants in the market may be encouraged to use standard documentation
  2. CCP institutions could insist on ISDA documentation for more uniformity in reporting
  3. ISDA`s Master Agreement may be used for introducing international standards of reporting

Thank you for your  
attention