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OUTLOOK: Main regulatory developments in Asia's OTC derivatives markets in 2019

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A number of important regulatory developments in the over-the-counter (OTC) derivatives markets will be closely watched this year including proposals from various industry associations appealing to regulators to review the state of reform.

One of the more prominent papers was published by the International Swaps and Derivatives Association (ISDA) in July last year. It outlined a number of areas and appealed to regulators, including the U.S. Commodity Futures Trading Commission, to consider reviewing regulations.

The areas raised included proposals to change the in-scope applicability of OTC derivatives regulations; postponing the mandatory requirements for posting initial margin; excluding physically settled FX swaps from the aggregate average notional amount (AANA) calculation; and a proposal to increase the thresholds for the aggregate average notional amount of non-cleared derivatives to $100 billion/100 billion euros from $8 billion/8 billion euros for the fifth phase implementation of initial margin requirements, slated for September 2020.

Developments on industry lobbying for the thresholds for the aggregate average notional amount of non-cleared derivatives to be increased to $100 billion/100 billion euros will be closely watched this year. The existing thresholds of $8 billion/8 billion euros set by the Basel Committee on Banking Supervision and the International Organisation of Securities Commissions will bring more than 700 entities into scope for the initial margin requirements when the rules take effect in September 2020.

Compliance with the fifth phase implementation of initial margin requirements will be a challenge as it will involve more than 7,000 relationships that will be required to exchange initial margin, said Kishore Ramakrishnan, partner at Temple Grange Partners in Hong Kong.

"Because the number of relationships involving initial margin is so massive, that is why the industry is proposing to increase the thresholds from $8 billion to $100 billion. If this does happen, the 7,000 initial margin relationships will fall [to] under 5,000," he said.

Ramakrishnan also pointed out that if physically settled FX swaps were also excluded from the calculation of the aggregate average notional amount of swaps, this could lead to a 35 percent reduction in the 700 additional entities that will be caught by the initial margin requirements during the fifth phase implementation.

Market participants in Asia could benefit if thresholds were increased

Many market participants in Asia could benefit if the thresholds for the aggregate average notional amount of non-cleared derivatives were increased to $100 billion/100 billion euros, as they likely would not be in scope for the initial margin requirements and hence not required to exchange initial margin, said Tom Jenkins, head of financial risk management at KPMG China in Hong Kong.

"If the threshold is not raised, many counterparties in Asia will be caught. Nobody knows yet what directions regulators are going to go," he said.

Others, however, are a little sceptical whether the industry lobbying will have any success.

"I am not sure how receptive regulators will be for the thresholds to be increased from $8 billion to $100 billion. The industry has a reason by asking for this but regulators will have their own views about whether this is appropriate," said Terry Yang, partner at Clifford Chance in Hong Kong.

At the global level, a few industry associations are still pushing for the thresholds for the aggregate average notional amount of swaps to be increased to $100 billion/100 billion euros. An outcome could be achieved in a few months' time, according to sources.

Significant amount of work awaits

Implementation of initial margin will enter its fourth phase come September this year, and a significant amount of work awaits market participants.

Market participants need to begin by identifying whether any of their entities will be caught by the fourth phase implementation, which will in turn help them to determine whether they will be required to post variation margin, Ramakrishnan said.

"Once that is done they have to work out the aggregate average notional amount of swaps if they are caught in the fourth phase, which has a threshold of $750 billion/750 billion euros, or if they are caught in the fifth phase, the threshold will be $8 billion/8 billion euros. You can see that as we get to the final phase, which is September 2020, the threshold suddenly drops to $8 billion. This is what I call the cliff effect. Essentially, everyone gets caught [by the initial margin rules]," he said.

Banks, corporates and buy-side firms caught by the fourth phase implementation of the initial margin rules will be required to make changes to their systems and infrastructure to facilitate their calculation of the aggregate average notional amount of non-cleared derivatives at the consolidated level, according to Ramakrishnan. Market participants would also need to decide the approach they will take to calculate initial margin. The approaches include the standard initial margin model (SIMM) developed by ISDA and the regulatory grid approach recommended by the Basel Committee.

Market participants in Asia dealing with multiple currencies will be required to do the calculation across multiple currencies, Ramakrishnan said.

Information about market participants' entities that will come into scope and the thresholds they have reached in their total OTC derivatives trades should be disclosed to all their counterparties at an early stage, according to Ramakrishnan.

"This is part of portfolio compression, confirmation and reconciliation. Such information disclosure to all counterparties needs to take place at least 12 to 18 months before September 20, 2020. It is all part of risk mitigation for non-centrally cleared derivatives," he said.

With eight months left until the fourth phase implementation in September, market participants need to begin work on a number of legal aspects, according to Yang. These include establishing custody arrangements, choosing the right custodian banks and contract negotiation.

"There will be other areas which are beyond my area of expertise. The market has two more phases to bring in market participants into the margin requirements. People shouldn't underestimate the amount of work required which is why the industry has until September 2020 to meet the phase five requirements. For those that will be caught by the phase five implementation they need to start to prepare this year," he said.

Conceptual challenges and nuances: transition away from Libor

Yang also pointed out a number of challenges which he termed "conceptual", one of which is the transition away from Libor to risk-free rates. The challenges stem largely from the fact that derivatives are used for hedging purposes or for risk associated transactions, which makes it trickier, he said.

"It is not just what the swaps market wants to do, but rather the swaps market has to make sure it is consistent with the changes in other markets. It is not just the derivatives markets, but [it] also [concerns] the loans and bonds markets as well," he said.

As the market moves away from the use of Libor, a considerable amount of coordination work will be required given the large number of market participants involved and the need to have everyone agree to the same fallback rates, Yang said.

"All this will have an impact on liquidity. For example, if half the market participants decide that they want to transfer from Libor to a particular risk-free rate, but others decide to use another risk-free rate or different methods of calculating new rates, this will eventually lead to market fragmentation," he said.

Yang also warned of the nuances that come with using fallback rates, particularly if Libor does not entirely cease to exist by 2021. Even though regulators have made clear to market participants they should move away from Libor by 2021, Libor rates may still be published and may render some fallback provisions invalid, he said.

"If Libor continues to be published by 2021, market participants may be forced to continue to use Libor by which time it may not be a good rate anymore because it may not be calculated in a comprehensive manner and so may not be accurate," Yang said.

It is, however, not within the power of regulators to prohibit financial institutions from publishing Libor by 2021 even though they have told the market to stop using it or publishing it, Yang said.

"This is more [an issue] for market participants to deal with; they have to manage it and it is not for regulators to manage it. Market participants can deal with it by being diligent around their contract management," he said.

Yang also suggested that market participants come to a decision soon on the risk-free rates they will use in the future rather than at a time nearer to 2021. Since none of the market participants involved in derivatives trades will have certainty about future losses or gains from a derivatives transaction, an earlier decision on a future risk-free rate will help both parties reach an agreement, he said.

"The nature of derivatives is such that a transition from Libor to another rate will mean that one party will lose while the other party will win. Right now when the end of Libor is still two years away, the parties will have no certainty about which future rates will be good for which party. If market participants leave that decision to the last minute, they will know if they will make a loss on a trade and they will not want to amend the rate. If they know they are going to lose money, they probably won't agree to use a particular rate," he said.

OTC derivatives reforms in Hong Kong and Singapore

Significant developments on OTC derivatives reforms have also taken place in Asia's leading financial centres, namely Hong Kong and Singapore, in recent months. On December 12, 2018, Hong Kong's Securities and Futures Commission (SFC) concluded its consultation on OTC derivatives and conduct risk.

The SFC's conclusion to its consultation paper covered a number of areas including risk mitigation requirements for all licensed corporations, trading relationships, dispute resolution and client-clearing requirements. The SFC will also introduce conduct requirements for licensed corporations which have dealings with group affiliates and other connected persons. This is mainly to address risk and to ensure that market participants act in clients' best interests and make appropriate risk disclosure.

The Monetary Authority of Singapore released on January 17 guidelines on risk mitigation requirements for non-centrally cleared OTC derivatives contracts. These address four main areas: trading relationship documentation; dispute resolution; portfolio reconciliation, portfolio compression and valuation; and trade confirmation and governance.

Market participants in the Asia-Pacific region will have to begin work to comply with the SFC and MAS requirements in the jurisdictions in which they operate, Ramakrishnan said.

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