Seminar on OTC Derivatives Global Reform[1]

Opening remarks by
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[1] Opening remarks delivered by Enrique Marshall, member of the board of the Central Bank of Chile, at the Seminar on OTC Derivatives Global Reform, organized by the Central Bank of Chile and The International Monetary Fund, and held in Santiago (Chile), on January 28-30, 2014. I thank Kevin Cowan, Gabriel Aparici and Daniel Calvo for their contributions and comments.

Good morning everyone. I would like to give a special welcome to our foreign visitors. On behalf of the Governor and the Executive Board of the Central Bank of Chile, I am pleased to open this seminar on OTC Derivatives Global Reform[2]. We will all agree that nowadays this is a well-timed topic for a seminar.

Derivatives are undoubtedly key instruments for risk management among financial and non-financial firms. They are intensively and increasingly used, however, if the regulatory framework does not contain a set of backstops that provide safety guarantees for participants, derivatives impose high risks with potentially adverse consequences on financial markets[3].

These backstops are essential in markets characterized by large transaction volumes and numerous participants, as those ingredients inevitable lead to a network of highly interconnected financial commitments. This issue has been known for a long time. However, the recent global financial crisis has reminded us that in such circumstances, negative shocks are transmitted at a high speed, with the well-known adverse impacts on the financial system as well as the real economy.

Interconnection risks become even more severe when markets operate with insufficient levels of transparency. Opacity limits the capacity of market participants to make informed financial decisions and the ability of regulators to judge intermediaries' exposures and risks.

OTC derivative markets, the focus of this seminar, often operates under high interconnectedness and a lack of essential information. This explains why they were at the center of the last financial crisis and raised a high level of concern among financial authorities. Exchange traded derivatives markets, on the other hand, did not produce the same level of preoccupation. They were neither an originator of the crisis nor a major transmission channel of financial disruptions.

In the aftermaths of the global crisis, the policy response from financial regulators has been to reduce interconnections, increase transparency and introduce more liquidity and capital requirements for financial intermediaries. Simultaneously, regulators have been developing incentives to move

[2] OTC is an abbreviation for over the counter.
[3] Activity levels in derivatives markets are reported in BIS (2013), "Triennial Central Bank Survey of interest rate derivatives turnover in April 2013 - preliminary results released by the BIS", September 2013.

derivatives trading from OTC markets towards more formal and organized exchanges, which have mechanisms in place to reduce exposures and mitigate systemic risks.

In this new environment, OTC derivatives markets have continued functioning, but actions have been taken in some jurisdictions to use central clearing for most types of derivatives. Such steps have been led under the mandate of the G20 and the coordination of the Financial Stability Board (FSB)[4].

The US policy response is embedded in Title VII of the Dodd-Frank Act, while the EU has acted through the European Market Infrastructure Regulation (EMIR). In both cases, there is a "mandatory clearing" for standardized OTC derivatives, among numerous others requirements aimed at strengthening infrastructure standards. An important point is that the new rules have effects not only in the jurisdiction where they were issued, but also in other countries.

The potential impact of these "extraterritorial effects" has been a matter of concern for economies that have substantial cross-border derivative positions with institutions in the US and the EU. This is certainly the case of Chile. After moving to a floating exchange rate regime in 1999, derivative markets have grown quickly. Turnover of foreign exchange derivatives has increased from 1.6% of GDP in 1998 to 5.3% of GDP in 2013.

The privately run pension system in Chile has played an important role in this development as their cross border positions have risen over time and, to a great extent, they are hedged back to local currency. The corporate sector is also a key player in this market. Given our floating exchange rate regimen, where fluctuations cannot be disregarded, firms are active in reducing currency mismatches using this type of derivatives. The authorities and the market see this positively, as it reflects firms have learned the lesson of past experiences that were so costly for the country.

The US regulation has already had an impact at the Chilean market. According to market information, some transactions have migrated from the US to Europe, in order to circumvent regulations. These movements have not had material effects on market participants. However, it raises the need of

[4] G20 (2009). "Leaders' Statement, The Pittsburgh Summit", September 24-25, 2009.

increasing the level of coordination among financial authorities from different jurisdictions.

Beyond any concern, we see ahead interesting opportunities to strengthen infrastructure standards in the region. Our assessment show that such standards are even weaker than those the US and other advance economies had previous to the crisis. Indeed, we share the sense of urgency raised by the FSB to address the main infrastructure gaps in order to develop a sound derivative market in this country and the region in general.

In Chile, the derivative market is almost exclusively OTC. Volumes, as I mentioned before, have increased but the level of sophistication remains bounded. Most of derivatives being traded are interest rate swaps and non-deliverable forwards with very few intervening currencies. The main market participants are commercial banks, with a market share of around 61%, followed by pension funds, with a share of 19%, and firms and other agents with a 16% of the total.[5] In addition, cross border transactions are all non-deliverable.

Clearing is being done on a bilateral basis. A month ago, a central counterparty was authorized to clear both OTC and exchange traded derivatives, although it is expected to operate mainly on the latter. There is another central counterparty in process of getting approval, which is expected to start functioning mainly on OTC derivatives at the end of this year, conditional on authorities' approval.

In terms of transparency, the authorities' access to information on this kind of transactions is still limited. Banks are force to report transactions to the Central Bank, while non-banks entities must inform foreign exchange derivatives and derivatives traded with foreign counterparties. So, the information received at the Central Bank is significant, but it is still insufficient for adequate financial stability surveillance. Let me be more specific on this point. Transactions between non-bank participants at the local level, for instance, are currently not reported to any financial supervisor.

In a context of changing global standards, this seminar is very opportune as it comes at a time when every one of us is engaged in setting priorities and

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[5] Acharán, M. y J. M. Villena (2011). "Mercado Cambiario 2000-2010: Comparación Internacional de Chile". Estudios Económicos Estadísticos N° 88, Banco Central de Chile, Septiembre

policy actions in connection with the issues that are on table. The program of the seminar has been designed to provide a better understanding of the correct implementation of the new standards, to review experiences of different jurisdictions, and to discuss how to improve coordination among national authorities.

This morning, we will have a review by IMF experts on OTC derivatives reforms with references to various countries and regions. This will be followed by presentations on the cases of Brazil and Mexico. Today´s program will close with a discussion on global vs. local clearing solutions and the role of the third country regulatory framework.

Tomorrow, we will review how CPSS-IOSCO principles apply to the OTC derivative context. Then we will have a presentation on Australian experience with supervision and oversight of CCPs and trade repositories. Finally, we will spend the rest of tomorrow and Thursday morning understanding the main elements of US and EU regulation and, particularly, their implications for third countries.

Before ending these remarks, I would like to thank the people and institutions that have made possible we meet today at this seminar. First of all, I would like to thank the IMF and the team from MCM for co-hosting this activity with us. Then, I would like to thank all our distinguished speakers for joining us here in Santiago and for the time they have spent in preparing their presentations. Next, I would like to thank the representatives from supervisory authorities and central banks in the region for joining us for this seminar. And last but not least, a word of thank for the people of the Central Bank and, particularly, for the staff of the Financial Policy Division, led with enormous enthusiasm by Kevin Cowan, who have worked hard in organizing this activity.