

Trade Repositories: Global versus Local **Franco Passacantando**

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1. Trade Repositories can greatly improve the transparency of the OTC market

Traditionally, data on OTC derivatives were held by individual counterparties, stored in proprietary systems in various formats. For the authorities and the public it was very difficult to obtain an accurate view of the market, its products and the risks it generated or allocated. The problem became evident during the 1998 crisis when large exposures of US insurer AIG and others on Credit Default Swaps suddenly appeared. In September 2009, the G20 leaders decided that all OTC derivatives contracts should be reported to trade repositories (TRs) in order to improve transparency, mitigate systemic risk and protect against market in the OTC derivatives markets.¹

Different jurisdictions are following different approaches. In some reporting is voluntary in others it is compulsory (in Europe reporting is compulsory for all OTC derivative contracts both eligible and non-eligible for central clearing). For some products the current data coverage is quite high. It is estimated that over 90 per cent of interest rate and credit derivative contracts are being reported to TRs. For foreign exchange derivatives the coverage is 50 per cent. No reliable estimates are available for other derivatives (commodity and equity).

2. The Bank of Italy's use of TR information

Comprehensive data about OTC derivatives, with varying levels of granularity, can greatly help authorities to fulfill their mandates of (i) assessing systemic risk and financial stability; (ii) conducting market surveillance and enforcement; (iii) supervising market participants; and (iv) conducting resolution activities.

The Bank of Italy has access to “public” and “non-public data” on credit default swaps (CDS) produced by the DTCC Trade Information Warehouse. The acquisition of “non-public data” started in 2010 using the portal developed by the DTCC to support regulators’ data requests on the basis of a framework developed by the OTC Derivatives Regulators Forum (ODRF). The DTCC updates the data on a weekly basis and responds also to ad hoc requests.

The Bank of Italy looks at three types of data: transaction level data, position level data and aggregate level data.

- Transaction-level data typically specify a) the contract terms and b) both counterparties to the contract.
- Position-level data provide all open positions for particular products or for counterparties.
- Aggregate-level data provide information on products, currencies, region, underlier, etc. Some TRs already make aggregate level data available to the public.

As far as counterparty location is concerned, transaction level data refer to counterparties that are supervised by the Bank of Italy while position level data refer also to counterparties located abroad, for instance data on the main positions (the first 10) held on Italian sovereign debt.

¹ See *Leaders Statement*, Pittsburgh Summit of the G20 Leaders, 24-25 September 2009, page 9, available at http://www.G20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

Some of the aggregate data the Bank of Italy uses are the total of CDS contracts in euros, the total of CDS contracts written on Italian reference entities² and CDS contracts written on the sovereign debt of specific countries as requested (Greece, Spain, Portugal, Ireland).

This **information is of great value in financial stability assessments and systemic risk monitoring**. CDS data have been used to monitor the overall size of the market (gross notional value of the CDS on securities issued by Italian residents), the concentration of positions (positions on Italian reference entities; positions sold/bought by Italian financial intermediaries), the level of exposure to common risk factor such as domestic sovereign debt or specific reference entities.

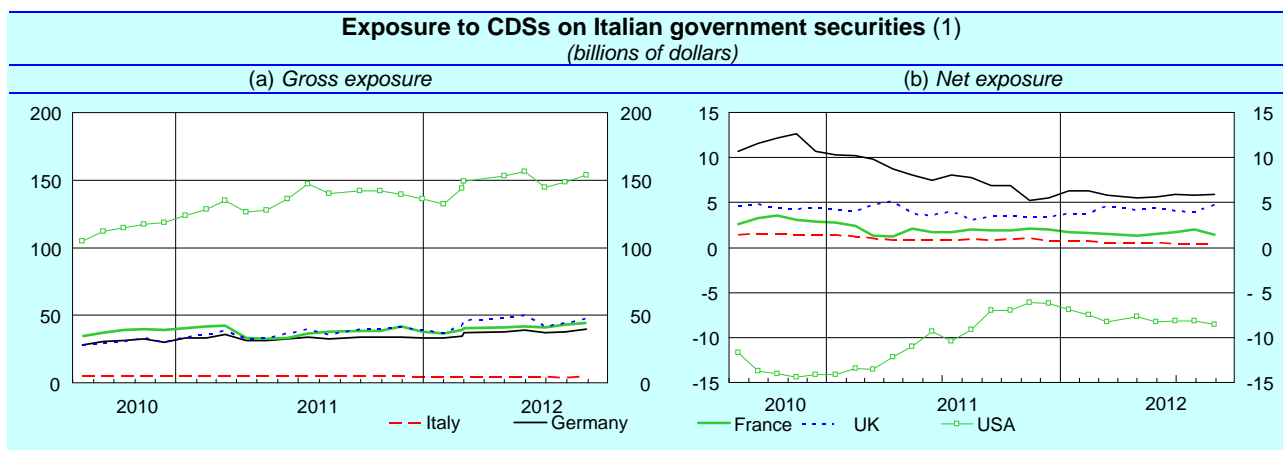
The output of data analysis is released to the public, in the form allowed by the confidentiality constraints in force (only aggregate anonymous information), through the regular publication of the Bank of Italy's Financial Stability Report (FSR).

The last FSR (April 2012) reported the exposures of Italian financial intermediaries and that of other main financial systems to common risk factors, notably sovereign debt.

The analysis highlighted that Italian banks CDS exposure to Italian debt was negligible as it was that to the government debt of Ireland, Portugal, and Spain:

- Italian intermediaries had limited exposure (gross and net) to CDS on Italian government securities (see table below). For no Italian bank did net notional exposure exceed 0.03% of its total assets.

IN THE TABLE: Italy, Germany, France, United Kingdom, United States



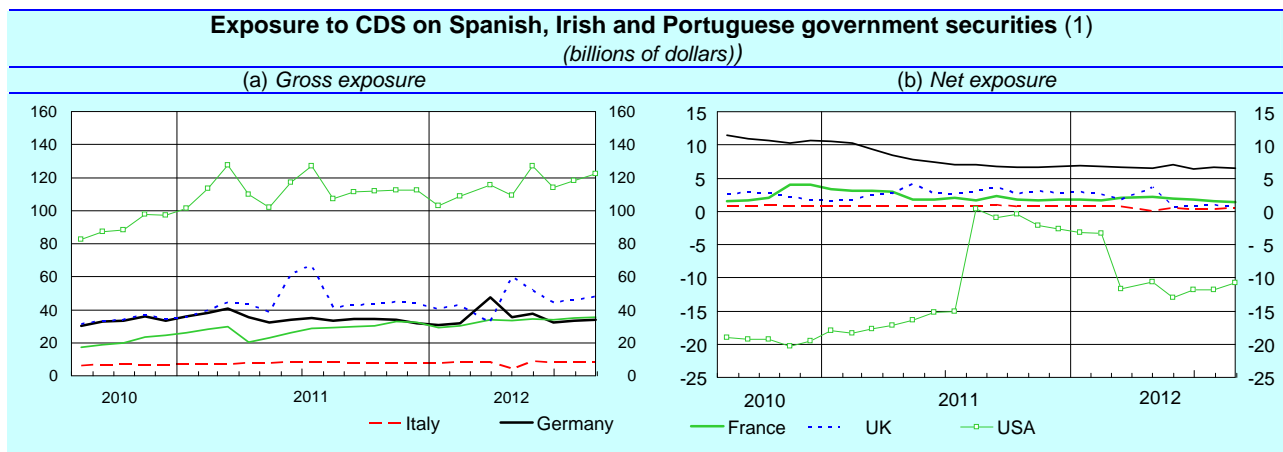
Source: Based on Depository Trust & Clearing Corporation data.
(1) CDS positions of financial companies of the countries specified. In panel (b) positive (negative) values indicate net sales (purchases) of protection against the risk of default. The net exposure of each country is calculated as the algebraic sum of the net exposures of resident ultimate parents to Italian government securities.

- the exposure (gross and net) to CDS on Spanish, Irish and Portuguese government securities was also small (table below). For no Italian entity did the net notional exposure to CDS on the government securities of these three countries exceed 0.05% of its total assets;

² The reference entities are the issuers of the “debt obligations” the CDS contract refers to. The reference entities may be public entities (for example the Republic of Italy) or private entities (usually grouped by sector – financial, industrial etc.). In the event of default by the reference entity, the buyer of the CDS receives compensation (usually the face value of the loan), and the seller of the CDS takes possession of the defaulted debt obligation.

- It is interesting to note that the main net sellers of protection on Italian government bonds are German (and English) entities, while the main net buyers are American financial institutions.

IN THE TABLE: Italy, Germany, France, United Kingdom, United States



Source: Based on Depository Trust & Clearing Corporation data.

(1) CDS positions of financial companies of the countries specified. In panel (b) positive (negative) values indicate net sales (purchases) of protection against the risk of default. The net exposure of each country is calculated as the algebraic sum of the net exposures of resident ultimate parents to Spanish, Irish and Portuguese government securities.

3. Evolution of the TR industry: global versus local

The OTC market is certainly a global market. Should we therefore expect a global TR monopolist to emerge in response to market needs? Should the authorities prevent this from happening in order to preserve competitiveness? Should they encourage the creation of local TRs to address the needs of local financial communities? I believe it is difficult to provide a definite answer to these questions because the industry is still very young, and it would be premature for the authorities to encourage a particular solution.

A global solution certainly presents many advantages:

- users would greatly benefit from a unified approach and common reporting standards;
- significant economies of scale and network externalities could lower the costs for the service providers;
- a “de facto” monopoly could lead to higher prices for users but this risk can be mitigated if the TR is owned and governed by the users.

However what is emerging is an alternative structure. In many jurisdictions the authorities are encouraging the creation of local TRs. The reasons often mentioned are:

- a local TR could better be tailored to local regulation and better be monitored by local overseers;
- the access of local small players could also be facilitated;
- a plurality of infrastructures would lower operational risks;

One possibility is also that a plurality of TRs will actually emerge, but each specializing in different product lines.

Certainly regulatory authorities cannot encourage a global monopoly. However they should also be concerned about data fragmentation or inadequate access to the information produced by TRs which would undermine the ability of TRs to achieve their ultimate goals. The European Commission and the ECB have stated that a position of neutrality is possible provided that authorities:

- (a) have unrestricted access to the data produced by the different TRs;
- (b) adopt common oversight frameworks;
- (c) cooperate closely in the oversight of TRs;
- (d) develop adequate mechanisms for aggregating the data.

On all these fronts some progress is being made although at an excessively slow pace.

(A) Authorities' access to data stored at TRs.

At the request of the Financial Stability Board (October 2011), the CPSS and IOSCO are developing a framework for authorities' access to TR data, building on the work of the OTC Derivatives Regulators Forum (ODRF).³ The framework, which will be finalized by the end of 2012, is aimed at identifying the minimum data that authorities can have access to (access level) for the performance of their statutory mandates (functional approach). Authorities should have the possibility to see and aggregate the data on individual transactions and on the positions of the various entities. Given the global nature of the OTC derivative market TRs will store cross-jurisdictional information. Issues of confidentiality therefore arise but I believe they can be overcome by adopting some safeguards. This issue is currently being discussed by CPSS-IOSCO. Possible safeguards being considered are the following:

- the authority which receives the data could implement strict policies to ensure confidentiality and where an authority has multiple mandates, internal procedures should be put in place to avoid information sharing across functional areas;
- a TR supervisory authority may use the data only for sampling and testing ("transaction testing"), and fix maximum time periods for how long data could be stored.
- Some limitations could also be considered to preserve the confidentiality of central bank transactions since their disclosure could have a major impact on the market.

(B) Common oversight frameworks.

Oversight principles for financial market infrastructures have been defined by the CPSS-IOSCO (PFMIs -April 2012): (legal basis, governance, risk management, business risk, operational risk, access and participation, links with other infrastructures, disclosure of rules and data, etc).

In the EU the regulation on OTC derivatives, central counterparties and trade repositories (European Market Infrastructures Regulation – EMIR) entered into force on 16 August 2012. On 27 September 2012, the European Supervisory Authorities (ESAs) adopted draft technical standards that are scheduled for final adoption by the European Commission by end-2012. The EMIR sets the following requirements for OTC derivatives, central counterparties and trade repositories:

³ In June 2010 the ODRF sent the DTCC its guide for responding to requests by the various authorities to access data on credit default swaps. The work that CPSS-IOSCO are carrying out is aimed at generalizing that guide for all the different classes of OTC derivative, taking account of the possible need for confidentiality safeguards.

- **clearing obligation** for standardized OTC derivative contracts (those eligible for clearing) and bilateral risk management for contracts not eligible for central clearing. Contracts eligible for central clearing will be identified by ESMA on the basis of predetermined eligibility criteria;⁴
- **reporting obligation** for all OTC derivative contracts (both eligible and non-eligible for central clearing);
- **uniform regulatory requirements for CCPs and TRs.** While CCPs will be authorized and supervised by national authorities with the involvement of a college of supervisors, TRs based in the EU will be authorized and supervised by ESMA;

For CCPs the primary responsibility is assigned to the competent national authorities owing to the fiscal responsibility of the Member State of incorporation. However, since a CCP's default will also impact on clearing members established in other Member States, all the relevant authorities and ESMA will be involved in the authorization and supervisory process.

For TRs the issue of fiscal responsibility is less important. Hence supervisory responsibility is granted exclusively to ESMA: "Trade repositories collect data for regulatory purposes that are relevant to authorities in all Member States. ESMA should assume responsibility for the registration, withdrawal of registration and supervision of trade repositories.";

- Given the global nature of the OTC market the EMIR envisages a **cross border application of rules**: EU market participants may use CCPs and TRs from other jurisdictions to clear and report trades if: i) the legal, supervisory and enforcement arrangements of another jurisdiction are equivalent to the EMIR for clearing and reporting obligations, risk mitigation techniques and non-financial counterparties; ii) cooperation agreements with the competent authorities of the third country are in place;

However there will be some exceptions: some non-EU OTC derivative transactions will be subject to the EMIR clearing obligation if they have a major impact (direct, substantial and foreseeable effect) in the EU.

(C) Authorities' cooperation in oversight activities

Principles for cooperation have also been defined by CPSS-IOSCO: The oversight activities are assigned to a group of authorities made up of a lead overseer (with direct responsibility over the TR) and other participating authorities identified in order to ensure the representation of each region with a material segment of the OTC derivative market. The cooperative oversight activities include the assessment of the TR with respect to applicable international standards, the review of proposed changes to the system and the review of the authorities' information needs.

(D) Information requirements and data aggregation problems.

Authorities should not underestimate the complexity of proper data analysis. There is a risk that the mere availability of data may give a false sense of security.

⁴ The eligibility criteria are: standardization of contractual terms and operational processes; volume and liquidity of the product; availability of fair, reliable and generally accepted pricing information; availability of at least one CCP to clear that class of derivatives. To identify contracts eligible for clearing ESMA will follow either a "bottom up approach" (when the CCP applies for authorization to clear a certain class of derivatives) or a "top down approach" (when the ESMA assesses contracts for which no CCP has applied for authorization to clear, in order to establish whether they have the characteristics making them subject to the clearing obligation).

In order to obtain proper informational outputs from the use of TRs, different methods for aggregating data have been investigated (CPSS-IOSCO Report on OTC derivatives data reporting and aggregation requirements, January 2012). Most important is the Legal Entity Identifier (LEI) as a tool to improve the ability to attribute OTC derivative activity to a party or group. During the crisis sometimes what appeared to be different counterparties were actually the same counterparty because of small differences in the codes identifying them adopted by different dealers.

In the past the financial industry could not agree on a common global entity identifier. The FSB has set out (June 2012 Report) recommendations and proposals to implement a global LEI system. The G20 in Los Cabos (June 2012) endorsed the FSB recommendations and asked the Board to take forward the work and launch the global LEI system by March 2013. Currently the regulatory community and the industry are collaborating to create LEI.⁵ However, the overall governance is still being discussed.

To properly aggregate data, the LEI is just the starting point. Other important steps will be the identification of Universal Trade Identifiers⁶ and Universal Product Identifiers.

4. Conclusion

In conclusion I think Trade Repositories should be encouraged to take a global approach and authorities should follow a neutral approach.

However if a global TR were to emerge, its resilience to operational risk will become of crucial importance. Incidents cannot be avoided, of course, but if an incident in a foreign TR will have a major impact on domestic operations and if it will reveal poor oversight or poor coordination among authorities, the whole system of cooperative oversight could be questioned and revisited.

It will also be important to monitor whether the activities of TRs may be extended to other services (e.g. netting, asset servicing, or effects settlement). This is of course already happening.⁷

⁵ SWIFT and the DTCC are involved in the development of a LEI in the United States, which will be the first to adopt such a system. In its Progress note on the Global LEI Initiative of 23 August 2012 the FSB reported that the US authority Commodity Futures Trading Commission (CFTC) “announced on July 24 that DTCC/SWIFT had been designated as the provider of CFTC Interim Compliant Identifiers (CICIs) for a limited period of two years. The CFTC also confirmed that the Commission plans to adopt the governance principles and LEI reference data requirements endorsed by the FSB, and that once these steps are completed the CICI system will subsequently transition into the global LEI”.

⁶ Unique transaction identifiers: industry raised concerns about the difficulty of using a consistent set of universal transaction identifiers (UTIs). CFTC rules require that a firm registered with the CFTC recognize an identifier generated by the firm. However, the CFTC does not have the legal authority to recognize UTIs for firms that are not subject to Dodd-Frank requirements. As a result, there may be two sets of identifiers that are used by industry: an international standard and a US standard. Industry fears that if other jurisdictions also have specific national requirements, the end result could be a proliferation of identifiers that are not compatible and will introduce unnecessary complexity and inefficiency into the market. To overcome this challenge, the DTCC and industry have developed a protocol on how UTIs might be generated and shared between parties, by allowing a given identifier to be used for the same transaction across multiple jurisdictions’ reporting obligations. The protocol will allow trade record identifiers to differentiate each trade side, while still being able to be matched easily. This prevents the proliferation of identifiers by avoiding a ‘matching’ identifier requirement for each trade side. Having both sides of a trade reportable separately is important for FX due to the likelihood that each trade side will be reported under different jurisdictions. To facilitate this protocol, industry is keen that regulators across jurisdictions be aware of what is being proposed, so that any potential conflicts or inconsistencies with proposed regulations or rules can be identified.

⁷ The DTCC also offers an automatic management of events (credit events such as bankruptcy, restructuring and failure to pay and other events such as restructuring, renaming and reorganization) that can occur to a transaction registered in the repository system. It offers also a Central Settlement service through a partnership with CLS Bank International (CLS). The Warehouse calculates the payments due between the counterparties to a transaction based upon legally binding records kept in the Warehouse’s central repository (gold records). Payments between counterparties are netted on a bilateral basis and then sent to CLS for payment in multiple currencies.

However, a further evolution could see TRs offering services with completely different risk profiles. Such an extension could raise significant concerns if spillover effects among different lines of business and activities would impact on macro financial stability.

Let me finally mention the importance of proper governance mechanisms. The PFMI (CPSS-IOSCO Principles for Financial Market Infrastructures) state that a TR's governance structure should effectively identify and manage conflicts of interests that may arise between its public role as a centralized data repository and its own commercial interests, particularly if it offers services other than recordkeeping. Needless to say, a TR serving the global community should also adopt a governance in which the interests and specificities of various jurisdictions are properly represented. A global repository cannot have a local governance framework.

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Annex

Current infrastructures in Europe,

the main provider is the DTCC trade repository based in London (DDRL) for interest rate, credit and equity derivatives. The DDRL is expected to be operating also for foreign exchange derivatives in Q4 2012 (as a joint venture between the DTCC and SWIFT).

The DTCC and the EFET (European energy trading industry) launched in April 2012 a trade repository service for commodity swaps based in the Netherlands (operated by the Dutch-based DTCC/EFETnet Global Trade Repository for OTC Commodity Derivatives).

There is another European-based initiative – REGIS-TR – devoted to delivering repository services to European customers but aiming to become a global trade repository for the registration of all OTC derivative asset classes. This Trade Repository was created by Bolsa y Mercado Espanoles (BME) and the Deutsche Börse Group.