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Panel on Financial Affairs

Meeting on 2 April 2012

Background brief on regulation of over-the-counter derivatives market

Purpose

This paper provides background information on the proposal to establish a regulatory regime for the over-the-counter ("OTC") derivatives market, and summarizes the discussion of the subject at the Panel on Financial Affairs ("FA Panel") on 3 January 2011.

Background

2. The global financial crisis of late 2008 highlighted the structural deficiencies in the OTC derivatives market, and the systemic risk it poses for the wider market and economy. In the wake of the crisis, G20 Leaders committed to reforms that would require –

(a) the mandatory reporting of OTC derivatives transactions to trade repositories ("TRs");

(b) the mandatory clearing of standardized OTC derivatives transactions through central counterparties ("CCPs");

(c) the mandatory trading of standardized OTC derivatives transactions on exchanges or electronic trading platforms, where appropriate; and

(d) the imposition of higher capital requirements in respect of OTC derivatives transactions that are not centrally cleared.

3. These requirements aim to reduce counterparty risk, improve overall transparency, protect against market abuse, and ultimately enable regulators to better assess, mitigate and manage systemic risk in the OTC derivatives market.

4. On 3 January 2011, the Administration, the Hong Kong Monetary Authority ("HKMA"), the Securities and Futures Commission ("SFC") and the Hong Kong Exchanges and Clearing Limited ("HKEx") briefed the FA Panel on the latest international developments in the regulation of the OTC derivatives market, and advised that they would work with relevant stakeholders to build a regulatory regime for the OTC derivatives markets in Hong Kong. The proposed regulatory regime would cover the reporting of OTC derivatives transactions to a local TR to be created by HKMA, and the clearing of standardized OTC derivatives transactions through an authorized CCP. At the initial stage, the reporting and clearing requirement would be applied to interest rate swaps and non-deliverable forwards. HKMA would build upon its existing Central Moneymarkets Unit infrastructure to develop a local TR in Hong Kong, whereas HKEx planned to establish a local authorized CCP to provide central clearing services for the specified products. The Administration also advised that amendments to the Securities and Futures Ordinance (Cap. 571) ("SFO") were required for implementation of the proposed regulatory regime.

Deliberations of the Panel on Financial Affairs

5. The major concerns expressed by Panel members and the responses of the Administration, HKMA and SFC during the discussion of the FA Panel on 3 January 2011 are summarized in the ensuing paragraphs.

<u>General issues</u>

6. A member considered that the Government should have acted before the Lehman Brothers Minibonds Incident in regulating the OTC derivatives market, and expressed doubt on whether the Government and the relevant regulatory bodies had the expertise and competence for regulation of the OTC derivatives market. The Administration responded that at present, trading of OTC derivatives lacked transparency. The proposed establishment of a local CCP for the clearing of interest rate swaps and non-deliverable forwards, and

a TR for the maintenance of transaction records of these OTC derivatives would improve the transparency of the OTC derivatives market, thereby enhancing investor protection. The global financial markets would continue to make concerted efforts to establish and implement effective regulatory regimes for OTC derivative markets.

7. On a member's concern as to how the establishment of a local TR would help improve the assessment of the risk of OTC derivatives, HKMA explained that the TR would enable the regulatory bodies to obtain information about the position held by individual financial institutions. Through the TR, market participants would also be able to obtain aggregate information on certain asset classes of OTC derivatives in order to assess and map out their risk management and investment strategies.

Coverage of the proposed regulatory regime

8. Some members expressed concern that the proposed regulatory regime would not cover equity derivatives and foreign exchange derivatives at the initial stage, and enquired about the practices in other major financial markets in this regard. SFC and HKMA explained that it was difficult to achieve standardization, which was a prerequisite for centralized clearing, for equity derivatives. The OTC derivatives market in Hong Kong was similar to those in the United Kingdom, the United States and Singapore in that foreign exchange derivatives constituted the greatest share of the OTC derivatives market. However, the majority of the foreign exchange derivatives involved short-term foreign exchange swaps whose risk was relatively low. Depending on the development in the international arena, Hong Kong might consider regulating OTC equity derivatives and some of the long-term foreign exchange derivatives at a later stage.

Financial arrangements

9. Some members expressed concern about the financial arrangements for the establishment and operation of the CCP in Hong Kong. A member opined that the expenditure of the CCP should be borne by market participants, and no subsidy should be made from the public purse. Some members were concerned that the development of the OTC derivatives market in Hong Kong might be adversely affected if high levels of fees were charged for OTC derivative transactions.

10. The Administration advised that the Government would not provide financial support for the establishment and operation of the CCP. HKEx advised that it would make an investment of about $180 million for setting up

the CCP, which was of strategic value for HKEx and Hong Kong's financial market. A guarantee fund would be set up jointly between HKEx and the subscribers to the CCP. The CCP would charge a fee on the OTC derivative transactions for the services provided, and the fees would not be set at such a level as to hinder the development of the market. The fees would be set based on a number of factors, including benchmarking with the fees charged in the global markets. The CCP was expected to operate at a loss in the initial years.

Renminbi OTC derivatives

11. A member enquired about the impact of the proposed regulatory regime on the development of Renminbi OTC derivatives in Hong Kong. The Administration advised that to ensure parity of Hong Kong's regulatory arrangements with those of global financial markets, Hong Kong would maintain close liaison and exchange information with other major financial markets on the regulation of OTC derivatives. Hong Kong enjoyed an edge over other financial markets in that it started the development of a Renminbi OTC derivatives market earlier than other places, e.g. a non-deliverable forwards market on Renminbi had already been established in Hong Kong. HKEx advised that while the HKEx would not develop derivative products on its own, it would consider providing a platform for clearing of standardized OTC Renminbi derivative products.

Non-centrally cleared OTC contracts

12. A member enquired what robust risk management requirements would be introduced for the regulation of the remaining non-centrally cleared OTC derivative trades. HKMA advised that given the higher risk involved in the trading of non-centrally cleared OTC derivatives, the contracts of such derivatives would be subject to higher capital requirements. The Basel Committee would review the capital requirement for financial institutions dealing with non-centrally cleared OTC derivatives.

Recent development

13. The Administration will update the FA Panel on 2 April 2012 on the progress of the work for establishing a regulatory regime for the OTC derivatives market in Hong Kong.

Relevant papers

14. The relevant papers are available at the following links:

Meeting of the FA Panel on 3 January 2011	Agenda Powerpoint presentation Minutes (paragraphs 22 to 38)

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