International swaps market reform
Promoting transparency and lowering risk

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In 2010, the US Congress passed the historic Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The CFTC is more than 80 percent complete with Dodd-Frank Act swaps market reform rulewriting, and now the marketplace is increasingly shifting to implementation of common-sense rules of the road.

Swaps market reform is about ensuring the vast derivatives marketplace serves the rest of the economy. In the aftermath of the 2008 global financial crisis, the G20 leaders agreed that it was time to bring transparency and oversight to the opaque swaps market. Since then, there has been significant global progress on reform. We continue to work in a coordinated way to implement the critical reforms agreed to in the aftermath of the global financial crisis. Regulators around the globe are making great progress, but we all must complete the task to bring transparency to these markets and protect the public.

I want to thank the Banque de France, Governor Christian Noyer, and First Deputy Governor Anne Le Lorier for asking me for my thoughts on finance and our global efforts to bring reform to the over-the-counter (OTC) derivatives markets. I'm honored to be writing for a French publication. Though I don't speak the language, two of my three daughters are fluent, and we look forward to reading the *Financial Stability Review*.

The role of finance and financial markets is to ensure that finance serves the rest of the economy. It does so by allocating and pricing the savings and investments of the public and helping businesses grow and manage their risks. It is to allow the public unfettered access to markets and information and to establish prices transparently and free of fraud and manipulation.

As the financial system failed in 2008, the swaps market, which was basically not regulated in the United States, Europe, Canada or Asia, failed to meet these objectives. The 2008 global financial crisis caused great damage. It affected millions of bystanders far and wide. Eight million American jobs were lost, and families across Europe are still struggling with the ongoing debt crisis.

Since the swaps market emerged in the 1980s, it has operated without the basic transparency and common-sense rules of the road that Americans have benefitted from since the 1930s. In the aftermath of the Great Depression, President Roosevelt and Congress put in place securities and futures market reforms. Those historic reforms established a foundation of transparency, competition and market integrity for the futures and securities markets. This democratisation of financial markets has led to many decades of US economic growth and innovation.

The Commodity Futures Trading Commission (CFTC) is one of two US market regulators. Futures have traded in the United States since the Civil War, when farmers and grain merchants came together and created a new type of marketplace. It was not until sixty years later that the Congress first passed legislation to regulate these markets. Our predecessor was set up in the 1930s to oversee the commodities market and related futures market. Initially, the futures market was where farmers, ranchers and producers sought to lock in the price of corn, wheat and other commodities at harvest time and manage their risk. By the 1970s, the CFTC's mission expanded to cover futures on other markets. This included metals, such as gold and silver, and energy markets for oil and natural gas. It also includes financial derivatives for interest rates and the stock market.

The derivatives markets, both the futures and swaps markets, allow companies to manage their risk through a derivatives contract, allowing them to focus on servicing customers, producing products, innovating and investing in the economy. With financial reform, the CFTC now oversees both the futures and swaps markets. These markets are vast. Together, the notional value of the US markets is more than USD 300 trillion – or more than USD 20 of derivatives for every dollar of goods and services produced in the US economy.

1| New international consensus to reform the swaps market

In 2009, a new international consensus was formed when the G20 leaders met in Pittsburgh. The leaders agreed the previously unregulated swaps market should be brought into the light through transparency and oversight by the end of 2012. Specifically, the agreement said: "*All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.*"

Since the 2009 meeting in Pittsburgh, each of the major market jurisdictions has been coordinating on implementing reforms to achieve these goals. Given our different cultures, political systems and legislative mandates, some differences are inevitable, but we have made great progress internationally on an aligned approach to legislation and now to implementation of reform.

The CFTC has consistently engaged with our international counterparts through bilateral and multilateral discussions to promote robust and consistent swaps market reform. We have worked with numerous authorities in Europe, including the European Securities and Markets Authority (ESMA), the Banque de France, the Autorité des marchés financiers (French Financial Market Authority), the European Commission (EC), as well as with financial regulators in Asia and Canada. The CFTC also is participating in and working closely with international standard setting bodies (SSBs) to develop and implement international standards for the swaps market.

The United States, Europe, Japan, Singapore, Australia, and the largest provinces in Canada have all made substantial legislative progress on reform.

In 2010, the US Congress passed the historic Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The law gave the CFTC oversight of the swaps marketplace, in addition to the futures market the agency has traditionally overseen. The law also gave the Securities and Exchange Commission (SEC) oversight of the security-based swaps market.

The CFTC is more than 80 percent complete with Dodd-Frank Act swaps market reform rulewriting, and now the marketplace is increasingly shifting to implementation of common-sense rules of the road.

For the first time, the public is benefiting from seeing the price and volume of each swap transaction. This post-trade transparency builds upon what has worked for decades in the futures and securities markets. The new swaps market information is available free of charge on a website, like a modern-day ticker tape.

For the first time, the public is benefitting from the greater access to the markets and the risk reduction that comes with central clearing.

For the first time, the public is benefitting from regulation of swap dealers. As of early March 2013, seventy-three swap dealers had registered. They are subject to standards for sales practices, recordkeeping and business conduct to help lower risk to the economy and protect the public from fraud and manipulation. Two major swap participants also had registered.

2| Transparency – lowering cost and increasing liquidity, efficiency, competition

The US transparency reforms of the 1930s have increased liquidity and competition in the securities and futures markets for decades. Such transparency – both pre- and post-trade – levels the playing field by giving all market participants access to critical pricing and transaction information.

The swaps market, however, prior to the passage of the Dodd-Frank Act, has not benefited from such transparency and competition. In fact, prior to reform, the swaps market has been the world's largest dark market.

With the passage of financial reform and the CFTC's completed rules, light is now being brought to these markets. Since December 31, 2012, provisionally registered swap dealers have been reporting in real time their interest rate and credit index swap transactions to the public and to regulators through swap data repositories. These are some of the same products that were at the center of the 2008 global financial crisis. Starting February 28, swap dealers began reporting swaps transactions in equity, foreign exchange and other commodity asset classes. Other market participants began reporting this month.

With these transparency reforms, the public and regulators now have their first full window into the swaps marketplace post-trade, a fundamental shift for the markets.

Reform will not be completed, though, unless the public also gets the benefit of transparency prior to the transaction. The Dodd-Frank Act mandated that standardised swaps (those required to be cleared and made available for trading) be traded on traditional exchanges or a new trading platform, called swap execution facility (SEF). SEFs will allow multiple market participants to view the prices of multiple available bids and offers, which will build on the democratisation of the swaps market that comes with the clearing of standardised swaps. The multilateral platform approach (what we call many to many) in the United States supports greater transparency for market participants.

The European and Japanese transparency reforms, as well as initiatives well underway in other jurisdictions – when fully implemented – will further align international reform efforts to bring transparency to the swaps market. The European Union has completed regulatory reporting under European Market Infrastructure Regulation (EMIR), which went into force in March. Further, Europe is considering pre- and post-trade public transparency through Markets in Financial Instruments Directive (MiFID 2) and Markets in Financial Instruments Regulation (MiFIR).

I look forward to Europe implementing such public transparency reforms, including multilateral trading platforms. It is important that we align internationally to bring transparency to the public seeking to hedge risk or invest.

Japanese transparency reforms require the reporting of certain classes of OTC derivatives, including interest rate, foreign exchange, equity and credit derivatives transactions.

3| Clearing – lowering risk and democratising the market

Clearinghouses have lowered risk for the public and fostered competition in the futures market since the late 19th century. Clearinghouses act as middlemen between two parties to a transaction, guaranteeing the obligations of both parties. Clearing has democratised the market by fostering access for farmers, ranchers, merchants, and other participants.

As of last month, the vast majority of interest rate and credit default index swaps are being brought into central clearing. Swap dealers and the largest hedge funds were the first to be required to clear. Compliance is being phased in for other market participants through this year.

Other jurisdictions also have made significant progress in fulfilling the G20 commitment to bring swaps into central clearing. Japan completed a clearing requirement in November 2012. Under EMIR, Europe soon will move to a clearing requirement as well. We understand that ESMA will be considering such matters this year. When completed, three major jurisdictions – Europe, Japan and the United States – will have a clearing requirement in place.

4| Swap dealer oversight – promoting market integrity and lowering risk

The US Congress included comprehensive oversight and registration of swap dealers as a foundational piece of the Dodd-Frank Act. It did so to promote market integrity and lower risk to taxpayers and the rest of the economy. The US Congress wanted end-users to continue benefitting from customised swaps (those not brought into central clearing) while being protected through the express oversight of swap dealers. In addition, the Dodd-Frank Act extended the CFTC's existing oversight of previously regulated intermediaries to cover their swaps activity.

The initial group of seventy-three provisionally registered swap dealers includes the largest domestic and international financial institutions dealing in swaps with US persons. Of the thirty non-US entities, five are French. It includes the sixteen institutions commonly referred to as the G16 dealers. Other entities are expected to register over the course of 2013 once they exceed the *de minimis* threshold for swap dealing activity.

In addition to reporting their trades with US persons to both regulators and the public, swap dealers will implement crucial back office standards that lower risk and increase market integrity. These include promoting the timely confirmation of trades and documentation of the trading relationship. Swap dealers also will be required to implement sales practice standards that prohibit fraud, treat customers fairly and improve transparency. These reforms will be phased in this year.

The CFTC is collaborating closely domestically and internationally on a global approach to margin requirements for uncleared swaps. We are working along with the Federal Reserve, the other US banking regulators, the SEC and our international counterparts on a final set of standards to be published by the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO). The CFTC's proposed margin rules excluded non-financial end-users from margin requirements for uncleared swaps. We have been working with global regulators for a consistent approach with regard to margin for uncleared swaps, and more specifically, for end-users. I would anticipate that the CFTC, in consultation with European regulators, would take up final margin rules, as well as related rules on capital, in the second half of this year.

Although no other country has a specific swap dealer registration regime, within EMIR, there are many requirements for risk mitigation similar to those that apply to swap dealers under the Dodd-Frank Act.

5| International coordination on swaps market reform

As the CFTC and the international regulatory community move forward on bringing reform to the swaps market, we all recognise that risk has no geographic boundary. Money can move in and out of markets and jurisdictions with the click of a mouse. Risk from the US housing and financial crisis contributed to economic downturns around the globe. Further, when a run starts on one part of a modern financial institution, almost regardless of where it is in the world, it invariably means a funding and liquidity crisis rapidly spreads to the entire consolidated financial entity.

The nature of modern finance is that large financial institutions set up hundreds, if not thousands of legal entities around the globe. They do so in an effort to respond to customer needs, pursue funding opportunities, improve risk management and comply with local laws. They do so as well, though, to lower their taxes, manage their reported accounting, and minimise regulatory, capital and other requirements, so-called "regulatory arbitrage". Many of these legal entities, however, are still directly connected back to their US parent. When an affiliate of a large, international financial group has problems, the markets accept this will infect the rest of the group.

This phenomenon was true with the overseas affiliates and operations of American International Group (AIG), Lehman Brothers, Citigroup, Bear Stearns and Long-Term Capital Management.

AIG Financial Products, for instance, was a Connecticut subsidiary of the New York insurance giant that used a British branch and an overseas-registered bank subsidiary to run its swaps operations in London. Its near-collapse ultimately required a government bailout of more than USD 180 billion and nearly brought down the US economy.

Last year's events of JPMorgan Chase, where it executed swaps through its London branch, are a recent reminder of this reality of modern finance. Though many of these transactions were entered into by an offshore office, the bank here in the United States absorbed the losses. Trades booked offshore by US financial institutions should not be confused with keeping that risk offshore.

The US Congress addressed this reality in the Dodd-Frank Act, which states that swaps reforms shall not apply to activities outside the United States unless those activities have "a direct and significant connection with activities in, or effect on, commerce of the United States".

To give financial institutions and market participants guidance on this provision, the CFTC last June sought public consultation on its interpretation of this provision. The proposed guidance is a balanced, measured approach, consistent with the cross-border provisions in the Dodd-Frank Act and the recognition that risk easily crosses borders.

As the CFTC completes the cross-border guidance, I believe it is critical that Dodd-Frank reform applies to transactions entered into by branches of US institutions offshore, between guaranteed affiliates offshore, and for hedge funds that are incorporated offshore but operate in the United States. Otherwise, American jobs and markets may move offshore, but, particularly in times of crisis, risk would come crashing back to the US economy.

The proposed guidance includes a commitment to permitting foreign firms and, in certain circumstances, overseas branches and guaranteed affiliates of US swap dealers, to meet Dodd-Frank requirements through compliance with comparable and comprehensive foreign rules. We call this "substituted compliance".

The Commission also proposed granting time-limited relief until this July for non-US swap dealers (and foreign branches of US swap dealers) from certain Dodd-Frank swap requirements.

In December, the Commission finalised the time-limited relief. In July 2013, when the relief expires, various Dodd-Frank requirements will apply to non-US swap dealers. Overseas banks that wish to look to substituted compliance to fulfill Dodd-Frank requirements are encouraged to engage now with the CFTC, as well as their home country regulators.

Under this time-limited relief, foreign swap dealers may phase in compliance with certain entity-level requirements. In addition, it provides relief for foreign dealers from specified transaction-level requirements when they transact with overseas affiliates guaranteed by US entities, as well as with foreign branches of US swap dealers.

The relief, as an interim step, took a narrower, more territorial-based approach to the definition of "US person".

The Commission is seeking yet additional public comment on the "US person" definition, as well as the aggregation requirements with respect to the *de minimis* calculation for swap dealer registration and the treatment of a "foreign branch".

Further, we must ensure that collective investment vehicles – including hedge funds, that either are managed (or otherwise have their principal place of business) in the United States or are directly or indirectly majority owned by US persons – are not able to avoid clearing or any other Dodd-Frank requirement simply due to how they are organised. If we don't ensure for this, the Post Office boxes may be offshore, but the risk will flow back to the United States.

The CFTC recognises the importance of international cooperation and coordination in the regulation of this highly interconnected global market. To this end, the CFTC has actively engaged in substantive discussions with foreign counterparts in an effort to better understand and develop a more harmonised cross-border regulatory framework.

6| Libor

This *Financial Stability Review* comes at a critical juncture.

It comes as there has been a lot of media attention surrounding the three enforcement cases against Barclays, Union Bank of Switzerland (UBS) and Royal Bank of Scotland (RBS) for manipulative conduct with respect to the London Interbank Offered Rate (Libor) and other benchmark interest rate submissions.

More importantly, it comes as market participants and regulators around the globe have turned to consider the critical issue of how we reform and revise a system that has become so reliant on Libor, Euribor and similar rates.

I believe that continuing to reference such rates diminishes market integrity and is unsustainable in the long run.

Recently, the public has learned that there are a number of factors that call into question the integrity of Libor, Euribor and other similar rates.

Foremost, the interbank, unsecured market to which Libor, Euribor and other such rates reference has changed dramatically. Some say that it is has become essentially nonexistent. In 2008, Mervyn King, the Governor of the Bank of England, said of Libor: "*It is, in many ways, the rate at which banks do not lend to each other.*" He went on further to say: "*[I]t is not a rate at which anyone is actually borrowing.*"

There has been a significant structural shift in how financial market participants finance their balance sheets and trading positions. There is an increasing shift from borrowing unsecured (without posting collateral) toward borrowings that are secured by posting collateral. In particular, this shift has occurred within the funding markets between banks.

The interbank, unsecured market used to be where banks funded themselves at a wholesale rate. The 2008 financial crisis and subsequent events, however, have shattered this model. The European debt crisis that began in 2010 and the downgrading of large banks' credit ratings have exacerbated the hesitancy of banks to lend unsecured to one another.

Other factors have played a role in this structural shift. Central banks are providing significant funding directly to banks. Banks are more closely managing demands on their balance sheets.

Looking forward, recent changes to Basel capital rules will take root and will move banks even further from interbank lending. The Basel III capital rules now include an asset correlation factor, which requires additional capital when a bank is exposed to another bank. This was included to reduce financial system interconnectedness. Furthermore, the rules introduce a liquidity coverage ratio (LCR). For the first time, banks will have to hold a sufficient amount of high quality liquid assets to cover their projected net outflows over thirty days.

At an IOSCO roundtable on financial market benchmarks held in London in February, one major bank indicated that the LCR rule alone would make it prohibitively expensive for banks to lend to each other in the interbank market for tenors greater than thirty days. Thus, this banker posited that it is unlikely that banks will return to the days when they would lend to each other for three months, six months or a year.

The public also has learned that Libor and Euribor – central to borrowing, lending and hedging in our economies – has been readily and pervasively rigged.

Barclays, UBS and RBS were fined USD 2.5 billion for manipulative conduct by the CFTC, the UK Financial Services Authority (FSA) and the US Justice Department. At each bank, the misconduct spanned many years; took place in offices in several cities around the globe; included numerous people – sometimes dozens, and even senior management; and involved multiple benchmark rates and currencies. In each case, there was evidence of collusion.

In the UBS and RBS cases, one or more inter-dealer brokers painted false pictures to influence submissions of other banks, i.e. to spread the falsehoods more widely. Barclays and UBS also were reporting falsely low borrowing rates in an effort to protect their reputation.

These findings are shocking, though the lack of an interbank market made the system more vulnerable to such misconduct.

In addition, a significant amount of publicly available market data raises questions about the integrity of Libor and similar rates today.

A comparison of Libor submissions to the volatilities of other short-term rates reflects that Libor is remarkably more stable than any comparable rate. For instance, in 2012 – looking at the two hundred and fifty-two submission days for three-month US dollar Libor – the banks did not change their rate 85 percent of the time. Some banks did not change their submissions for three-month US dollar Libor for upwards of one hundred fifteen straight trading days. This means, in effect, that one bank represented that the market for its funding was completely stable for one hundred fifteen straight trading days or more than five months.

Further, when comparing Libor submissions to the same banks' credit default swap spreads or to the broader markets' currency forward rates, there is a continuing disconnect between Libor and what those other market rates tell us.

Nassim Nicholas Taleb, the bestselling author of *The Black Swan*, has written a recent book called *Antifragile: things that gain from disorder*. He notes that systems that are not readily able to evolve and adapt are fragile. Such systems succumb to stress, tension and change. One of his key points is that propping up a fragile system in the interest of maintaining a sense of stability only creates more instability in the end. One can buy an artificial sense of calm for a while, but when that calm cracks, the resulting turmoil is invariably greater.

I think that the financial system's reliance on interest rate benchmarks, such as Libor and Euribor, is particularly fragile. These benchmarks basically haven't adapted to the significant changes in the market. Thus, the challenge we face is how the financial system adapts to this significant shift.

International regulators and market participants have begun to discuss transition. The CFTC and the FSA are co-chairing the IOSCO Task Force on Financial Market Benchmarks. One of the key questions in the consultation with the public is: how do we address transition when a benchmark is no longer tied to sufficient transactions and may have become unreliable or obsolete?

Without transactions, the situation is similar to trying to buy a house, when the realtor cannot provide comparable transaction prices in the neighborhood – because no houses were sold in the neighborhood in years.

Given what the public has learned, it is critical to move to a more robust framework for financial benchmarks, particularly those for short-term, variable interest rates. A reference rate has to be based on facts, not fiction.

I recognise that moving on from Libor and Euribor may be challenging. Today, Libor and Euribor are the reference rates for a significant portion of the international futures and swaps market and the basis for many mortgages written in Europe and the United States.

Yet, as the author Nassim Taleb might suggest, it would be best not to fall prey to accepting that Libor or any benchmark is "too big to replace".

7| Conclusion

The role of finance is to serve the rest of the economy. Swaps market reform is about ensuring the vast derivatives marketplace serves the rest of the economy. In the aftermath of the 2008 global financial crisis, the G20 leaders agreed that it was time to bring transparency and oversight to the opaque swaps market. Since then, there has been significant global progress on reform. We continue to work in a coordinated way to implement the critical reforms agreed to in the aftermath of the global financial crisis. We must complete the task to bring transparency to these markets and protect the public.