Regulatory-Driven Market Fragmentation

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"An open and resilient financial system, grounded in agreed international standards, is crucial to support sustainable growth… We will continue to monitor and, if necessary, tackle emerging risks and vulnerabilities in the financial system; and, through continued regulatory and supervisory cooperation, address fragmentation."

G-20 Leaders' Declaration, December 1, 2018

Fragmentation in Derivatives Markets

"Fragmentation in global derivatives markets would be bad news for anyone who directly or indirectly uses them to hedge their risk…with the net result that companies, pension funds and financial institutions have to pay more to hedge risks. The world, and Europe in particular, already stands on the verge of disruption from the multiple geopolitical and market risks that overhang it. So pursuing a fragmented approach to financial regulation, and in the process pushing up the cost of managing many of those very same risks, seems obtuse to say the least."

Financial Times, October 2018

Sources of Regulatory Fragmentation

"There are four types of harmful regulatory fragmentation… discrepancies, overlaps, desynchronization, and competition:

Discrepancies: [I]ncompatible requirements being imposed by different authorities to the same financial institution…

Overlap: For various policy reasons, jurisdictions incorporate extraterritoriality in their regulations. Such practice results in the application of two different regulatory regimes on the same market or transaction…

Desynchronization: [T]he staggered implementation of internationally agreed standards by different authorities…

Competition: Jurisdictions use regulations, such as location policy, ring-fencing regimes, or internal [total loss-absorbing capacity (TLAC)] requirements, to secure resources or activities within their own jurisdictions."

Ryozo Himino, JFSA Vice Minister

Examples of Regulatory-Driven Market Fragmentation

Extraterritoriality

- **Scope of Application of a Jurisdiction's Rules:** Most jurisdictions (e.g., US) require (1) transactions executed outside of their borders by entities they define to be within their regulatory purview, or (2) activities conducted inside their borders by third-country firms, to comply with their rules even when they would fall under the oversight of a third-country regulator.

- **Equivalency/Substituted Compliance Determinations:** The process by which regulators in one jurisdiction determine the regulations in another jurisdiction to be comparable is often conducted on a granular, rule-by-rule basis.

Examples of Regulatory-Driven Market Fragmentation

Capital

- **Market risk capital rules (Fundamental Review of the Trading Book - FRTB):** Significant uncertainties exist about the timing and extent of implementation of these rules in key jurisdictions.
- **Net Stable Funding Ratio (NSFR)**: The global standard developed by the Basel Committee on Banking Supervision (BCBS) as part of its review of the Net Stable Funding Ratio gives national jurisdictions the ability to impose a Gross Derivatives Liability Add-on (GDLA) for derivatives that ranges from 5% to 20%.
- **Credit Valuation Adjustment (CVA):** Jurisdictions differ in requiring CVA risk charges for certain transactions, including those with corporates, pension funds and public sector institutions in their home and in third-country jurisdictions.
- **Leverage Ratio:** Jurisdictions differ in whether they require segregated margin posted by clients with their bank counterparties for cleared swaps transactions to be counted in calculating banks' capital requirements under the leverage ratio.

Examples of Regulatory-Driven Market Fragmentation

Non-Cleared Margin

- **Timeframe for Posting Margin:** Jurisdictions differ in the timeframe they impose for the calculation and settlement of both initial margin and variation margin, with some requiring it in T+1, and others requiring T+2 or later, depending on the standard settlement cycle of the relevant collateral.
- **Collateral Eligibility Requirements:** Collateral eligibility requirements vary considerably across jurisdictions.
- **Posting of Initial Margin for Inter-Affiliate transactions:** Some jurisdictions (e.g., US prudential regulators) require swap dealers that are banks to post and collect initial margin (IM) for their inter-affiliate transactions. The US CFTC provides an exemption, as does the JFSA and many other jurisdictions.
- **Standard Initial Margin Model (ISDA SIMM) Backtesting:** Some jurisdictions (e.g., EU, Japan) may require all counterparties, including non-dealers, to monitor and backtest industry-standard models used to calculate IM for their trades.

Examples of Regulatory-Driven Market Fragmentation

Clearing

- **Clearing Location Policy**: Some jurisdictions (e.g., Japan) require certain trades (e.g., yen-denominated swaps in Japan) executed within their borders to be cleared at central counterparties within their borders that are subject to local supervision.
- **Client clearing**: Some jurisdictions require persons/clients that are not members of CCPs to only clear swaps with CCPs that are registered locally (e.g., registered with the CFTC as a derivatives clearing organization).
- **MPOR for IM Requirements**: Jurisdictions differ in the minimum Margin-Period-of-Risk (MPOR) they require CCPs to use in setting IM they require for cleared transactions.

Examples of Regulatory-Driven Market Fragmentation

Trade Execution

- **Trading Location Policy:** Requirements that certain trades must be executed on designated platforms within a particular jurisdiction

- **Trading Personnel Location Policy:** US rules require trades between non-US entities that are arranged, negotiated, or executed by US personnel ("ANE Transactions") to be cleared, executed, and reported pursuant to US rules.

Data and Reporting

- **Trade reporting**: Jurisdictions differ in whether they require one or both counterparties to a trade to report the transaction to a trade repository.

- **Required data fields:** Different jurisdictions have different definitions, formats and allowable values for the trade data required to be reported.

Examples of Regulatory-Driven Market Fragmentation

Netting

- **Scope of Eligible Counterparties:** Jurisdictions differ in the scope of eligible counterparties covered by netting legislation. Some differentiate based on type of bank (state-owned v. privately owned) and others by type of firm (bank v. securities v. insurance).
- **Scope of Eligible Transactions:** Jurisdictions differ in the scope of eligible transactions covered by netting legislation. For example, some jurisdictions do not recognize physically-settled commodity transactions as eligible transactions, but do recognize financially-settled commodity transactions.

Benchmarks

- Certain jurisdictions (EU) are requiring that only approved benchmarks or indices can be used within their borders in order to ensure their accuracy and integrity. Benchmark administrators and data contributors are subject to new rules and processes. Providers and users of unapproved benchmarks may be fined.

Potential Solutions

Policymakers could work to reduce regulatory-driven fragmentation by:

- Recognizing the important role that global markets play in generating sustainable growth while developing regulations that address jurisdictional concerns.
- Reducing the gap between global standards and national regulations to ensure greater consistency in implementation.
- For smaller jurisdictions, implementing global standards when and where appropriate. In the meantime, market participants from larger jurisdictions should be allowed to engage in *de minimis* derivatives activity in these smaller jurisdictions.

Potential Solutions (Continued)

Policymakers could work to reduce regulatory-driven fragmentation by:

- Implementing a risk-based framework for the evaluation and recognition of the comparability of derivatives regulatory regimes.
- International standard-setting bodies should establish a process that would enable national regulators to implement equivalency and substituted compliance determinations in a predictable, consistent and timely manner.
- International standard-setting bodies should regularly review reform initiatives to ensure they remain relevant and appropriate, and are achieving policy goals.