

## ONGOING INITIATIVES

## LEGAL INFRASTRUCTURE FOR DERIVATIVES

Mr. Keith Noyes

Regional Director, Asia-Pacific, International Swaps and Derivatives  
Association, Inc. (ISDA)

### The effectiveness of netting and collateral as risk mitigants.

US\$ trillions	Dec.2010	Dec.2011	Dec.2012	Dec.2013
Notional Amounts, Total OTC contracts <sup>1</sup>	601,046	647,811	632,582	710,182
<b>Gross Market Values</b>	21,296	27,297	24,733	18,658
<b>% of Notional Amounts</b>	<b>3.54%</b>	<b>4.21%</b>	<b>3.91%</b>	<b>2.63%</b>
Gross Credit Exposure (after netting)	3,480	3,938	3,609	3,033
<b>% of Gross Market Value</b>	<b>16.34%</b>	<b>14.43%</b>	<b>14.59%</b>	<b>16.26%</b>
<b>% of Notional Amounts</b>	<b>0.58%</b>	<b>0.61%</b>	<b>0.57%</b>	<b>0.43%</b>
Exposure collateralized, average, all OTC derivatives <sup>2</sup>	69%	66%	71%	82%
Gross Credit Exposure (after netting and adjusted for collateral)	1,079	1,339	1,047	0,546
<b>% of Gross Market Value</b>	<b>5.07%</b>	<b>4.91%</b>	<b>4.23%</b>	<b>2.93%</b>
<b>% of Notional Amounts</b>	<b>0.18%</b>	<b>0.21%</b>	<b>0.17%</b>	<b>0.08%</b>

<sup>1</sup> Bank for International Settlements (BIS), May 2014 and prior, Table 19, <http://www.bis.org/statistics/dt1920a.pdf>

<sup>2</sup> Office of the Comptroller of the Currency (OCC), Quarterly Report on Bank Derivatives Activities, <http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/derivatives-quarterly-report.html>

## Legal Infrastructure as Risk Mitigant in Capital Markets

### 1. Legal Netting Infrastructure: Close-out netting

- The most important risk reduction tool in modern financial markets
- Underpins the risk management of OTC derivatives, which includes such end user hedging products as FX options, cross currency swaps and inflation swaps that cannot currently be centrally cleared; also important for repo markets (and by extension the development of corporate bond markets)

### 2. Protection of Collateral Interests

- Collateral: Widely used as a credit risk mitigation tool, important role in working capital funding for SMEs, letters of credit for trade finance and the trading of financial hedging instruments.
- Margin, likewise plays a critical role in the safe functioning of clearing houses for OTC derivatives
- Commonly exchanged between counterparties either through title transfer or security interest pledge arrangement
  - Title Transfer Arrangement: Where the legal certainty is not provided, under bankruptcy, collateral taken under a title transfer arrangement could be re-characterized as an asset of the estate of the defaulting party and claimed by other creditors.
  - Pledge Arrangement: In some jurisdictions, i) the local security law does not support mark-to-market of collateral, ii) the secured party's ability to re-use the collateral is often limited and iii) enforcement of collateral interest is often difficult.

### 3. Margining of Non-Cleared Derivatives

- BCBS-IOSCO: Initial and variation margin to be made mandatory for non-centrally cleared derivatives.
- Requirements for jurisdictions:
  - Implementing rules and regulations to support BCBS' guidelines
  - Standardization of initial margin calculation model and credit support documentation
  - Robust protection of collateral rights

## APFF Action Plan

- Identify legal structural weaknesses in each jurisdiction
- Organize educational seminars targeting
  - 1) Regulatory/legislative bodies
  - 2) The judiciary
- APFF resources will be leveraged to coordinate outreach, provide expert speakers and follow up on outstanding issues.