Asia in the starting blocks

Forthcoming moves to regulate over-the-counter derivatives will have a particularly strong impact on Asian markets, writes **Donna Bales** of Balmoral Advisory

Two and a half years ago, representatives from the G20 countries made commitments to improve the regulation and supervision of over-the-counter (OTC) derivative markets by the end of this year. These commitments were made in response to growing international pressure and the widely-held view that derivatives had been a significant source of uncertainty during the global financial crisis. With the deadline fast approaching, the proposed regulations are now beginning to take shape in markets around the world. As these new regulations are analysed, one can only hypothesise about how different markets will feel the impact of these changes. One thing is certain however, these regulations will challenge the status quo.

The consequences of these regulatory changes for Asia are of particular interest because regulators are faced with the task of meeting objectives that are perhaps too advanced in detail and scope compared to the current stage of market development in the region. Unlike the US and Europe, Asia is made up of multiple markets each at different stages of their development life cycle: some markets are firmly established, while others are still finding a foothold. Regulators have to perform a delicate balancing act as they try to juggle domestic and global interests and objectives.

Furthermore, many of the markets in Asia have a long way to go before they can be considered mature derivative trading centres with market depth and liquidity comparable with that of established western markets. Much has been written about the growth in Asian derivatives volumes with such sensationalist headlines as "Asian futures volumes surpass the US". The reality is somewhat different. While it is true that pure volumes are high, three critical factors are usually overlooked. First, the bulk of the region's trading volumes are in China and India where the markets are awkward to access or inaccessible to outsiders and are dominated by retail investors. Second, the contract size is "tiny" when resized and compared with western equivalents. Third, the true health of a futures market is more accurately assessed by the amount of outstanding positions known as "open interest". The amount of open interest is often abysmally low, which reflects the short term and speculative nature of retail participation in markets such as India and China and, to some extent, South Korea.

Yet there are products and markets that stand out. The OSE Nikkei 225 and the HKEx Hang Seng index are active, mature products and volumes in futures and options on the KRX KOSPI 200 are enormous. In markets such as Thailand, Malaysia and Indonesia however, the onerous controls on OTC trading may well stifle these products in their very early stages of development.

These market structure nuances will have wide-reaching implications for market participants and exchanges as they position themselves ahead of regulatory change. Ultimately, Asian OTC trading only accounts for 7 per cent of global volumes and half of this is in Japan. There is simply not enough activity to justify separate facilities in each country. Also, cost pressures will force market participants to make decisions to support markets that will provide the best return.

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Asian markets will feel the most impact from the Financial Stability Board's (FSB) recommendation that all OTC standardised derivative products are cleared centrally. Mandatory central clearing of OTC derivatives is a discussion that is well advanced around the globe. Asian regulators have participated in this discussion yet still find themselves with complex decisions that must take into account domestic interests, market realities and global demands. It is not a question of whether a policy is put in place but rather how it is constructed so that it satisfies the global mandate without adversely affecting the current dynamics of the domestic markets. Many exchanges in Asia are considered "national treasures" and operate as quasi government entities, which means that sovereignty issues may outweigh some of the practical consequences of disparate regulatory policy across Asia such as increased costs and fragmentation of liquidity.

The industry continues to recommend that the most effective and efficient way to reduce systemic risk would be for local market financial institutions to clear through a global, well-capitalised and maintained central counterparty (CCP). At this stage, it is unclear how the majority of countries in Asia will position their policy, however, it appears that many are adopting a "domestic market" model whereby a local independent CCP is established with no offshore interoperability. Supporters of this model cite financial stability concerns and access issues for local participants as reasons for requiring clearing through a domestic CCP.

The more "mature" financial markets in Asia – Australia, Hong Kong, Japan and Singapore – have all come out with a preliminary stance on how they will construct their policy to meet the G20 objectives. Unfortunately, discrepancies in policy stance are already evident.

Both Hong Kong and Japan have outlined their intention to establish their own clearinghouse. The Hong Kong Exchanges and Clearing Limited (HKEx) is establishing a new clearinghouse that will serve as a CCP for the Hong Kong market. In its consultation paper, issued in October 2011, it proposed to phase in the introduction of mandatory clearing starting with interest rate swaps (IRS) and non-deliverable forwards (NDF).

In Japan, the Japan Securities Clearing Corporation (JSCC) began clearing Markit iTraxx Japan credit default swap contracts in July 2011 and is expected to begin clearing IRS soon. According to information released in the

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Financial Instruments and Exchange Act (FIEA), stability concerns are stated to be key influence in its decision regarding which products will require mandatory clearing, however, the exact products will not be revealed until the end of the year. For products that do not require mandatory clearing in Japan, trades can be cleared through a foreign CCP provided it is recognised by JFSA, the Japanese regulator and an interoperability arrangement exists between the foreign CCP and a domestically authorised CCP.

The Monetary Authority of Singapore revealed an even wider policy stance in its recently released consultation paper. It believes that supervisory co-operation and co-ordination can address financial stability concerns and therefore it will not limit central clearing to domestic CCPs. It will create a recognition framework for foreign CCPs thereby introducing a "choice model" for market participants. Similar to Hong Kong, it will take a prudent approach and phase in the clearing obligation, and will most likely start with IRS and NDFs in selected currencies. It is worth noting that the Singapore Stock Exchange already has a well-functioning CCP.

In July 2011, the Australian Council of Financial Regulators issued a discussion paper but no official stance has been made public since then. It will be interesting to see how the Australian position evolves given they rejected the SGX/ASX combination on the grounds of "national interest" and the absence of a local clearinghouse.

South Korea, China and India seem to be leaning towards domestic models starting with mandatory clearing of IRS.

The proliferation of multiple CCPs across Asia poses many concerns for regulators, exchanges and market participants. Multiple domestic CCPs within the region could limit choice for market participants, lead to fragmentation of liquidity, reduce netting benefits and increase costs for institutions currently clearing through foreign CCPs. A poorly run CCP could introduce more systemic risk – exactly the opposite of the intended outcome.

Asia is already a region made up of many market silos, which complicates trading. By introducing further fragmentation, overall derivative activity could be impacted. Global participants may decide to be more selective in the markets they trade and limit their CCP membership. Local participants may be restricted to trading with certain counterparts due to their inability to access foreign CCPs, which could curb local market trading activity. Differing eligible collateral requirements among Asian CCPs may have the unintended consequence of increasing the amount of collateral market participants must post, thus inflicting significant liquidity constraints and funding costs on them. All these issues may lead to market participants deciding to "opt out" of certain markets, which will ultimately impact trading volumes and profits and reduce the global relevance of smaller exchanges.

Diverse models also introduce potential legal, regulatory and financial arbitrage concerns. As CCPs compete to provide clearing services, market participants with cross-border trading activities may take advantage of clearing through CCPs that are less strictly governed or have more relaxed capital and margin requirements. Inconsistent risk management frameworks may eventually pose greater risks to the market.

Co-operation among regulators will be essential for success. There are still some questions that must be answered. Are the regulators equipped to handle the increased regulatory responsibility? What will mutual co-operation look like in practice?

There is no doubt that the proposed regulations within the region will take on many shapes before the end of year deadline. There is no perfect answer for any market in Asia and regulators will need to consider a multitude of factors to ensure they do not curtail growth by implementing policies that are too expensive.

Clearly, a more open regulatory policy in each market and a more uniform approach among Asian regulators will benefit the whole of Asia. However, other factors such as capital market development, market access, current exchange infrastructure and general liquidity are important components that will help define the overall winners and losers of this game-changing global mandate. ■

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Career in brief

Donna Bales is a product development and business professional with a proven track record of managing complex capital market industry initiatives during times of significant market change and market structure reform.

Bales is the founder and managing director of Balmoral Advisory, a Singapore-based consultancy providing comprehensive market research intelligence and advice on "go to market strategy" to businesses that are expanding their presence in Asia.

In addition, she acts as a strategy advisor to an international communications firm, College Hill Asia. Bales holds a Bachelor's degree in Economics from the University of Western Ontario.