The future of trade repositories: opportunities, challenges and the pursuit of global market transparency

by Michael Bodson, The Depository Trust & Clearing Corp. (DTCC)

When representatives from the G-20 met in the aftermath of the 2008 financial crisis, they set an ambitious goal to bring greater stability and transparency to the previously opaque over-the-counter (OTC) derivatives market. While policymakers and industry participants have made a great deal of progress in recent years to deliver on this promise, in particular by mandating the reporting of transactions to trade repositories, many challenges remain to securing the level of transparency and risk mitigation necessary to protect the integrity of the financial system and re-establish public trust in financial institutions and markets.

A combination of ongoing legal and market issues, including the lack of a harmonised set of global rules and the extraterritorial application of new regulations, has the potential to undermine the G-20 vision of creating a global view of financial risks. As we approach the five-year anniversary of the start of financial crisis, policymakers and industry participants need to increase their collaboration in order to allow trade repositories to reach their full potential – as well as to create new opportunities to leverage them to enhance the transparency of a wider spectrum of financial markets and products in the future, including repos, cash instruments and collateral.

Global data key to risk mitigation

Trade repositories are arguably among the most significant risk management innovations to emerge from the financial crisis of 2008. New rules in most major jurisdictions require trade reporting to repositories because this data provides critical insights into market exposures and

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The Depository Trust & Clearing Corp. (DTCC) potentially dangerous market activity that could lead to financial instability.

Trade repositories emerged as a key tool of systemic risk management in the wake of the Lehman Brothers' bankruptcy in 2008. At the height of the crisis, as panic swept across global markets, DTCC publicly released data from its trade repository, which held the vast majority of the global inventory of CDS trades, to calm fears over concerns about exposure to Lehman. This experience reinforced two key points: (i) regulators need timely access to comprehensive, detailed, accurate data on global OTC derivatives activity so they can identify and monitor risk exposures and respond quickly during times of crisis; and, (ii) the underlying data held in the repository must be accurate and global in order to bring full transparency to the market.

Barriers to OTC market transparency

However, multiple threats exist today that could undermine the availability of a centralised, global data set in the future. Foremost among these are:

- the continued presence of divergent national/regional regulations;
- unresolved legal issues, including the extraterritorial reach of certain provisions of the Dodd-Frank Act;
- the existence of local privacy and confidentiality laws, which could limit the reporting of some derivatives data or hinder international data sharing; and
- the likely fragmentation of data across multiple trade repositories.

For example, there are as many as 18 trade repositories in various stages of development globally at this time, and more are likely to come online in the near future. These repositories are predominately regional or national in scope, which means they will hold only a small percentage of the trades in the massive OTC derivatives marketplace. As such, these repositories will be unable to provide the level of market transparency that policymakers need to effectively monitor and mitigate systemic risk. Only a global repository that aggregates data and offers the appropriate safeguards to prevent duplication, omission and other data errors can ensure the highest degree of clarity and insight into the market. Based on current conditions, it appears likely that the OTC derivatives market will be less transparent in the future than it is today.

Regulatory harmonisation

While there is a strong spirit of partnership and collaboration among regulators to harmonise rules to resolve these challenges, policymakers remain at an impasse when it comes to creating global regulatory solutions. In the case of trade repositories, despite near-universal agreement on their importance in identifying global systemic risk, we are seeing both within markets and across markets a lack of coordination and standardisation.

For example, only two jurisdictions, the US and Japan, require trade reporting at this time. While the Commodity Futures Trading Commission's rules call for only one side of the trade to report with a unique swap identifier, the Japan Financial Services Agency mandates that both sides report but without a unique identifier to match the trade. As a result, this lack of standardisation of data and process is making aggregation of the two data sets very difficult. Furthermore, many other issues exist that will further hinder the ability to aggregate data in the future, all of which will diminish the power of trade repositories to provide transparency into market activity.

Despite the good faith efforts of all stakeholders, national and regional rules continue to dominate the regulatory landscape, and efforts to forge consensus around a set of principle-based rules that nations can adopt through equivalence and mutual recognition have not yet yielded the desired result. Organisations such as the G-20, the Bank for International Settlements, the Financial Stability Board and CPSS-IOSCO have played an important role in formulating global recommendations, but because these principles are not mandated they are frequently subject to jurisdictional interpretation in terms of both content and timing of implementation.

Differing legal and tax systems, maturities and sophistication levels of financial markets and products are among the basic causes that are driving regional and national standards versus global ones. This has prompted some in the industry to question whether the time has come to empower an international standard-setting body like IOSCO to write, implement and enforce regulations globally – as well as to empower it with the same binding arbitration authority as the World Trade Organization to address differences of opinion efficiently while still protecting each country's sovereignty. While the reality is that this approach may be overly simplistic, the fact that it is being spoken about reflects the growing concern among stakeholders that financial reform may be veering off course at a critical juncture.

Derivatives and beyond

These challenges are all the more pressing because trade repositories hold enormous potential to boost transparency in other financial markets. In fact, increasing transparency of the entire global financial system represents the holy grail of financial reform.

As financial markets continue to evolve and innovate, especially in response to new rules, we are witnessing a host of unintended consequences as well as the creation of increasingly complex systems and financial products with little to no transparency. Today, for example, new regulations are driving demand for more liquid assets, making efficient collateral management crucial to prevent a potential future liquidity crisis. Repositories offer a solution because they hold detailed collateral information, which can give regulators a deeper understanding of systemic liquidity risk, particularly during times of extreme market stress.

Similarly, amidst ongoing efforts to improve oversight of the shadow banking sector, European supervisors are considering the creation of a repository for the repo market – recognising that such a database could provide a window into repo rates and volumes in near real-time and could serve as an invaluable resource to central banks, market participants and industry supervisors. Trade repositories that serve these markets would bring the industry one step closer to global financial transparency.

The advent of trade repositories marked a turning point in systemic risk management in the OTC derivatives markets, but the legacy of repositaries does not need to be limited. If the regulatory and financial communities can collaborate to address the primary challenges confronting the trade reporting landscape today, these infrastructures will have a promising future in bringing an unprecedented degree of transparency to the global financial system.

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