Defining Derivatives Eligible for Ringfenced Banks

Key Considerations

Context

The OECD Secretariat is increasingly active in international discussions on the reform of banks’ business models and the design of financial regulation. Specifically, we note that the G20 Leaders’ Statement in St. Petersburg in September 2013 encouraged the OECD to work with the Financial Stability Board (FSB) in this area.

This BIAC paper examines one important aspect of approaches for ringfencing – mainly how to define derivatives eligible for ringfenced banks – and highlights the possible consequences entailed in such approaches. In particular these considerations focus on defining derivatives, which is proving unsurprisingly challenging in several jurisdictions. We underline the need for a holistic approach with due emphasis on regulatory consistency across jurisdictions.

Ringfencing and the focus on derivatives

BIAC supports appropriate regulatory measures conducive to stability, economic growth and investment. We note that regulators in a number of jurisdictions are working to structurally separate banks, alongside many other regulatory measures, with the objective of avoiding a repeat of the 2008 global financial crisis. The roots of the 2008 global financial crisis were complex, and without challenging any specific regulatory measure, we believe that greater analysis and impact assessment is required generally to improve understanding about where the actual problems lie and, importantly, what would be the most effective solutions for addressing them.

In this context, we encourage OECD policymakers to bear the following in mind:

- Derivatives are tools – their impact depends on how they are used, rather than on the characteristics/structure of the derivative itself. Used improperly, they can fuel instability. However, when used properly, derivatives provide a useful means to hedge positions, thereby contributing to greater stability in the financial system by redistributing risks.

- Examine not simply the types of derivatives, but rather the business models of the financial institutions using such derivatives. Much attention is currently being placed on the definition of derivatives¹ used by a particular financial institution in order to determine whether or not that institution should be structurally separated from the

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¹ For example, one directional vs. multi-directional or with vs. without optionality, etc.
ring-fenced entity. We are concerned that this is an overly-simplistic approach which most importantly ignores the business model and balance sheet of the particular financial institution. Two financial institutions could have access to the very same derivatives products and yet, due to differences between their respective business models, present very different risk profiles. Furthermore, an institution using more complex derivatives may well use it for hedging purposes and have a lower risk profile of a second institution using “simple” derivatives for speculative purposes. It should be remembered that the original intention of ringfencing was to separate those financial institutions that use derivative products to support their clients and/or better manage their portfolios, from other institutions that use derivatives for speculative (and prop trading) purposes.

- **Consider the impacts of liquidity and valuation.** In addition to credit and market risk of a bank’s portfolio risk profile, it is critical to also consider impacts of the derivatives’ liquidity and valuation, whose inaccuracies (or only apparent accuracies) showed their severe impacts in the last financial crisis.²

Notwithstanding BIAC concerns regarding the effectiveness of ringfencing in the first place³, any regulatory approaches towards ringfencing should focus on the business models of financial institutions and the capabilities of those institutions in measuring and managing risks, rather than solely overly-simplistic definitions of derivatives. Close consultation with the financial industry, as well as the broader business community users of financial services, should be actively encouraged in order to take into account specific needs of different actors.

### The possible unintended consequences of current regulatory approaches for ringfencing

While intended to bolster financial stability, the implementation of ringfencing, particularly if based on far-reaching, inflexible and prescriptive parameters, could lead to numerous side-effects that should be taken into careful consideration. Specifically, we wish to highlight the following possible consequences:

- **Costs to SMEs.** SMEs use derivatives to hedge their underlying positions most often relating to their funding sources or raw materials, hence needing to hedge against foreign exchange rates, interest rates, inflation or market fluctuations of the raw materials or energy requirements at the base of their manufacturing processes. However, if an SME’s bank becomes ringfenced and can no longer offer those hedging products, the SME can either no longer hedge its positions at all, or can only do so by using other (non-ringfenced) financial institutions. In the case of the former, the SME may already face increased cost for credit (as the SME’s newly-ringfenced bank needs to generate returns for the same credit risks from a more limited number of products

² Derivative products, as simple they can be, if not aligned to other underlying exposures in the portfolio of the bank, may be the cause of liquidity shortcomings (e.g. an exponential increase in margin calls during a market crisis), similarly if such positions are not valued correctly.
³ BIAC (2014) “Structural Reform of Banks’ Business Models”.

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| 2 | Page |
than before). Meanwhile, the latter case would likely be costly from the SME’s perspective, as its business would represent generally low return for the financial institution and with higher risks, hence not attractive unless charging fees. A reduction in financing options for SMEs is an outcome that should be avoided.

- **Increased systemic risks.** Central to the ringfencing argument is that trading activities should not put depositors at risk and threaten the traditional savings/lending model. Unfortunately, by determining ringfencing solely on the basis of artificial definitions of products and counterparties, rather than considering the risk and liquidity profiles of financial institutions, this core argument may not be properly addressed. It is possible, for instance, that derivative products which are classified as complex can be decomposed into simpler derivatives that meet definitional requirements. This may lead to a ringfenced bank that “appears” to have only simple derivatives, but in reality their combination could be far riskier than a non-ringfenced institution.

- **Regulatory fragmentation.** Opportunities for regulatory arbitrage may grow if different jurisdictions apply different definitions to derivatives products when implementing their respective ringfencing approaches. Greater international consistency should be encouraged.

- **Cumulative side-effects.** The cumulative impacts of the various regulatory measures being introduced at the same time since the 2008-09 global financial and economic crisis, which diverge from or gold-plate the internationally agreed regulatory programme, could significantly damage economic growth. Comprehensive analysis at the global level of the cumulative impacts of different regulatory approaches is needed.

### Directions for more co-ordinated financial regulation

BIAC calls for any regulations to be clear, designed in co-operation with the private sector, and harmoniously implemented for a genuinely level playing field. We strongly recommend the OECD Secretariat and national governments to take the considerations expressed in this paper into account. More generally, there needs to be greater balance between financial stability, economic growth, and investment, as highlighted in the BIAC paper “The case for a more co-ordinated approach to financial regulation” (March 2014).

While BIAC expresses a number of reservations about the structural reform of banks’ business models⁴, we understand that some jurisdictions are proceeding to implement ringfencing regulations. Where this is happening, BIAC underlines that a risk-based approach should lie at the core of such efforts – and not simply arbitrary product definitions.

Risk-based approaches that the OECD may wish to consider in order to frame initial discussions with industry could, for example, include:⁵

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⁵ These two examples do not constitute an exhaustive list of approaches and nor do they represent BIAC positions; rather, they are proposed simply in order to spur discussions and progress in this area.
• **Example 1:** Following the suggestion of the OECD Secretariat\(^6\), if the proportion of a financial institution’s derivatives exposures (regardless of clients) is above a certain percentage threshold of total assets, it may imply that the institution is using derivatives for purposes beyond the needs of their retail clients – i.e. instead using derivatives for speculative (and prop trading) purposes. This may justify the need for a ringfenced entity with a percentage of derivatives lower that the set threshold. While such an approach would require further discussion and analysis, its advantage is that it reflects to some extent the business model of the financial institution and its actual use of derivatives. Furthermore, it could be relatively easy for regulators to monitor such a threshold.

• **Example 2:** The derivative definition currently under discussion in a number of jurisdictions should focus on the market ability to price and trade the product. If the product is properly marked-to-market, rather than marked-to-model, or has a closed formula, then it is a known value and has market liquidity. While again this approach would require further discussion and analysis, its advantage is that it looks at the ability to value and hence monitor the risk and liquidity profile of the resulting portfolio, and of the financial institution as a whole.

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