

POSITION PAPER



ESBG Response to European Commission Public Consultation on Derivatives and Market Infrastructure

9 July 2010



Introduction

ESBG is pleased to be given the opportunity to respond to the European Commission's consultation on Derivatives and Market Infrastructure. ESBG Members – savings and mostly retail banks across the EU - frequently perform the role of intermediaries for the investment community even though they usually are not major counterparties in the derivatives market.

I. Clearing and risk mitigation of OTC derivatives

Questions:

What are stakeholders' views on the clearing obligation, the process to determine the eligibility of OTC derivative contracts for mandatory clearing, and its application? Do stakeholders agree that access from trading venues to CCPs clearing eligible contracts should be guaranteed?

In principle, it is in the interest of investors to move towards on-exchange trading and standardised products which costs are approximately eight times lower than OTC trading. As OTC derivatives are created by an agreement between two individual counterparties they can cover a range of products from highly standardized (so-called “exchange look-alike”) to tailor-made contracts with individualized terms regarding underlying, contract size, maturity and other features. Most of these contracts are held to maturity by the original counterparties, but some are altered during their life or offset before termination.

The number of types of OTC-traded derivatives is unlimited in principle as they are customized and new contracts are created continuously. A broad universe of exchange-traded derivatives exists as well: for example, over 1,700 different derivatives are listed on the three major global derivatives exchanges. Whilst the OTC segment accounts for almost 84 percent of the market with around €383 trillion of notional amount outstanding, BIS statistics and working papers show that since 2007, however, the exchange segment has grown faster than the OTC segment. This is widely perceived to be a result of the increasing standardization of derivatives contracts which facilitates exchange trading, and increasing risk aversion amongst investors. Other contributing factors are a number of advantages of on-exchange trading: of which price transparency, risk mitigation and transaction costs are among the most important. As a result, standardisation in the market is an ongoing and consequential process driven by the anticipated cycles of the innovation curve, and that any infrastructure put in place must seek only to manage this flow from OTC to on-exchange.

ESBG therefore proposes a third approach (as opposed to bottom-up or top-down) and that is the *community standardisation management* approach. In this way, a body of stakeholders would be brought together as a council to create an approach to pan-European management of the transition of OTC products to standardised products for on-exchange trading. This ‘Derivatives Migration Council’ or DMC would assess and evaluate the suitability of exchange-look-alike products in the OTC environment for migration to the on-exchange environment and deliver the recommendation to ESMA and the European Systemic Risk Board as the regulatory bodies for this sector. The regulators would ratify the recommendation of the DMC before the DMC worked to facilitate the migration in a structured way to all exchanges active in Europe. The DMC would be an established not-for-profit international association funded purely by stakeholders in an appropriately fair manner.

This community-led approach would ensure greater involvement of stakeholders and allow in-market recognition of products for standardisation. The regulator would be able to request specific products for transition inspection by the DMC and also back the transition of agreed products with appropriate legislative support. Due to the constant innovation in the OTC market, it would be impossible to set percentage targets for standardisation, but the general principles for ongoing migration of OTC products to on-exchange would be part of the charter of the DMC. Furthermore ESBG suggests a staggering of the transition to clearing of newly standardised products, prioritising heavy users first. This will prevent operational difficulties where a large number of financial counterparties try to sign up all at once, which potentially neither the CCP nor the general clearing members will have the operational capacity to deal with. If market participants are forced to react to new rules in too short a timeframe, suboptimal outcomes are probable. One possible solution could be for the DMC to ask for details of volume by counterparty from the major market players and then schedule clearing adoption, on a counterparty by counterparty basis, based on that data.

While this approach outlines a general principle of market-driven OTC to on-exchange standardisation, it should be emphasized that this must not be at the expense of OTC innovation, but as management of a complementary continuing process of industrialisation of innovation.

ESBG agrees that this increased management of standardisation of products should be accompanied by the suggested legal principle of access to a CCP for all market participants.

Question:

Do stakeholders share the general approach set out above on the application of the clearing obligation to non-financial counterparties that meet certain thresholds?

Given the *community standardisation management* approach outlined earlier, support for the application of the clearing obligation to non-financial counterparties would be subject to the outlining of thresholds proposed by the DMC and ratified by the regulators. The DMC would retain responsibility for ensuring that thresholds remain in tune with the fluctuating market on a medium term basis and of regularly appraising the regulators of intended changes.

Question:

Do stakeholders share the principle and requirements set out above on the risk mitigation techniques for bilateral OTC derivative contracts?

The overwhelming majority of counterparties in OTC trades already have in place robust, resilient and auditable processes to monitor the value of outstanding contracts, to reconcile portfolios and to manage the associated risk. This definition of position tracking or management is already well established and is core to any successful business operating in the OTC derivatives market. However, due to the innovative and competitive nature of the market, there is currently no common approach to position tracking. One of the tasks of the DMC would be to evaluate and provide the industry with best practise, and potentially methods, for ensuring efficient position tracking. The DMC could also be tasked by the regulator to investigate the area of contract exchange and create industry solutions to standardise electronic methods of contract content confirmation through a contract management scheme. In line with other initiatives on the exchange of information between counterparties, this type of scheme would be developed using international standards to make it relevant to the global nature of derivatives trading.

Any attempts to standardise contract content confirmation through a unified system should be industry driven due to the global nature of the derivatives market. Creating a purely European solution could lead to a two-tier system and irrevocably damage Europe's position in the derivatives business. As derivatives trading currently accounts for 0.4% of European GDP, this would be counter-productive to growth initiatives in the EU.

II. Requirements for Central Counterparties

Questions:

Do stakeholders share the general approach set out above on organisational requirements for CCPs? In particular comments are sought on the role and function of the Risk Committee; whether the governance arrangements and the specific requirements are sufficient to prevent and manage potential conflicts of interest; stringent outsourcing requirements; and participation and transparency requirements?

Do stakeholders consider that possible conflicts of interests would justify specific rules on the ownership of CCPs? If so, which kind of rules?

ESBG broadly supports the requirements for CCPs as laid out, although it would be an appropriate further task of the DMC to manage processes such as harmonising the public disclosure of prices and fees, and the criteria for counterparties wishing to access the services of CCPs. It should be noted that while it is seen as a positive step to regulate, no major European clearing house has ever come close to being in financial difficulty. Therefore any steps taken must ensure that CCPs remain competitive within the global market and that their cost-base is not greatly impacted by the requirements. ESBG proposes that CCPs are mandated to hold a specific banking license, similar to Payment Institutions as defined by the Payment Services Directive, that would facilitate scrutiny from existing national regulators.

In the derivatives market, transparency on market and counterparty risks and price discovery, as well as safety could be improved by offering incentives such as capital relief to players in the OTC segment for disclosing prices and using CCPs. Agreeing and adhering to common CCP standards internationally would make the safety and reliability of CCPs more comparable and understandable, and ensure that risk standards do not become a parameter of competition between CCPs, which might erode the level of security they offer. It is in this area that a common initiative harmonised by the DMC and in conjunction with the regulator could be most impactful. The economic benefits of further eliminating unwanted risks, however, could be offset by significantly higher costs for eliminating these risks and should hence be analyzed in detail.

Questions:

Do stakeholders share the approach set out above on segregation and portability?

As a general principle, the ability of a counterparty to select and change CCP is conducive to a competitive market and could enhance the business case for standardisation of products. However, while enshrining the principles in legislation, this should be a market-led initiative as the major requirements for portability would be standardisation of portfolio reporting and the channels for transfer of assets and positions from one CCP to another. The aforementioned DMC would be the ideal body for managing this standardisation effort, and potentially managing the transfer scheme to ensure portability is achieved in an appropriate manner.

Questions:

Do stakeholders share the general approach set out above on prudential requirements for CCPs? In particular: what should be the adequate level of initial capital? Are exposures of CCPs appropriately measured and managed? Should the default fund be mandatory and what risks should it cover? Should the rank of the different lines of defence of a CCP be specified? Will the collateral requirements and investment policy ensure that CCPs will not be exposed to external risks? Will the provisions ensure the correct management of a default situation? Are the provisions above sufficient to ensure access to central bank liquidity without compromising central banks' independence?

While in general ESBG agrees with the suggested prudential requirements for CCPs, a number of points should be highlighted:

- Whereas the principle of Initial Capital should be part of the legislation, the absolute value of capital should not be enshrined. As in other financial services legislation, such as Article 6 of the Payment Services Directive 2007/64/EC, the method for calculating initial capital requirements should be documented. This should ideally be based on a formula agreed with stakeholders and representing recognition of their cost base so as not to increase the burden on their clearing members significantly.
- The principle of margin requirements is already part of the business of CCPs and covering of exposure is intrinsic in their nature. Their ability to remain flexible and to compete on margin is part of the long-term trend of migration from OTC to on-exchange trading and consequently regulating precise values of margin would implicitly impact the desire to increase standardisation. Applying general rules to the calculation of margin may be beneficial and enshrining principles that margins should be sufficient to cover outstanding risk beyond capital are welcomed, but could only be applied should initial capital requirements remain flexible as suggested.
- The creation of a default fund is a flawed idea and contrary to the ongoing importance of Europe in the derivatives market. As CCPs have always maintained strong risk profiles on clearing members and ensured that risk is either mitigated or hedged, the additional costs to those using the services of European CCPs may make them uncompetitive and damage the prominence of the European derivatives market.
- As a consequence of the previous two points, it is clear that the fund elements of the default waterfall requirements should not be included, although the principle of non-use of margins from non-defaulting members is strongly backed.
- An additional role for the DMC could be in the devising and standardisation of models for margin requirements, collateral requirements and other risk control mechanisms. Standardisation of stress testing and back testing of models would allow direct comparison of risk control that is important for clearing members and regulators alike.

Questions:

Do stakeholders share the general approach set out above on the recognition of third country CCPs? Are the suggested criteria sufficient? Do stakeholders consider that additional criteria should be considered?

Do stakeholders agree with the extension of the clearing obligation to contracts cleared by third country CCPs to ensure global consistency?

It is imperative that in a global market such as derivatives, where European players are already considerable within the market and the impact on European GDP is significant, steps are not taken that create a 'Fortress Europe' and prohibit the ability for European Corporates and Investors to obtain appropriate risk protection and follow innovative investment

strategies. However the risks of facilitating regulatory arbitrage are also recognised and the value of creating a list of well regulated non-EU CCPs is high. However, this list should not become a trading limitation in the derivatives market and should simply play a (significant) part of the risk assessment of participants.

It should be a significant aim of the body creating common CCP standards within the European market to harmonise these with international efforts. As concluded by BIS, agreeing and adhering to common CCP standards internationally would make the safety and reliability of CCPs more comparable and understandable, and ensure that risk standards do not become a parameter of competition between CCPs, which might erode the level of security they offer.

III. Interoperability

Question:

Stakeholders' views are welcomed on the general approach set out above on interoperability and the principles and requirements on managing risks and approval.

In general ESBG is supportive of the general approach on interoperability and the principles outlined. However, an important part of the process needs to be the approval of any interoperability agreement by the clearing members of the CCPs, following the appropriate risk assessment and collateralisation research. As the clearing members will inevitably bear the cost of any increased risk due to the interoperability agreement, invariably to satisfy the needs of a single or small segment of clearing members initially, they must be able to decide as a unit to accept or reject the proposal. Given the obligation on CCPs outlined in section II to create a Risk Committee, it should be a further task of the committee to manage the process to obtain agreement from members based on a thorough risk assessment and details of financial impact for each clearing member. CCPs should be given the opportunity to offer partial interoperability, being only for a specific class(es) of derivatives.

In order to support the principle of interoperability between all entities in the market, it would be a pertinent task for the DMC to lead development of a standardised data format for transmission of data between counterparties, CCPs and Trade Repositories. In this way, the financial impact of further interoperability beyond the first implementation would be considerably reduced. This should also include a clear legal basis for the transfer of data from the market participants to the trade repositories and CCPs as well comprehensive rules governing the access to such data received and retained by TRs and CCPs and the protection of personal data and business secrets in this context.

IV. Reporting obligation and requirements for trade repositories

Questions:

What are stakeholders' preferred options on the reporting obligation and on how to ensure regulators' access to information with trade repositories? Please explain.

The OTC segment uses automated processing solutions primarily for standard products. Newly introduced, exotic, less liquid or complex OTC derivatives are usually handled manually, with resulting delays and risks of errors. By December 2007, only 20 percent of OTC equity derivatives were processed electronically compared to about 44 percent of OTC interest rate derivatives and 91 percent of credit derivatives. Operational risk events do occur more often in the OTC segment but they have not resulted in the complete failure of players

with the exception of outright fraud. Consequently the reporting obligation for these standard products “exchange-look-alike” products would be easy to manage and effective, and indeed could be part of the process of migrating products from OTC to on-exchange. However, with non-standardised products being managed through paper-based contracts on the whole and with registered trade repositories invariably unable to record details of specific derivatives contracts in this part of the market, the impact of further regulating trade repositories on the overall systemic risk would be negligible.

Enshrining the ambition to migrate products from OTC to on-exchange is by far the best way to increase reporting of trades.

Questions:

Do stakeholders share the general approach set out above on the requirements for trade repositories? In particular, are the specific requirements on operational reliability, safeguarding and recording and transparency and data availability sufficient to ensure the adequate function of trade repositories and the adequate protection of the data recorded?

The principles outlined are conducive to the efficient operation of trade repositories and their ability to enhance the transparency of the derivatives market. However, again it should be noted that with the global nature of trade repositories, the imposition of cost elements on European businesses should be considered in any legislation to ensure that regulatory arbitrage does not become an issue in this sector.

V. Technical reference glossary of definitions

Questions:

Do stakeholders agree with the definitions set out above?

Within the terms of the answers given in this document, ESG largely agrees with the definitions as laid out. However, it should be noted that these definitions in place refer to bodies that may or may not have responsibility for certain actions in the future of this legislation and due care should be taken to ensure that the parties outlined in the definition match the legislation. In addition, the definitions for ‘competent authority’, ‘ESMA’ and ‘Regulator’ have been omitted from the list. These should be included in any future list of definitions in the forthcoming regulation.



About ESBG (European Savings Banks Group)

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of € 5967 billion (1 January 2008). It represents the interest of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG Members are typically savings and retail banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their region. ESBG Member banks have reinvested responsibly in their region for many decades and are one distinct benchmark for corporate social responsibility activities throughout Europe and the world.



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