European Commission Communication on "Ensuring efficient, safe and sound derivatives markets"

Response from the City of London

28 August 2009

Communication "Ensuring efficient, safe and sound derivatives markets"
Response from the City of London

The City of London welcomes the opportunity to submit the following high level comments in response to the consultation on derivatives markets - COM (2009) 332 final.

Summary

- OTC derivatives were not a key factor in the financial crisis
- Whilst they demonstrated considerable resilience at that time, we recognise that further improvements should continue to be made in market infrastructure in order to safeguard financial stability
- A "one size fits all" approach is not appropriate given the heterogeneity of OTC derivative products
- A globally coordinated regulatory approach is vital as the derivatives market is a global one
- Moves towards further standardisation where practicable is to be welcomed; not all products are capable of standardisation as they are bespoke transactions which can precisely hedge risk. Encouraging further standardisation may ultimately reduce risk management capabilities
- The relationship between OTC markets and exchanges should be viewed as symbiotic rather than competitive
- Encouragement for the use of CCP clearing for standardised OTC contracts for those trades that can be cleared is to be welcomed – this should however not be mandated but left to the discretion of the end user
- The Commission's recognition of the continuing need for bilateral customised transactions is to be welcomed
- The location of a European CCP should be decided on the basis of market preference

Introduction

1. London is one of three major international centres for trading financial derivatives, together with New York and Chicago. Our annual research report "The Importance of Wholesale Financial Services to the EU Economy 2009" due to be published shortly, indicates that the EU27 continues to dominate the world OTC derivatives market, accounting for 66% of the interest rate derivative market and 60% of the foreign exchange market in 2007. Within the EU London is the major OTC derivative trading centre, accounting for 39% and 44% of global trade in foreign exchange and interest rate derivatives markets respectively.[1]

2. As underlined in the Commission's own assessment, OTC derivatives were not a key factor in the financial crisis. Indeed the OTC markets demonstrated considerable resilience at that time. However we recognise that further improvements should continue to be made in market infrastructure, in order to safeguard financial stability.

[1] These values are based on data from BIS, Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in 2007, the most recent collection of country level data on OTC derivatives

3. We agree with the Commission that mitigating the systemic impacts of counterparty risk and enhancing the operational efficiency and transparency associated with OTC derivatives trading are important objectives. However given the heterogeneity of OTC derivative products and client types and needs we would oppose a "one size fits all" approach to clearing and trading through requirements that are unduly prescriptive and disproportionate. Not only is it important for firms to have flexibility in their choice of clearing and execution venues, it is also important for the health of the market as a whole that there should be efficient competition between various clearing and execution venues.

4. We emphasize that the development of OTC markets has made a significant contribution to global risk mitigation and to economic growth over the past 25 years. Therefore any future regulatory framework must ensure that this role is not undermined. A balance needs to be struck between greater standardisation (including the use of CCPs) and retaining a viable OTC derivatives market. The OTC markets are not primarily used for speculation. Indeed they fulfil an essential function for investing institutions.

5. The perception of the OTC markets as being "unregulated" is unfounded. In contrast to exchanges (which are mandated to regulate the content, behaviour and participation in specified products) the primary regulatory focus in OTC markets is on the participants themselves based on their activity, the nature of their counterparties and types of assets involved. OTC market activity itself is also subject to extensive codes of conduct set by regulators. Whilst recognising that change is inevitable and welcoming the objective of "ensuring efficient, safe and sound derivatives markets", it is vital to ensure that any new regulatory framework is based on a long-term approach.

6. As the derivatives market is a global one, we would urge the Commission to pursue a globally coordinated regulatory approach, particularly taking into account developments in the US. We would also urge that proportionality be a key element of this approach. In particular we welcome your acknowledgement that the foreign exchange derivatives market is large, well-established, mature and transparent. It performed without fault during the crisis. As the US Treasury has recently excluded foreign exchange derivatives from mandatory platform based trading, we would therefore also urge the Commission to recognise the specific characteristics of this market and to avoid potential regulatory arbitrage.

7. The relationship between the OTC markets and the exchanges should be viewed as symbiotic rather than competitive. Each fulfils a different set of requirements. OTC contracts by their bespoke nature are best placed for the purposes of precisely hedging risk.

Standardisation

8. Whilst we support, where practicable, moves towards further standardisation (through improvements in automation and contract documentation), it is important to bear in mind that not all products are capable of standardisation, being bespoke transactions. It should also be borne in mind that OTC markets have a natural tendency to evolve in the

direction desired by end users. If regulators push too hard for standardisation, the product development process for new products, common to the OTC market, may be severely damaged, to the detriment of eg bona fide hedgers in the commodities market.

9. Moves towards encouraging "standardisation" may also reduce the number of non-standardised contracts available and in so doing may ultimately reduce risk management capabilities rather than enhance them. End users (such as EU sovereign debt management agencies, corporates etc) may see a reduction in the effectiveness of their risk management procedures, if standardisation of contracts results in a reduction in their ability to tailor contracts to match their risk exposures. We would therefore urge the focus for standardisation to be placed on processes not contracts.

10. It would be a mistake to conclude that there is a direct or necessary correlation between the degree to which a contract is 'standardised' and the degree of risk that the contract presents. There will be an ongoing need for bespoke derivatives to allow financial and non-financial firms to hedge the specific risk exposures these firms face. Firms' risks are usually specific to their particular circumstances of their business (for example, the sectors and markets in which they are active, their geographical locations and corporate strategies). Since these risks are particular to the company in question, the derivative used to hedge that risk should be customised to address those specific risks. If the use of non-standardised derivatives to hedge risk was made prohibitively expensive through higher capital charges, firms' ability to manage their risks effectively would be severely compromised. It is unlikely in most cases that standardised derivatives available on exchanges or MTFs will be able to cover the totality and specificity of the risks that a firm faces. Attempts to manage idiosyncratic risks by using standardised derivatives will likely serve to increase risk precisely because such contracts are not tailor made to the specific risk exposures of a firm. In this regard, caution should be exercised to avoid raising systemic risk through regulatory responses that are not appropriately risk sensitive.

Central Data Repository

11. We support the use of a central data repository for most asset classes and increased market transparency to regulators. However we acknowledge that it may not be appropriate to have a repository for an asset class such as commodities, which already has a high level of regulatory reporting and where dealers occupy a very small share of the market.

12. Full disclosure of trades and positions to regulators is crucial to ensure they are adequately informed, however making granular trade information publicly available might undermine the ability of the market to execute large orders.

13. Furthermore many natural (hedging) participants in IRS, FX and commodity derivatives are corporations who are not regulated. Any increase in reporting requirements should be measured against the additional burden it would impose, which if disproportionate might drive participants out of the marketplace.

<u>CCP Clearing</u>

14. We support the Commission's encouragement of the use of CCP clearing for standardised OTC contracts for those trades that can be cleared, but this will need to be accompanied by an assessment and possible mitigation of the increase in concentration of risk. Moves towards increased central clearing must be implemented in ways which are beneficial to both banks/market makers and investors. However these moves should not be mandated but left to the discretion of the end user. Central clearing is a complex proposition and one that could significantly increase costs to end users. Furthermore different market participants will favour different CCP clearing models, depending on their activities/strategies and due regard should be taken of these preferences.

15. We welcome the Commission's recognition of the continuing need for bilateral customised transactions which by their nature are not suited for central clearing. Limiting the ability of market participants to customise their risk management strategies would be a backwards step.

16. The question of governance within a CCP is extremely important, in particular the extent to which the CCP's risk management processes may be vulnerable to inappropriate shareholder and stakeholder influence.

17. Moves from bilateral to CCP clearing will require many financial services firms to implement substantial systems and organisational changes once a CCP mechanism is proposed – we would therefore urge the Commission to provide an adequate consultation/transition period.

18. Access to CCP infrastructure should be granted on fair, reasonable and non-discriminatory terms. Furthermore we believe that the location of a European CCP should be decided on the basis of market preference.

<u>Trade execution</u>

19. We acknowledge the Commission's desire to encourage trading to move to transparent trading platforms but believe that institutional and corporate counterparties should retain the right to choose how their transactions can best be executed. There are many valid reasons why OTC markets trade separately from exchange markets, such as the ability to hedge specific risks, lower trading costs and increased flexibility.

20. Any attempt to force migration of an illiquid market onto an electronic exchange in order to increase transparency risks simply exposing the lack of liquidity and causing the market to dry up. Normal market forces provide the best assessment of when the benefits of exchange or other electronic trading outweigh the benefits of OTC trading, either cleared or bilateral.