European Commission's consultation on Derivatives and Market Infrastructures

Response from the International Regulatory Strategy Group

London, July 2010

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1. The International Regulatory Strategy Group (IRSG) wishes to respond to the Commission's Public Consultation on Derivatives and Market Infrastructures.

2. The IRSG is a practitioner-led body comprising leading UK-based figures from the financial and professional services industry. It aims to contribute to the shaping of the international regulatory regime, at global, regional, and national level, so that it promotes open, competitive and fair capital markets globally that support sustainable economic growth. Its role includes identifying strategic level issues where a cross sectoral position can add value to the existing industry views. It is an advisory body both to the City of London Corporation, and to TheCityUK, a new independent practitioner-led body which is being established to coordinate the promotion of the UK-based financial services industry.

3. We welcome this consultation and look forward to the release of the actual and full proposed text in order to analyse and understand the full implications. We are committed to being fully engaged at all stages of the drafting process.

4. The EU dominates 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.

5. We welcome the Commission's earlier acknowledgement that OTC derivatives were not a key factor in the financial crisis; however, we accept that improvements should continue to be made in market infrastructure in order to safeguard financial stability. At the same time the heterogeneity of OTC derivative products, client types and needs means that we would oppose a "one size fits all" approach to clearing and trading through requirements that are unduly prescriptive and disproportionate. The future regulatory framework must ensure a balance between greater legal and process standardisation (and the use of central counterparty clearing) and retaining a viable OTC derivatives market. Furthermore we stress the importance of pursuing a globally coordinated regulatory approach given the global nature of derivatives markets.

6. A particular example of an OTC market that requires a different response is foreign exchange (FX), currently assumed to be within scope of the Commission's proposals and therefore potentially subject to the clearing obligation. As recent cost benefit analysis by consultants Oliver Wyman has shown, any requirement to clear FX business is unlikely to deliver net cost benefits and may concentrate rather than disperse systemic risk. The global FX industry already manages settlement risk - the most important risk - via CLS. Given the recent outcome in the US, whereby most FX products will be exempted, we believe the Commission should adopt a similar approach. Otherwise

there is a danger that the FX industry will migrate from its centre in Europe to the US or to Asia, with a consequent loss of tax revenues and employment.

7. Although the Commission specifically excludes the matter of supervisory structures, we nevertheless take the opportunity to state our preference for supervision of CCPs to be conducted at national level, subject to standards agreed at the level of the ESFS and ensuring consistency. We believe it critical that CCP legislation includes provisions giving Competent Authorities responsibility and accountability for overseeing the process of obtaining interoperability.

8. We have the following specific comments to make on the issues covered in the consultation paper:

Clearing and risk mitigation of OTC derivatives

9. The right balance must be struck between imposing clearing requirements and ensuring reduction in systemic risk.
10. We are concerned that the top down approach will mean that pressure is put on CCPs to clear a product without due care being taken with risk mitigation.
11. We support the clearing exemption for corporates (non-financials). We would also support a de minimis threshold for financial firms. A clearing threshold should be set at such a level as to ensure that non financial counterparties are not unduly burdened with a requirement to clear contracts through a CCP, while ensuring that only end-users that pose a significant risk reach the thresholds and are subject to mandatory CCP clearing of the relevant contracts. In theory a threshold system could apply to both financial and non financial counterparties. Exception could also be granted to financial counterparties that take positions below what can be considered systemically relevant, considering the sum of the net positions.
12. We believe that mandatory 100% clearing requirement for trades that are subject to the clearing obligation would prevent institutions from managing risk positions on bilateral trades by using those products. It could reduce opportunities for bilateral netting between counterparties, potentially increasing bilateral risk.
13. Further clarity is required to determine how the combined top-down/bottom-up approach to determine derivative contracts that are subject to the clearing obligation would work in practice. We propose the following:
    - CCPs and their Risk Committees should have the final say on what is eligible for clearing (ie those contracts that <u>may</u> be cleared). There should be objective considerations and criteria for determining eligibility for products to be cleared. These should include: pricing methodology, liquidity, the CCP's capabilities, and the ability of members to support a default process – see for instance the appendix to the CPSS-IOSCO Consultative Report “Guidance on the application of the 2004 CPSS-IOSCO recommendations for central counterparties to OTC Derivatives CCPs – May 2010”.
    - Eligibility (in terms of the mandatory clearing obligation i.e. those contracts that <u>must</u> be cleared) should be based on clear objective systemic considerations and

incorporate the same criteria. This process should also allow for situations where a product no longer met the criteria (for instance where there is insufficient liquidity) so that the clearing obligation could be removed.

14. Overall there is a benefit in minimising the number of CCPs per asset class. A single global CCP would deliver maximum efficiency (in terms of netting, one CCP infrastructure to build to etc), but not necessarily maximum reduction of systemic risk as any such CCP would itself become systemically risky as a potential single point of failure. Also while CCP proliferation would be highly undesirable, a small number greater than 1 would be more likely to promote fair pricing of services. Whichever structure emerges, we stress the importance of the application of high standards to avoid a race to the bottom.

15. In the event of a member default a CCP has access to:

    1) Required margin balances (initial and variation)

    2) Default fund

    3) CCP capital

16. It is important to be clear that these are not interchangeable concepts – the default fund contribution and the CCP capital cover different risks. In particular, the use which the CCP may make of the default fund is limited by the CCP's rules. Generally, a CCP may only apply the default fund to reduce losses suffered by it due a clearing member's failure to pay, after the application of that clearing member's margin to the loss, first applying the contributions of the defaulting clearing member before applying those of the other clearing members. Thus, unlike the capital held by a bank, which may be used as a buffer to absorb all types of loss, the default fund of a CCP is limited to protecting the CCP against the risk that one of its members might default on its outstanding contracts, and may only be disposed of in strict accordance with the conditions provided for in the CCP's rules

17. There is a risk that conflating financial derivatives and commodity derivatives will result in regulations designed to deal with the effects of financial derivatives being applied to commodity derivatives. The failure to properly distinguish between the two could result in unintended damage to the commodity futures markets, which are based on physical delivery and thus price formation.

18. Given the use of derivatives to manage risk within cross border groups, it is important for transactions entered into for such purposes to be excluded/exempt from the clearing requirement. If they are to be excluded, they must not attract punitive capital treatment.

19. We are concerned at the reference in Section I 5(b) of the Consultation Paper which appears to indicate that collateral will be required in respect of all bilateral derivative contracts. Mandatory collateral requirements would in many circumstances make it uneconomic to enter into derivatives transactions thus potentially depriving financial institutions and their corporate clients of important risk mitigation techniques.

Requirements for CCPs

The consultation paper contains a number of proposals in this area with which we broadly agree, namely:

20. We generally support the use of CCPs, wherever that is the safe course to follow. However, since a CCP is likely to be systemically important, it should have standards of supervision, financial-resource requirements, liquidity requirements and disclosure standards commensurate with, or higher than, those of any bank undertaking the same activity.
21. The combined effects of the clearing obligation, commercial pressure on CCPs to launch clearing services for instruments that might become the subject of the clearing obligation, granting of interoperability rights (even though 'at present limited to cash instruments only)' to CCPs, and the current lack of global harmonisation of binding standards on CCPs' risk management standards could lead to an intensification of competition between CCPs. Standards to which CCPs must adhere must be robust. It is vital to ensure there is no 'race to the bottom'. It follows that there must be robust standards of governance generally and so as to prevent abuse in the likely event that natural monopolies arise amongst the CCPs, such as on a product basis.

22. Prudential standards for CCPs must address margin requirements (both initial and variation) and the default fund, as well as, capital requirements. The use of robust initial margin coupled with daily variation margin should be enough to deal with losses generated by the CCP. It is important that initial margin, as the first line of defence, is sufficient. Minimum margin requirements should be set and CCPs should not compete by lowering initial margin requirements which would put pressure on the default fund.
23. With regard to default procedures: CCPs must have a clear and robust process for managing member defaults. The procedures should provide for an insolvency of the CCP and set out an orderly process for its winding down. Forced allocation of positions to surviving clearing participants exposes them to potentially unlimited market risk and lead to additional defaults which would in turn increase systemic risks.
24. A default fund should be mandatory. To ensure the default fund element of a CCP's waterfall protection structure provides adequate protection against systemic risk, it is critical that an appropriate balance be struck between the default fund and margin, having regards to the needs of risk management but also the inherent conflicts to which a CCP is subject in this determination. Margin costs should be proportionate to the risks. See above regarding the need for minimum margin requirements.
25. Membership criteria should include minimum capital depending on products cleared. There should be a robust process for evaluating the credit quality of members.
26. There should be rigorous standards of transparency around: membership criteria, product approval, margin requirement (inc. how calculated), emergency powers, limits on liability of clearing members and governance framework
27. We would encourage a high level approach to be adopted vis à vis third country CCPs and data warehouses. Unless there is evidence of concerns, we would advocate a clear and sensible modus operandi being put in place to determine their use being approved.

However there are several areas where we disagree, namely:

28. We do not agree that a user owned model is somehow more risky. Users have more at stake as it is their money at risk (both as the user of the CCP and its shareholder) and therefore have an incentive for the CCP to engage in prudent risk management practices.
29. The Risk Committee should not include clients (although clients could be consulted) but only those who bear the default risk, i.e. clearing members. It should not be a requirement for the Risk Committee to include “independents” and should be a decision for the CCPs and their members.
30. We also wish to highlight the potential difficulties in ensuring that the principles of segregation and portability prevail over domestic laws and regulations. In the absence of a pan-European harmonised insolvency regime, substantive amendments to the national laws of Member States will be required to provide the requisite legal certainty. Choice of clearing model is a critical factor.
31. Regarding segregation, the legislation must deal explicitly with key investor requirements in central clearing, rather than leaving it to subsequent interpretation by regulators or by the market. This includes:
    - Specifying how asset segregation, down to omnibus and individual client level will be made available to any client and effective across the EU in the event of counterparty default. In similar fashion there must be regulations covering contract portability. This may also require adherence to best practice standards for default management within the CCPs, with full transparency for the auction process and published procedures for moving positions.
    - Definitively establishing within the EU how certainty of contract is to be achieved within the central clearing arena (dealing with the legal relationships between the executing member, clearing member, clearing house, investment manager, the manager’s client and the client’s custodian).

Interoperability

32. A business case needs to be presented when pursuing links. User demand should be part of that business case.
33. We agree that interoperability should at present be limited to cash instruments only. Any consideration of interoperability for derivative products should take into account the paramount need to be able to standardise all aspects of the product and processes sufficiently and the very great potential for additional systemic risk of a CCP failure bringing down the other CCPs. We believe that the proposed legislation must be capable of being extended to non cash instruments and that any regulation should not prevent or inhibit current interoperability arrangements on fixed income and derivatives that already exist, or their future expansion.

Reporting obligation and requirements for Trade Repositories

34. The paper does not address the difficulties caused by different banking secrecy and data protection standards. Trade repositories and financial institutions should not be in the position where in order to comply with transparency requirements they are in breach of local data laws.

35. Any legislation should not prevent the emergence of one trade repository per asset class. Regulators will benefit from access to a single source of data per asset class which will allow them to more easily assess systemic risk rather than the fragmentation of data across multiple repositories.

36. Standards of data confidentiality, as faced in relation to trade repositories, will apply equally to CCPs.

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